Explanatory Memorandum

October 2011

CURRENCY

This issue of **Client Alert** takes into account all developments up to and including 15 September 2011.

Cash economy still on ATO radar

In a recent speech, the Commissioner said compliance activities in relation to benchmarking and the cash economy are continuing. He said businesses outside the relevant benchmarks are subject to ATO review and/or audit, and where the businesses do not have adequate records to substantiate their performance, the ATO will make a default assessment using the appropriate small business benchmark.

The benchmarks will also be used to issue a default assessment in cases where businesses fail to lodge a tax return after repeated requests, the Commissioner said. In the last financial year, he said 470 default assessments based on the small business benchmarks were issued and various prosecution activities were taken.

The Commissioner also noted other compliance programs such as data-matching Government payments with businesses and online trading activities by individuals. He said the ATO receives data on overseas funds transfers and investigates cases where businesses appear to be sending more money overseas than could be explained by the reported turnover. In relation to online trading activities, the Commissioner said 70 cases are currently subject to ATO compliance action for either failing to lodge income tax returns or not reporting online sales.

Mr D'Ascenzo said some other compliance activities currently underway include the specific targeting of contracting arrangements and phoenix activities. He said the Government's proposed new reporting regime for contractors to commence on 1 July 2012 would enable the ATO to use data-matching to identify instances of unlawful contracting. Further, the Commissioner said compliance action in relation to phoenix activities is continuing and as at June 2011 over $847m in taxes and penalties were raised from the finalisation of 1,722 cases.

TIP The ATO has recently launched a "cash economy" web page on its website containing details of current compliance activities, support for businesses, FAQs, worksheets and tools. The web page is available at: www.ato.gov.au/businesses/pathway.aspx?pc=001/003/070&alias=casheconomy

Source: Commissioner's address to the Council of Small Business Australia, the NAB National Business Summit, Sydney, 27 July 2011, www.ato.gov.au/corporate/content.aspx?doc=/content/00287660.htm

Don't take the bait on tax avoidance schemes

The ATO has released a guide on its approach to dealing with tax avoidance schemes. It says during the last financial year it issued more than 230 formal notices to entities to either attend an interview under oath and/or provide documents and/or information regarding various arrangements.

The ATO said currently it is looking at arrangements including the following:

- higher risk, widely offered financial products marketed without an ATO product ruling, including financial products that bring forward deductions and delay income receipts, products that transform capital investments into revenue streams in order to generate deductions for interest, products that change an income stream into a capital receipt in order to qualify the CGT discount, and franking credit schemes;
- mortgage structuring arrangements marketed without an ATO product ruling whereby the arrangement diverts money from the payment of investment loans to the repayment of linked home loans;
- non-arm's length financing of otherwise acceptable arrangements either to change the tax consequences of the investment or to hide the true timing of events; and

- schemes designed to exploit social consciences such as the use of non-arm's length financing to make artificially inflated donations to charities, and offers of pre-payments for voluntary future year carbon credits to theoretically offset the carbon footprint of a business like a medical practice.

In addition, the ATO said it is also seeing tax avoidance schemes which are a risk to small businesses including the following:

- employee remuneration schemes (employee benefit arrangements), FBT avoidance and abusive labour hire schemes (ie incorrectly representing employees as contractors);
- abusive trust arrangements such as the use of hybrid trusts, trust loss schemes and "straw man" beneficiary schemes; and
- schemes to avoid the deemed dividend rules under Div 7A through the use of companies limited by guarantee, various forms of interposed trust arrangements or unpaid director's fees.

TIP The following Taxpayer Alerts issued by the ATO this year should be noted :

TA 2011/1 "Loans to members of companies limited by guarantee and the operation of Division 7A" – available on the ATO Legal Database at: http://law.ato.gov.au/pdf/tpa/tpa1101.pdf

TA 2011/2 "Certain labour hire arrangements utilising a discretionary trust to split income" – available on the ATO Legal Database at: http://law.ato.gov.au/pdf/tpa/tpa1102.pdf

TA 2011/4 "Deductibility of unpaid directors fees" – available on the ATO Legal Database at: http://law.ato.gov.au/pdf/tpa/tpa1104.pdf

TA 2011/5 "FBT Avoidance through an arrangement where an employer repays an employee's loan from a purported employee share trust" – available on the ATO Legal Database at: http://law.ato.gov.au/pdf/tpa/tpa1105.pdf

Source: ATO publication, "Dealing with tax avoidance schemes", 15 August 2011, www.ato.gov.au/corporate/content.aspx?doc=/content/00289267.htm

Capital gains tax bills for failing test

The Administrative Appeals Tribunal has recently handed down two separate decisions concerning capital gains tax (CGT) concessions for small businesses. Details are as follows.

CGT: taxpayer fails net asset value test – valuation not justified

The AAT has confirmed that a taxpayer was not entitled to the CGT small business concession with respect to the sale of a marina for $8.9m as the then $5m maximum net asset value test was not satisfied.

Background

The taxpayer acquired a marina in June 1996 for $1.675m and after a series of unprofitable and barely profitable years, entered into a contract to sell the marina as a going concern for $8.9m on 4 July 2006. The contract was completed on 14 August 2006. The taxpayer sought a private ruling from the Commissioner to determine the market value of the marina to be between $4m and $4.5m. The Commissioner disagreed saying value should be the sale price of the marina and issued an assessment accordingly.

Decision

During the proceedings, the AAT had evidence from two expert valuers engaged by the taxpayer and the Commissioner respectively. The taxpayer's valuer came up with a market value for the marina of $4.5m and the Commissioner's valuer had the market value of the marina at $5.3m on 4 July 2006.

The AAT said of the evidence presented by the taxpayer's valuer: it is a "somewhat curious practice to adopt a market value by references to offers made and the sum at which a vendor was prepared to sell [$4.5m]. The practice is not improved by a process of separating the component parts and valuing them by reference to yield figures that, in my view, simply cannot be justified". Hence the Tribunal found the taxpayer had failed to discharge the onus of proof.

Further, the Tribunal agreed that the valuation performed by the Commissioner's valuer using two conventional approaches of capitalisation of operating profit and direct comparison had more merit. The AAT accepted "[the Commissioner's valuer's] reasoning and his conclusions ... that the marina had a market value of $5.3m in July 2006" moreover, it was satisfied that the market value of the marina "was at least that amount".

In conclusion, the Tribunal affirmed the Commissioner's assessment and held the taxpayer was not entitled to the CGT small business concession as the net asset value test was not satisfied.

AAT Case [2011] AATA 589, Re Syttadel Holdings Pty Limited and FCT, AAT, Ref No: 2010/1912, Hack DP, 26 August 2011, www.austlii.edu.au/au/cases/cth/AATA/2011/589.html

CGT: taxpayer fails net asset value test – valuation of assets flawed

The AAT has confirmed that a taxpayer was not entitled to the CGT small business concession in respect of the gain he made on selling two $1 shares in a company for $4.9m on the basis that he failed the maximum net asset value test. The issue to be determined by the AAT was whether the market value of a motel and caravan park that the company held through a chain of unit trusts exceeded the (then) $5m threshold for the maximum net asset value test.

After indicating that the taxpayer bore the onus of establishing the market value, the AAT ultimately rejected the valuations supplied by the taxpayer (as opposed to the $11.9m calculated by the Commissioner) on a number of grounds, including the following.

First, although one of the taxpayer's valuations was said to have been made on a "going concern basis", there was no attempt to estimate future profits and the AAT said that a valuer choosing to undertake a valuation by reference to the "income generating potential" of a business must ascertain the income stream which the business may be expected to generate. As a result, the AAT said the valuation was worthless as it made no attempt to consider this matter.

Secondly, the valuations were not made "just before the CGT event" (ie the sale of the shares) as required but in one case 17 months after that time, while another valuation was not produced until years after the relevant event. Furthermore, the two valuations were prepared in accordance with an inspection which was according to the AAT "almost certainly, the same inspection for both valuations" and made in compliance with instructions to value the assets on a historical basis.

Thirdly, one valuation separated the properties while another combined them and at the same time failed to properly account for improvements. In this regard, the AAT found there was no valid reason why the two assets could not be valued separately.

For these reasons, the AAT found that the taxpayer's valuations were flawed and could not be accepted and that, as a result, the taxpayer had failed to discharge the onus which he bore. Furthermore, the AAT stated that it seemed the sale of the shares was undertaken with one end in mind, and that was to obtain the concession. It also noted that the taxpayer's accountant admitted that the sale price was calculated so as to obtain the small business concession.

Finally, the AAT noted that the taxpayer had probably incorrectly taken into account only half the value of the motel and caravan held by the final unit trust in the chain in view of the 50% holding in that unit trust. In this regard the AAT said the effect of the legislation was that the full value of the unit trust's net assets must be taken into account in these circumstances.

AAT Case [2011] AATA 588, Re Venturi and FCT, AAT, Ref No 2010/1378, Block DP and Frost SM, 25 August 2011, www.austlii.edu.au/au/cases/cth/AATA/2011/588.html

Share trading business existed, says Tribunal

The AAT has held that a taxpayer was not a passive investor in relation to share trading activities and was carrying on a business of share trading for the year ended 30 June 2008.

Background

The taxpayer was a chief executive of a services company and traded shares in his own name on the share market. The taxpayer claimed that he was carrying on a business of share trading for the following reasons:

- he "used a stock-picking and research service" on a daily basis and "conducted research on the Financial Review website ... online searches on the Commsec website and elsewhere";
- he talked regularly to his brokers;
- he formed investment strategies "after reading books by well-known businessman like Warren Buffett and George Soros";
- he set up and used a margin lending facility; and
- he "spent two hours each day on these transactions".

The taxpayer argued that the only reason he did not sell much of his portfolio during the relevant period was due to the global financial crisis. The Commissioner contended the taxpayer was not conducting a share trading business as he did not have a formal business plan, did not sell many shares during the period, did not have a place of business and appeared to hold stocks which delivered reliable dividends.

Decision

The Tribunal was satisfied that the taxpayer was carrying on a business as in its view:

- "the taxpayer intended to make a profit out of his activities during the year of income";
- "the activities were occurring on a relatively large scale, at least in value";

- "he certainly regarded it as a serious business ... making regular trades during the course of the year of income";
- "the taxpayer certainly behaved as if he were following a systematic strategy, albeit ... not detailed, scientific or formal"; and
- "he made purchase decisions according to consistent general criteria".

In the Tribunal's view, "the taxpayer's perception of himself as a trader ... is accurate having regard to the objective facts". Hence the Tribunal held that the taxpayer was in the business of trading shares for the year ended 30 June 2008. The Tribunal said "the fact that [the taxpayer] did not end up selling many of the shares during that period was an accident of history that can be explained in particular by the ... GFC".

TIP	Some commentators have noted the outcome of this case as "unusual". It was not known at the time of writing whether the Commissioner will appeal the decision.

AAT Case [2011] AATA 545, AAT, Ref No: 2010/4083, McCabe SM, 5 August 2011, www.austlii.edu.au/au/cases/cth/AATA/2011/545.html

Taxpayer loses excess super contributions tax appeal

The Federal Court has dismissed a taxpayer's appeal against an AAT decision which had upheld a superannuation excess contributions tax assessment against a taxpayer for breaching the $1m non-concessional contributions cap for the transitional period to 30 June 2007.

Background

The Commissioner issued the taxpayer with an excess non-concessional contributions tax assessment of $86,867 for the 2007 income year in respect of non-concessional contributions totalling $1,186,811.

The taxpayer objected against the assessment claiming that a payment of $355,000 from her personal superannuation fund was received by her in a capacity as trustee (and not beneficially in her personal capacity) before being on-paid to the iAccess Superannuation Fund (IPAC Fund). The taxpayer originally intended that the $355,000 amount would be paid directly from her personal superannuation fund to the IPAC Fund. However, she allegedly received independent professional advice to implement the transaction by drawing a cheque from her personal superannuation fund in her favour (deposited to her account), followed by a bank cheque drawn by her in favour of the IPAC Fund.

The taxpayer argued that, as she received the $355,000 amount as a bare trustee, it was a "roll-over superannuation benefit" and not an eligible termination payment (ETP) under former s 27A of the ITAA 1936. The taxpayer also submitted that the amount could not be treated as an ETP as there was no written application for a benefit payment according to the fund's trust deed.

The Commissioner considered that the taxpayer intended the $355,000 to be an ETP (rather than a roll-over) as part of a re-contribution strategy which inadvertently breached the transitional $1m non-concessional contributions cap under s 292-80 of the *Income Tax (Transitional Provisions) Act 1997*. The Commissioner also noted that the taxpayer's personal superannuation fund, of which she was the sole director of the corporate trustee, had reported the $355,000 amount as a benefit and the taxpayer included the ETP in her personal tax return.

First instance decision

At first instance, in *AAT Case [2011] AATA 35, Re Player and FCT*, the AAT upheld the assessment after ruling that the $355,000 amount was in fact received by the taxpayer from her personal superannuation fund and treated by her as an ETP before being on-paid to the new fund as a non-concessional contribution. In doing so, the AAT dismissed the taxpayer's argument that the payment from her personal super fund was received by her in a capacity as trustee (and not beneficially in her personal capacity). As the taxpayer had treated the payment to her as an ETP and accounted for it in this manner, the AAT held that the amount paid to the IPAC Fund could not be treated as a "roll-over superannuation benefit" under s 306-10 of the ITAA 1997.

Decision

In dismissing the taxpayer's appeal, the Federal Court ruled that the AAT had not erred in concluding that the amount paid to the taxpayer's new super fund was not a "roll-over superannuation benefit" under s 306-10. The Court considered that it was open to the AAT to conclude that the taxpayer had received the purported amount "both legally and beneficially" so that s 306-10 could not apply.

However, the Court expressed some criticism of the Tribunal's reasoning which had suggested that the fact that the taxpayer treated the payment as an ETP in her filings with the Commissioner was fatal to the payment qualifying as a roll-over superannuation benefit. "How a taxpayer characterises a receipt in the

taxpayer's filings with the Commissioner is never conclusive of its true character, albeit evidence of how the taxpayer viewed its character", the Court said.

Nevertheless, the Court was satisfied that the AAT only had regard to the taxpayer's treatment of the payment as an ETP as no more than evidence of her beneficial receipt of the payment. In other words, the Court said the taxpayer's treatment of the payment as an ETP did not, in the view of the Tribunal, conclude the issue as to whether or not it qualified as a roll-over superannuation benefit; it was merely evidence pointing towards a conclusion that she received the payment beneficially.

On a positive note, the Court agreed with the AAT's observation questioning the Commissioner's contention that s 306-10 will be satisfied only if a payment is made directly by a complying superannuation plan to another plan, so that if the amount is first deposited to a different account before being on-paid, the requirements of s 306-10 will not be satisfied. The Court agreed with the AAT's view questioning the ATO's position and noted that it could be argued that where (by way of example) a superannuation plan pays money into a solicitor's trust account, with a direction that the amount be on-paid to a superannuation plan, the legislative provisions might be said to be satisfied.

In addition, the Court dismissed the Commissioner's preliminary argument that the taxpayer's appeal should be dismissed for failing to specify a ground raising a question of law. While the Court accepted that the Commissioner's argument had "considerable force", it found there was at least one ground of appeal which raised a question of law, as required by s 44(1) of the AAT Act.

Player v FCT [2011] FCA 869, Federal Court, Edmonds J, 5 August 2011, www.austlii.edu.au/au/cases/cth/FCA/2011/869.html

TIP The Assistant Treasurer has released a consultation paper on the Government's proposal to refund certain excess concessional contributions. Public consultation closed on 7 September 2011.

As part of the 2011–2012 Budget the Government proposed that eligible individuals would be given a once-only option to have excess concessional contributions up to $10,000 refunded and assessed at their marginal tax rate for the financial year in which the contribution was made. The refund option is proposed to only apply for the first year in which the concessional contributions cap is breached, commencing from 2011–2012.

Unfortunately, the once-only nature of the measure only provides partial relief where a taxpayer may have repeated the error over a couple of financial years. Due to the time lag for the Commissioner to collect and process contributions data to notify a taxpayer about a potential cap breach, it may be a couple of years before a taxpayer becomes aware of a problem. The "use it or lose it" nature of the refund option also means that a taxpayer will not be able to save up this "get out of jail card" to only use it for a subsequent breach to prevent a severe penalty where an excess contribution automatically triggers the $450,000 bring forward rule for non-concessional contributions.

In addition, the refund option will not provide any relief for taxpayers who inadvertently exceed the concessional cap by more than $10,000 or for breaches before 1 July 2011. Such taxpayers will need to apply to the Commissioner to disregard or reallocate the excess contributions under s 292-465 of the ITAA 1997 – an extremely narrow concession.

The paper is available on the Treasury website at:
www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=2125.

SMSFs warned on improper lending of money

The ATO has issued a warning to trustees of SMSFs to ensure loan terms comply with the law and fit their investment strategy.

The ATO says it is concerned that some trustees are lending money on favourable terms from their SMSFs to people who provide advice or assist in the running of the fund. It warns that this arrangement may lead to the loss of the complying status of the fund and concessional tax rates.

Before lending any money, the ATO says trustees should consider the fund's investment strategy and seek advice before entering into such arrangements. Should the trustee decide to lend money from their SMSF, it says they should:

- have an appropriate loan agreement signed by all parties
- the loan agreement should specify all the terms of the loan, such as:
  - the security for the loan;
  - the repayment period;
  - repayment due dates;

- the amount of the repayments;
- the interest rate.

The ATO notes the trustee should ensure the conditions of the loan agreement do not provide the borrower with favourable terms. Further, the trustee should also ensure the interest and repayments received by the fund accord with the loan agreement, the ATO says. Should the loan agreement not be followed, it says the trustee should take appropriate action to ensure that members' benefits are not put at risk.

Source: ATO publication, "SMSFs and lending", 31 August 2011, www.ato.gov.au/superfunds/content.aspx?doc=/content/00290911.htm