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MKT
TAXATION ADVISORS

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TAX DISPUTES – RULE NUMBER #1

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Section 170 Income Tax Assessment Act 1936 - Bai v Commissioner of Taxation [2015] FCA 973.

Introduction

We know that tax laws are extremely complicated, but many dealings with tax authorities are about the facts, not some complex tax interpretation question that needs High Court clarification. Unlike ordinary legal disputes, the Tax Commissioner does not have to prove his case – a notice of assessment is prima facie evidence that an assessment has been properly made.

Section 14ZZK of the Taxation Administration Act 1953 shifts the onus of proving their case to the taxpayer who "… has the burden of proving … that the assessment is excessive or otherwise incorrect and ***what the assessment should have been***"

As the cases noted below show, Tribunals and Courts consistently reinforce that taxpayers must show what the "true" assessment should have been in order to win a case against the Tax Commissioner.

Taxpayers must provide evidence which satisfactorily establishes their actual or true taxable incomes. There is no "off the rack" formula for how a taxpayer can prove what their "true" income is. It may be as simple as producing documents showing that a particular deposit represents the proceeds of the tax free sale of the family home (for example) or as complicated as reconstructing business records covering a number of years. As with most dealings with the Tax Commissioner credibility may be a factor in determining whether taxpayer submissions are likely to be accepted.

Taxpayers (and their advisers) who simply focus on the Commissioner's failings and are unwilling or unable to produce evidence showing that the Commissioner's assessments are excessive will not be doing themselves any favours.

Rule Number #1

Rule Number #1 for assisting clients in their dealings with the Commissioner is to remember that the taxpayer has the onus of proving on the balance of probabilities what their correct taxable income (and tax payable) is. Poking holes in the ATO numbers will not be enough.

Rigoli v Commissioner of Taxation [2015] FCA 803

The Full Federal Court decision in Rigoli (handed down on 15 March 2016) confirms the difficult task taxpayers (and their professional advisers) face in satisfying the burden of proof in disputes with the Tax Commissioner.

This decision was the second time the Full Federal Court had considered the matter. Mr Rigoli's disputes with the Tax Commissioner seem to have involved prosecution for tax fraud, default assessments for significant sums and two hearings before the AAT, a single judge of the Federal Court and the Full Federal Court.

For our purposes, the key question was whether Mr Rigoli had established his true taxable income.

The Commissioner's default assessments were supported by a report from an accounting expert setting out, as best he could, the financial position of a partnership during the relevant years.

Mr Rigoli's position seems to have been that because of an absence of proper record keeping and accounting he could not precisely establish his taxable income for the relevant years. He asked the Tribunal (and the Federal Court) to accept that the Commissioner's income figures did establish his assessable income, and that a deduction for depreciation should be allowed for an amount agreed with the Commissioner.

On the face of it the taxpayer's position seems reasonable. While it appears his records were a mess, Mr Rigoli would have used depreciable plant in deriving income and he engaged an expert to arrive at an estimate of what that depreciation would have been. Mr Rigoli submitted that if the Commissioner's expert determined that his income was $X in the relevant years then the correct taxable income would be determined by taking off deductible expenses, such as depreciation.

Rigoli Decision

Unfortunately for Mr Rigoli, the Full Federal Court took a different view. Leaving aside all of the other legal complexities that come with twice litigating tax issues through each of the AAT, the Federal Court and the Full Federal Court, the most recent decision in Rigoli was that:

1. The onus is on the taxpayer (Mr Rigoli) to establish his "true" or "correct" taxable income;
2. The expert accounting report obtained by the Commissioner was for the purposes of providing a reasonable basis for making default assessments under section 167 ITAA 1936;
3. The expert report was merely a best effort at determining the correct financial position of the relevant partnership and the taxpayer, and it "did not establish Mr Rigoli's taxable income"; and
4. Because the expert accounting report did not establish Mr Rigoli's actual income in the years in question, Mr Rigoli could not rely on the report to establish that his correct taxable income was the amount shown in the expert report LESS a deduction for depreciation.

Bai v Commissioner of Taxation [2015] FCA 973 & [2015] FCA 1083

These decisions deal with the onus of proof where the Commissioner claims an unlimited amendment period because he is of the opinion there has been fraud and evasion. There are other decisions relating to the same business entities which also address important onus of proof issues including Zhang v Commissioner of Taxation [2016] AATA 117 and Chang v Commissioner of Taxation [2013] AATA 611.

The Bai decision sets out the Tribunal's brief summary of the law relating to the taxpayer's burden of proof at paragraph 16, and then considers whether the tribunal applied the correct onus of proof test. The issue in this case is whether the taxpayer is required to show that there has been no fraud or evasion on the balance of probabilities or beyond a reasonable doubt.

Bai Decision

The conclusion of the Court was that by requiring the taxpayer to "exclude the possibility" of fraud or evasion the Tribunal had effectively applied "the criminal onus of proof beyond reasonable doubt" which is the wrong test and the matter should be reconsidered by the AAT.

These cases, and a long line of other decisions including PNGR and Anor v Commissioner of Taxation [2013] AATA 942 and Mulherin v FC of T 2013 ATC 20-1423, clearly show that the burden of proof imposed on taxpayers is a significant hurdle to establishing that less tax is owed than the Commissioner is claiming. It is not enough to merely point to errors in the Commissioner's calculations and taxpayers must satisfy the Tribunal or Court of their correct tax liability on the balance of probabilities.

How taxpayers go about doing this will of course depend on their own particular circumstances, including whether they are faced with default assessments, as well as the process the

Commissioner has used to arrive at any additional tax that is claimed (for example, asset betterment).

Where risks are recognized early enough in the audit process, it may be possible (and preferable) to satisfy tax auditors of the source of funds (for example) before any default or amended assessments are issued.

Tax Disputes - Rule Number #1

To the extent that issues in dispute cannot be resolved at the audit stage, taxpayers and their professional advisers must remember Tax Dispute - Rule Number # 1:

It is not enough to show the Commissioner's figures are wrong - taxpayers must produce persuasive evidence to establish, on the balance of probabilities, that their taxable income and tax payable is less than the amount claimed by the Commissioner.

Damian O'Connor, BA LLB (Hons) Solicitor and Chartered Tax Adviser is the Managing Principal of the specialist taxation law firm, Tax + Law. He has more than 40 years' experience in tax and commercial and family legal issues with a focus on managing tax disputes. Damian works with accountants and other law firms to help deliver the best tax outcomes for their clients. His experience includes 23 years with the Australian Taxation Office and as a tax partner of a national law firm.

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Building Superannuation balances post the Federal Budget

With the changes to contribution caps announced in the recent May Federal Budget, building large balances and getting a family SMSF involved in investment projects using contributions as the primary method has become significantly more difficult. Members with large asset bases outside their superannuation will no longer be able to contribute these assets into their funds using simple personal contributions.

However, there are still strategies that can be utilised to transfer wealth and assets into superannuation and pass them onto the next generation in a tax effective manner. The strategies will require more careful planning and may take longer to employ successfully than previously, but if timed correctly and with the right analysis clients can still achieve their goals.

For most clients with SMSF's who run a business their aim is usually to have the premises in which they run their business owned by their SMSF so they are able to get a deduction at the company or personal tax rate and pay tax on the income at the concessional superannuation rates. Where the business is to be carried on by children upon the parents' retirement, this becomes an even more valuable strategy. With the changes in contribution caps this will require some alternative strategies to get into the fund.

Some alternatives to consider include:

1. Using Reg 13.22C compliant Unit Trusts or Companies:

Using Unit Trusts is a great way to involve a superannuation fund with another related party to carry out a project or purchase property if the fund is unable to purchase the entire asset in its own right but the balance can be funded from assets outside the fund. The fund can, over time, acquire additional units from the related party increasing the exposure to the asset held by the Unit Trust. There are some rules that need to be carefully followed including:

I. The trustee of the unit trust cannot borrow;
II. The trustee of the unit trust cannot be a party to a lease with a related party (unless the asset is business real property);
III. The assets of the unit trust cannot include:
  a. An interest in another entity (for example, the unit trust cannot purchase shares in a company with its surplus funds)
  b. A loan to another entity, unless the loan is a deposit with an authorised deposit-taking institution (generally this means that it can have an Australian bank account only); and
IV. No asset can be acquired that has a charge over it.

Using the combined resources of the Superannuation Fund and a related party to purchase a commercial property to be used by the business is a great strategy to acquire a property that the fund would not be able to acquire in its own right. The Fund could then acquire additional units as it build up cash from concessional contributions to eventually own all the units and indirectly, the entire property.

2. Limited Recourse Borrowing Arrangements (LRBA):

LRBA's are another method an SMSF may utilise to acquire assets if contributions cannot be made to acquire the asset in full. Careful planning will be required to ensure the fund has sufficient liquid assets as well as a good income stream to allow it to take on a limited recourse borrowing arrangement to fund the acquisition will be important.

You will need to carefully consider the asset that you wish to transfer to ensure that it generates the types of cash flows required to meet the repayments on an LRBA. If the group has plenty of assets this borrowing my even be funded by a related party LRBA. However, bear in mind the ATO have released important information detailing interest rates, loan-to-value ratios ('LVRs') and other terms that constitute safe harbours for SMSF limited recourse borrowing arrangements

('LRBAs') so that arrangements will be taken to be consistent with an arm's length dealing (PCG 2016/5).

3. Making Contributions for children:

For funds where the assets of the fund are largely comprised of commercial property then the ability for the fund to meet its pension obligations especially as members get older may become very difficult. One strategy to combat this is to bring children (under or over 18 and especially if they are involved in the family affairs) into the superannuation fund and use their contributions to fund the pension requirements of the parents. This allows for the assets to remain in the fund indefinitely and the children to get the benefits of the assets already in a low tax environment.

The three methods above offer alternative methods to simply making contributions for members as a means to acquire property and other large assets by an SMSF. These alternatives may be used on their own or in combination with each other depending on the client's circumstances. Consideration needs to be given to the issues related to each of these strategies before they are employed and also important to consider CGT and Duty if the property to be acquired by the fund is currently owned by the members directly or another entity in the family group.

If you have any queries in relation to this, please contact Chris Schoeman.

REDUCED CORPORATE TAX RATE FOR SMALL BUSINESSES

For small business entities operating in a company structure, the reduced corporate tax rate of 28.5% will apply for the 2015-16 financial year. To be eligible for this, the company must be carrying on a business and have an aggregated turnover of less than $2 million in the 2014-15 or 2015-16 financial year.

The corporate tax rate will remain at 30% for all other companies that are not small business entities. This includes passive companies, such as corporate beneficiaries receiving trust distributions, and other companies with an aggregated turnover of $2 million or more.

The 2016-17 Federal Budget

The 2016-17 Federal Budget proposed to expand this concession in two ways. First, the current rate of 28.5% will be further reduced to 27.5% effective 1 July 2016. This is part of the Government's long-term plan to reduce the corporate rate to 25% for all corporate entities (regardless of their turnover) over a 10-year period. However, it is currently unclear how this will apply to companies not carrying on a business (e.g. corporate beneficiaries).

Second, the Budget also proposes to increase the small business entity threshold from $2 million to $10 million effective 1 July 2016. This is significant considering the current $2 million threshold has been in place since 1 July 2007 and is well overdue for an increase.

The proposed measures are expected to provide cash flow benefits to more small businesses. This also means that more small businesses will be eligible for the various small business concessions, including the immediate deductions for depreciating assets costing less than $20,000 (until 30 June 2017), business start-up costs, such as the professional fees and government charges, and prepaid expenses under the 12-month prepayment rules, among other things.

Unfortunately, the threshold increase will not apply to the Small Business CGT concessions. This means the current threshold of $2 million still applies. It is unclear whether the new Small Business Restructure Rollover as it is not specifically one of the Small CGT Concessions, however in our view, the new threshold will not extend to the Restructure Rollover either.

Maximum Franking Credits

The maximum franking credit rate for franked dividends declared in 2016 remains unchanged at 30% for all companies, however it is unclear when that will reduce in line with the tax paid by companies from 2017 onward. Therefore, consideration should be given to the company's franking credit account balance before declaring or paying fully franked dividends, as over-franking of dividends will result in the company having to pay franking deficit tax. To counter that, the widening gap between the corporate tax rate and the highest marginal tax rate for individual taxpayers, means companies will need to consider the tax profile of their shareholders and their capacity to frank dividends so that any top-up tax can be minimised.

If you would like to discuss this further, please contact Peter Hong of our office.

The New Small Business Restructure Rollover - Opportunities and Threats

The new Small Business Restructure Rollover (SBRR) applies from 1 July 2016 and its object is to provide greater flexibility for small business owners to restructure their businesses and the ownership of their business assets without having to deal with the tax and CGT implications of the movement of assets.

Moving business assets from an individual sole trader to a company or a trust, from a company to a trust or vice versa, will be much easier under the new SBRR however the devil is still in the detail and we have identified the following issues that still remain unclear:

Genuine Restructure

The first condition that needs to be satisfied in order to access the SBRR is that the transaction must be part of a "genuine restructure of an ongoing business".

The legislation defined this to include a "bona fide commercial arrangement" undertaken to "enhance business efficiency". The Tax Office has attempted to further explain the phrase "genuine restructure" in Law Companion Guideline LCG 2016/D 3 stating that:

> *" A 'genuine restructure of an ongoing business' is one that could be reasonably expected to deliver benefits to small business owners in respect of their efficient conduct of the business going forward. It is a composite phrase emphasising that the SBRR is not available to small business owners who are restructuring in the course of winding down or realising their ownership interests."*

The ATO has provided some examples in their Guidelines of what circumstances would constitute a genuine restructure of an ongoing business. Importantly they accept the following as genuine restructures:

- Transfers for bona fide asset protection reasons, such as protecting assets against the risk of being sued;
- Moving the business from a trust to a company so as to allot shares to key employees;
- Moving the business to a company to allow for a new capital contribution by an incoming shareholder; and
- Moving the business out of a company or trust back to an individual to simply their affairs.

On the flipside, the ATO provide the following examples of what are NOT genuine restructures:

- Moving business assets from a company back to a sole trader as a precursor to a sale of the business;
- Separating businesses to enable them to split between children as part of succession plans; and
- Moving business assets for purposes not associated with the efficient operation of the business going forward.

In a welcome move, the legislation does provide a safe harbour for "genuine restructures" where for three years after the asset is transferred, the assets remain held by the new entity, continue to be used by the business and do not have any material private use. The safe harbour effectively deems the transfer to qualify as a "genuine restructure" such that is satisfies the first condition.

However, in LCG 2016/D3 the ATO states that whilst a taxpayer may qualify for the safe harbour rule, that does not stop the ATO from seeking to apply the general anti-avoidance provisions of Part IVA where the ATO believes the asset transfer is motivated primarily by tax reasons.

Without further guidance from the ATO, and ultimately the Courts, as to the meaning of the term "genuine restructure" and the protections offered within the safe harbour, there will remain significant risk in applying the rollover, certainly without either a Reasonably Arguable Position prepared by a tax advisor, or even a Private Ruling obtained from the ATO.

We expect further guidance from the ATO after the SBRR's introduction on 1 July 2016 and welcome the opportunity to discuss how it may benefit your small business clients. Please contact Sean or Nigel to discuss.

CHANGES TO TAXATION OF DIRECTOR OPTIONS MAY LEAD TO REFUND ENTITLEMENTS

The ATO has been forced by a recent Federal Court decision to withdraw Tax Determination TD 2014/21 on the timing of the taxation of employee share options.

This may lead to refund claims for those directors whose tax liability was calculated on the basis of TD 2014/21's principles.

In essence, any director who has been taxed on options valued at shareholder approval date should consider if they have overpaid tax and, if so, are they still in time to amend the appropriate tax return.

The Federal Court decision in Davies v Deputy Commissioner of Taxation [2015] FCA 773 was at odds with the Commissioner's views expressed in TD 2014/21 that the rights created by an employer agreeing to seek shareholder approval for the grant of options or issue of shares to a director was not an 'indeterminate right'.

Instead the Federal Court concluded in essence that a right created under contract which is a contingent right to receive shares is a right which, on the contingency being satisfied, becomes a right to acquire a beneficial interest in a share and is accordingly an indeterminate right.

Because of this decision, the relevant day for calculating the assessable value of options granted will not be the date of the shareholder meeting which approves a grant of options to directors, but the date of the contract under which it was agreed to the grant of options (albeit conditional on shareholder approval).

Consider an example:

> *On 30 September 2015 a company entered into an employment contract with an incoming MD, the remuneration package including 5 million 2-year Incentive Options with an exercise price of 135% of the 5-day VWAP prior to 30 September 2015.*
>
> *The grant of the Incentive Options was conditional on shareholder approval being obtained at the company's next AGM to be held on 30 November.*
>
> *The 5-day VWAP on 30 September 2015 is $0.20, therefore the exercise price is $0.27; the 5-day VWAP on the AGM date is $0.30 reflecting shareholders' optimism about the magic the incoming MD would weave!*
>
> *The Incentive Options would have no assessable value if the relevant date to calculate the assessable value of the Incentive Options is 30 September 2015.*
>
> *If, however, the relevant day was the AGM date, the MD is required to include assessable income of $150,000.*

This change may lead to significant refund claims for those directors following the ATO view where the taxable value of the options was calculated at shareholder approval date.

Employers may also have to amend previous reporting to the ATO of assessable amounts calculated on the principles set out in TD 2014/21. It is therefore important that all employers who have agreed to the issue of shares or grant of options to directors subject to shareholder approval, review the basis for their calculations.

Directors should also ask questions about the basis of such calculations, recognising that the window to seek an amendment is limited by time.

These changes could also affect employees generally where shareholder approval for the issue of shares or grant of options was sought.

Please contact Walter Tieleman or Ben Reynolds should you wish to discuss further.

2016 MKT Trustee Resolutions

As you may be aware, trustees are required to have made their 2016 resolutions to distribute trust income on or before 30 June 2016. It is recommended that the resolution is made in writing and is in a format that is compatible with the respective Trust Deed. A written record will provide better evidence of the resolution and avoid a later dispute with the ATO as to whether any distribution of income was effectively made by 30 June. If the resolution is not made and signed by 30 June, the ATO may assess the trust income to the trustee at 49%.

To assist you in starting the process with your clients, we have made available a template letter to contact clients explaining the requirements. This presents a great opportunity for you to review your clients' 2016 income year in real time, implement tax planning strategies and effectively draft a Trust Resolution that gives your clients the most tax effective outcome.

To assist you in preparing the trustee resolutions for your client, we have updated our trustee resolution templates for your use. To download the 2016 Trustee Resolutions Template, please visit our website www.mkttax.com.au.

If you have any problem in downloading the work papers, please contact Nicola Devonald at our office.

The ATO Resolutions Checklist

The ATO has helpfully provided its Resolution Checklist on their website. The key points in that checklist are:

1. The Resolution must be made by the earlier of the date the Trust Deed requires or 30 June;
2. The Resolution must be recorded in writing if the Deed requires, however if the Deed is silent the ATO recommend that it is writing "to avoid a later dispute."
3. Where Streaming of capital gains and franked dividends is allowed in the Deed, the Resolution must be in writing;
4. The ATO does not accept distributions of notional amounts (such as franking credits) in line with its "preliminary" views in TR 2012/D1;
5. The ATO does not accept that income other than capital gains and franked dividends can be streamed to specific beneficiaries, such as rent, interest, foreign income etc.

Review of existing Trust Deed

Of course, the first step in the process is to ensure that your clients' Trust Deed enables you to make the distributions you wish and in that regard we are able to review your Deed, arrange for any variations that are required, and then tailor a trustee resolution to suit your client's Deed.

What is required by you is to then determine and insert the actual distributions of trust income, capital or streamed capital gains and franked dividends for each beneficiary.

MKT are able to undertake the Trust Deed review and preparation of a tailored Trust Resolution for that Deed for a fixed fee of $550 (plus GST). PAN members receive a 10% discount off this fee.

Where amendments are required to the Deed, we will obtain a quote from our solicitor to prepare the Deed of Variation for your approval.

If you would like MKT to Review the Deeds of any of your Trust clients please forward a copy of it, together with all amendments and variations to Peter Hong of this office as soon as possible, advising whether the Trustee will require the power to stream either capital gains or franked dividends in this year's Trust distribution.

If you have any queries or require any assistance with reviewing Trust Deeds or preparing 2016 Trust Resolutions please contact Peter Hong or Sean Pearce.