client alert | explanatory memorandum

April 2015

CURRENCY:

This issue of **Client Alert** takes into account all developments up to and including 17 March 2015.

Separate ATO appeals unit needed to resolve tax disputes

The Government has released the Inspector-General of Taxation's report on the ATO's management of tax disputes. The report was prepared at the request of the House of Representatives Standing Committee on Tax and Revenue to assist with the large business and high-wealth-individual themes of its Inquiry into Tax Disputes. The Inspector-General's report will now be considered by the Committee as part of the Inquiry. In releasing the 147-page report, the Government said the "recommendations by the Committee, as well as those of the Inspector-General, will be considered by the Government on conclusion of the Inquiry".

The Inspector-General observed that a key concern for taxpayers "appears to be a lack of separation between the ATO's original decision makers and its officers who review such decisions" and that this gives "rise to a lack, or perceived lack, of independence leading taxpayers to believing their cases were not reconsidered afresh and they were denied a fair hearing". This, in turn, leads taxpayers to believe they cannot have their matter objectively considered until they reach the Administrative Appeals Tribunal (AAT) or the Federal Court.

The Inspector-General noted that while the ATO's recent initiatives represent a positive step in its management and resolution of tax disputes, "there is a need for further improvements which was sustainable over time and made available to all taxpayers including small business and individual taxpayers". In this regard, the Inspector-General **recommended the "creation of a separate and dedicated Appeals Group, led by a new Second Commissioner, to embed the improvements within the ATO structure and provide a framework that is less dependent on the views and ideals of the ATO leadership of the day".** The Inspector-General said this move would also bring the ATO more in line with comparable international revenue authorities.

The proposed new Appeals Group would manage and resolve tax disputes for all taxpayers, including the conduct of pre-assessment reviews, objections and litigation (including identifying test cases and providing oversight on settlements), as well as championing the use of alternative dispute resolution (ADR) throughout the dispute cycle. Mr Noroozi said the separation from both the ATO's compliance and legal advisory functions would facilitate a fresh and impartial review of the taxpayer's case. Officers of the new proposed area would be empowered to resolve disputes through the most appropriate means, taking into consideration the individual circumstances of the taxpayer, their case, and an assessment of the ATO's precedential view. Additionally, he said the new area would ensure that settlements are appropriately scrutinised and in the best interests of the community.

Mr Noroozi acknowledged submissions calling for a separate agency to manage tax disputes, noting that such an agency would represent the highest levels of independence. He also noted that there would be challenges with this option, for instance increased costs and overlap with existing external review bodies such as the AAT. However, Mr Noroozi said he believes that this option should be considered in future if significant concerns persist following implementation of the Appeals Group.

The Inspector-General was of the view that it was paramount that the proposed Appeals Group be headed by a new Second Commissioner, in order to achieve the highest level of independence while retaining the dispute management function within the ATO. Mr Noroozi noted that such roles are statutorily appointed and their tenure and remuneration pre-determined by the Government and the Remuneration Tribunal, respectively. He said such an arrangement accords with the views of the International Monetary Fund on the separate leadership of an internal appeals function where organisational and practical separation (such as through a separate agency) cannot be achieved.

The Inspector-General also said he believed that a legislated framework pursuant to which the ATO can establish protocols to manage intra-agency communication would further foster the independence of the proposed Appeals Group. In this regard, the Inspector-General recommended that the Government consider

legislative change. Mr Noroozi pointed out that the US model for managing intra-agency communication provides a helpful guide. He added that stakeholders were "generally supportive" of this approach drawing comparisons to the use of "Chinese walls" in large professional service firms to manage conflicts of interest.

Source: Inspector-General of Taxation, "The Management of Tax Disputes", January 2015, www.igt.gov.au/content/reports/tax_disputes/downloads/management_tax_disputes.pdf; Assistant Treasurer's media release, 27 February 2015, http://jaf.ministers.treasury.gov.au/media-release/010-2015.

Single Touch Payroll consultation noted big changes afoot

On 28 December 2014, the Government announced that it would cut red tape for employers by simplifying tax and superannuation reporting obligations through Single Touch Payroll.

Under Single Touch Payroll, employers will be required to electronically report payroll and super information to the ATO when employees are paid, using Standard Business Reporting-enabled software. In addition, Single Touch Payroll will streamline TFN declarations and Super Choice forms by providing a digital channel to simplify the process of bringing on new employees. It could also cut red tape by notifying super funds and government agencies, such as the Department of Human Services, when an employee ceases employment.

Single Touch Payroll will be available from July 2016. To meet their Single Touch Payroll obligations, employers would be required to use, and if necessary acquire, appropriate payroll software. The ATO noted the Government has yet to make final decisions on its implementation.

The ATO had released a discussion paper which sought submissions on:

- transition arrangements;
- suggestions on how to minimise implementation and compliance costs; and
- the potential for employers to remit employee PAYG withholding and the super guarantee at the same time employees are paid.

The closing date for submissions was 6 March 2015.

The following are some key points raised by the ATO in the paper:

Reporting capability

The reporting function in Single Touch Payroll will eliminate paper-based payroll reporting by requiring businesses to report digitally instead. This will reduce the double handling of data. The ATO would also be notified of the super contribution amounts that the employer will pay to the super fund. As a result of the ATO's improved visibility of employee super entitlements and payments, the ATO will be in a better position to ensure that businesses are meeting their employee super obligations.

Real-time reporting and payment capability

Despite the Single Touch Payroll reporting function offering significant benefits, it is unable to solve the potential problem of businesses accruing large quarterly pay-as-you go (PAYG) withholding, and superannuation bills being due for payment at around the same time. By reporting and paying the PAYG withholding and superannuation guarantee (SG) for employees at the payroll cycle, businesses would be able to smooth out the cash flow spikes that previously existed. However, the increased frequency of payments will result in cash flow impacts, particularly on transition. The following additional points are made by the ATO:

- There are a small percentage of businesses in a net GST refund position, or entitled to fuel tax credits, that are also likely to see an impact on cash flow.
- Changes to the frequency of payments may have consequences for other business practices, such as payment of invoices.
- Employers would face the initial transition impact of paying the PAYG withholding and super bill for the last reporting period at the same time as moving to paying their tax and super at the payroll event. However, the ATO noted that there will be no change to a taxpayer's ability to enter into a payment arrangement for those who struggle to meet their obligations.
- The increase in payment frequency for SG will have an impact on the volume of payments and contribution messages going through SuperStream gateways and clearing houses. This may result in an increase in administrative costs associated with making super contributions.

Commencing employment

A common problem is businesses not receiving information regarding their employees' choice of super fund on time. With Single Touch Payroll, employees would be offered the option to supply their details electronically through an online government portal directly to their employer's payroll software. Alternatively,

employees or employers could enter the employee's details directly into the employer's payroll software and have the ATO validate the details.

Cessation of employment

The introduction of Single Touch Payroll could allow businesses to easily notify super funds, the ATO and the Department of Human Services of employees that have ceased employment. This could be done via payroll software allowing for an "employee ceased" indicator to be entered. Super funds will be able to receive information on employees who are no longer employed. Super funds could also use the information to communicate with members about choosing the fund for future employment.

Administration of penalties

As with other areas of tax and super, administration penalties may apply for failures to meet certain obligations under Single Touch Payroll. The ATO says the Commissioner will "provide support to employers making a genuine attempt to comply with their obligations under Single Touch Payroll". As a result, the ATO says discretion in the administration of penalties under Single Touch Payroll "will be necessary during the transition period and ongoing". In this regard, the ATO is seeking comments on the circumstances in which the Commissioner should use his discretion in administering penalties.

Software

Businesses or their payroll providers may be required to either purchase or upgrade existing software, potentially at an additional cost. In the past, it was recognised that all businesses may not be able to buy, continually upgrade and operate the latest computer systems. Based on the experience with Real Time Information in the United Kingdom, the ATO says it is "expected that some basic, entry-level software packages will be available free of charge". It says this will help businesses that do not currently use software transition into an electronic business model without software costs.

Transition options

Any employer will be able to transition to Single Touch Payroll from July 2016. The Commissioner will be able to delay the start date to allow for situations where employers find it difficult to meet the required timetable. The paper sets out a potential phased approach to implementing Single Touch Payroll based on whether an employer has a withholding greater or less than $100,000. It suggests that employers with withholding greater than $100,000 could fully transition to Single Touch Payroll by July 2018 (with exemptions to apply in exceptional circumstances). However, the ATO suggests employers with withholding less than $100,000 could transition to Single Touch Payroll by July 2019 (with exemptions to apply in exceptional circumstances).

Source: ATO, Single Touch Payroll discussion paper, 16 February 2015, https://www.ato.gov.au/General/Consultation/What-we-are-consulting-about/Papers-for-comment/Single-Touch-Payroll-discussion-paper.

Time limits on trustee tax assessments clarified

The ATO has issued Practice Statement PS LA 2015/2 outlining its practice of limiting the period within which it will raise an original trustee assessment. It notes that the practice means returns lodged by trustees are broadly exposed to similar time limits for review as other taxpayers.

However, the ATO notes that in any income year, a trustee may be issued separate assessments under s 98 for each relevant beneficiary and/or an assessment under ss 99A or 99. It states that its practice about time limits applies separately to the making of each of these original assessments.

Generally, the ATO notes that it will not issue an original trustee assessment more than four years after the relevant trust tax return was lodged, or more than two years after lodgment for the 30 June 2014 and later income years if the trust was a small business entity (and none of the qualification in item 3 of the table in s 170(1) of the ITAA 1936 apply).

According to the PS LA, the time limits listed above do not apply in the following circumstances:

- if the trustee has not lodged a trust return for the year in question;
- if the Commissioner is of the opinion that there has been fraud or evasion;
- where an extended or unlimited amendment period would apply; or
- where the time limit is extended – in cases where the ATO has started to examine the affairs of a trust (or related entity) and the examination will not be completed within the time limits, the ATO may seek the trustee's agreement to extend the period.

The PS LA contains five examples on practical applications of the above principles including examples of the time limit within which to raise an original trustee assessment; multiple trustee assessments; where time limits do not apply (unlimited amendment period); extension of time limits; and extended timeframes.

Date of effect

Practice Statement PS LA 2015/2 applies from 19 February 2015.

Source: ATO, Practice Statement PS LA 2015/2, 19 February 2015, http://law.ato.gov.au/atolaw/view.htm?docid=%22PSR%2FPS20152%2FNAT%2FATO%2F00001%22.

GST credits for employee accommodation refused

In a test case decision, the Federal Court has dismissed a taxpayer's appeal concerning its entitlement to input tax credits (ITCs) for certain acquisitions relating to mining accommodation (employee/contractor housing) in Western Australia.

Background

The taxpayer, Rio Tinto Services Ltd, is the representative member for the Rio Tinto Ltd GST group, which includes Hamersley Iron Pty Ltd and Pilbara Iron Company (Services) Pty Ltd (PICS). The case was conducted as a test case re GST paid by Hamersley and PICS for October 2010 on expenditures including construction and purchase of new housing, refurbishment and repairs of residential housing, mould removal and general hygiene cleansing, and cleaning housing and landscaping. The Court noted that Hamersley owns around 2,300 houses and apartments in towns in the Pilbara.

Rio Tinto claimed it was entitled to ITCs of nearly $600,000 for acquisitions made by Hamersley and PICS in providing, and maintaining, residential accommodation for Hamersley's workforce in the Pilbara region. The accommodation is leased to the workers and the provision of the accommodation is an input taxed supply under s 40-35. Hamersley makes losses on providing the accommodation and the rent charged is generally subsidised by the company.

Rio Tinto argued that the acquisitions in question were made wholly for a "creditable purpose" because the supply was not an end commercial objective in itself but was wholly incidental to Hamersley's mining operations as a necessary and essential part of those operations.

The Commissioner accepted that the provision of the accommodation was a necessary and essential part of Hamersley's business. However, he rejected the company's ITC claims on the basis they fell within the terms of s 11-15(2)(a) of the GST Act because they related to making supplies that would be input taxed. The issues in question were: (i) whether the acquisitions were made solely or partly for a "creditable purpose"; and (ii) if made solely or partly for a "creditable purpose", the amount of credit to which the taxpayer was entitled.

Decision

The Court noted that an acquisition is not a "creditable acquisition" to the extent it "relates to" making supplies that would be input taxed. Under s 40-35(1)(a), input taxed supplies include a supply of residential premises by way of lease.

The Court said Rio Tinto accepted that the provision of the accommodation was an input taxed supply and that there was a connection between the acquisitions and the provision of that accommodation. However, the company argued that the connection was not a relevant connection for s 11-15 purposes. It submitted that for s 11-15(2)(a) to apply, the making of an input taxed supply, and not the making of a taxable supply, must be the "moving cause" or "purpose" of the acquisition. The company contended that the "moving purpose" in supplying the accommodation was the carrying on of Hamersley's enterprise of mining and selling iron ore (ie the making of taxable supplies), and not the leasing of accommodation as an end activity in itself (ie making input taxed supplies). Rio Tinto argued there was not a sufficient and material connection between the acquisitions in question and the making of input taxed supplies for the purposes of s 11-15(2)(a).

The Federal Court however disagreed and rejected Rio Tinto's construction of s 11-15.

It was also argued by the taxpayer that the legislative policy (for the enactment of s 40-35) would be defeated by the Commissioner's construction of s 11-15 by reason that Hamersley's business is to profit from the making of taxable and GST-free supplies of iron ore, not from the provision of accommodation. In response, the Court said:

- the task of statutory construction does not seek, as Rio Tinto sought to do, to identify or assume the underlying policy of a provision and then to construe that policy;
- the fact that it may be necessary for Hamersley to subsidise the accommodation rent in order to attract and retain its workers, thereby making a loss, "does not gainsay the application of s 11-15(2)(a)". The

Court said the decision to provide the rental subsidy was a commercial choice by Hamersley that did not impinge on the proper construction of s 11-15;

- it is the transaction that determines the GST outcome. The provision of the accommodation was an input taxed supply.

In the result, the Court dismissed the taxpayer's application. In the Court's view, the acquisitions in question all had a direct connection with Hamersley's provision of leased accommodation and that connection constituted a sufficient material relationship for the purposes of s 11-15(2)(a). It held the acquisitions were not made for a "creditable purpose".

Appeals update

The taxpayer has appealed to the Full Federal Court against the decision.

Rio Tinto Services Ltd v FCT [2015] FCA 94, www.austlii.edu.au/au/cases/cth/FCA/2015/94.html.

Penalty for promoting pharmaceuticals donations scheme

In a lengthy and detailed judgment, the Federal Court has found that a promoter of a scheme involving the purchase and donation of pharmaceuticals to charities with foreign operations engaged in conduct that resulted in himself and two other entities being a promoter of a tax exploitation scheme. As a result, civil penalties totalling $1.5 million were imposed.

Background

The Court said the promoter brought the scheme to Australia in 2009 and 2010. Under the scheme, participating entities incurred a liability to pay for pharmaceuticals for use in foreign markets, but liability for payment of 92.5% of the purchase price would be deferred for 50 years at very low interest. Participants would claim immediate deductions for the full amount of the purchase price.

The Court noted that this was only the second time it had been called upon to consider the civil penalties provisions of Subdiv 290-B of Sch 1 to the TAA, the first being in *FCT v Ludekens* [2013] FCAFC 100.

Decision

In the Court's view, "the conduct of Mr Arnold, whether it was conduct on his part, conduct as the guiding mind and will of Leaf Capital or conduct as the guiding mind and will of Donors Without Borders was so integrated in its nature, planning, sequence, timing and supervision that it is not possible…to identify sets or sequence of acts and characterise those as being totally referrable to Mr Arnold, or Leaf Capital, or Donors Without Borders. In my view, the acts constituting the conduct of Mr Arnold cannot be allocated as being exclusive to himself or either of the two corporate respondents; their respective roles in the DWB Scheme were so overlapping in the conduct called for from Mr Arnold that each and every act on his part was related to the other acts on his part; they were all part of the same course of conduct."

After reviewing the relevant law, cases, facts and submissions, the Federal Court concluded that: (i) the scheme was a "scheme" for the purposes of s 290-65(1) of Sch 1 to the TAA; (ii) at the time of the conduct mentioned in s 290-50(1), it was reasonable to conclude that each respondent (and each participant) entered into or carried out the scheme in question for the dominant purpose of getting a "scheme benefit" for each participant from the scheme; (iii) at the same time, it was not reasonably arguable that the scheme benefit was available at law; and (iv) by reason of (i), (ii) and (iii), the scheme was a "tax exploitation scheme" for the purposes of s 290-65(1).

The Court imposed a penalty of $1 million on the promoter, $400,000 on the second respondent, and $100,000 on the third respondent. Edmonds J said (at [171] and [207]): "Specific deterrence is a significant factor where, as here, the contraventions involved deliberate wrongdoing, sustained denials of contraventions and lack of remorse".

"Potential promoters must be left in no doubt that acting on the commercial temptation to engage in the proscribed conduct in relation to tax exploitation schemes, so as to realise the significant potential rewards that can be available, will result in substantial penalties. The penalties need to be substantial enough to persuade potential promoters that it is not worth the risk of whether a tax exploitation scheme will escape the detection by the Commissioner."

FCT v Arnold (No 2) [2015] FCA 34, www.austlii.edu.au/au/cases/cth/FCA/2015/34.html.

ATO reaction

In commenting on the case, ATO Deputy Commissioner Tim Dyce said the so-called philanthropic scheme was modelled on an arrangement which previously failed in Canada, and involved the purchase and donation of AIDS pharmaceutics to charities in Africa. "As we discovered, the purchasers only paid 7.5% of the grossly inflated price of the drugs, yet claimed tax deductions of 100%".

Mr Dyce said that, in delivering his judgment, Justice Edmonds noted at least five grounds why the scheme was not available under the law, including that there was no actual delivery of the pharmaceuticals to the charities concerned at the relevant time.

Source: ATO media release, 6 February 2015, https://www.ato.gov.au/Media-centre/Media-releases/Promoters-of-AIDS-pharmaceuticals-donations-scheme-fined-$1-5-million.

Tax concessions following business sale cancelled

The AAT has confirmed that Pt IVA applied to a scheme carried out by taxpayers that enabled them to qualify for the CGT small business concessions by way of "creating" liabilities for the purpose of passing the maximum net asset value test (MNAV) test. Interestingly, the taxpayers argued (contrary to their lodged tax returns) that these liabilities did not "relate to" any relevant CGT assets and, therefore, the MNAV test had not been passed, in order to negate the Commissioner's claim that Pt IVA applied to the arrangement.

Background

The taxpayers were the trustee of a unit trust that made the capital gain, its various family trust beneficiaries and certain "primary" individual beneficiaries of those family trusts. The unit trust carried on a business of manufacturing rain water tanks, pool shells and farm product (together with the related unit trust that operated various parts of the business). On 1 July 2005, the unit trust sold its business asset for over $8 million. Its tax return, and those of the other taxpayer beneficiaries who would receive the "flow-on" effect of the distributions of the gain, were prepared on the basis that the unit trust qualified for the CGT small business concessions.

However, several weeks before the sale, the business was restructured by way of introducing four new "protection trusts" to receive capital distributions from the unit trust in relation to re-valued goodwill (and resolutions were duly made to make such distributions). At the same time, loans were made by these protection trusts to the unit trust to finance these distributions (which were repaid soon after the sale). In addition, various loans existed between related trusts.

The Commissioner claimed the restructure, with the resulting new liabilities of the unit trust, was motivated by a desire to come within the (then) $5 million MNAV threshold in order to access the CGT small business concessions in respect of the capital gain of $5.4 million that the unit trust would otherwise have made on the sale but for the liabilities. In short, the Commissioner claimed that the liabilities in question – namely, unpaid present entitlements of $1.4 million, a loan-back of $500,000 and the loans totalling $50,000 between two related trusts – were "created" under the arrangement in order to obtain a "tax benefit" for Pt IVA purposes.

Accordingly, the Commissioner made Pt IVA determinations and issued amended assessments to increase the assessable income of both the family trusts (in proportion to their unit holdings in the unit trust) and their primary individual beneficiaries (in proportion to distributions previously made to them). In addition, the Commissioner imposed 50% shortfall "scheme" penalties. Note that the Commissioner also originally issued amended assessments to corporate beneficiaries of the family trusts but later conceded they were outside the time permitted for the making of amended assessments and abandoned his claim of "fraud or evasion".

On the disallowance of the taxpayer's objections to the amended assessments, the taxpayers applied to the AAT for review. Before the AAT, they argued that, contrary to the position they took on claiming the CGT small business concessions on the lodgment of their tax returns, they did not qualify for the concessions as the relevant liabilities did not in fact "relate to" any assets of the unit trust for the purposes of the MNAV test.

Decision

Subject to several minor adjustments, the AAT affirmed the Commissioner's objection decisions and ruled that Pt IVA applied to the arrangement.

However, the AAT first found that the relevant liabilities did "relate to" the assets of the unit trust and therefore the taxpayers had prima facie qualified for the CGT small business concessions. Specifically, it found the taxpayers had not satisfied the onus of proving the liabilities were not "related to" the assets of the unit trust and that in its opinion, at least the unpaid present entitlements of $1.4 million and the loan-back liability of $500,000 were more than likely related to its assets.

In arriving at this conclusion, the AAT made the following points:

- the taxpayers' expert accounting evidence was not relevant (although may be of assistance) as the question of whether the liabilities were "related to" the assets was a matter of mixed fact and law on which the AAT was bound to reach its own conclusions;
- the legal test is that a "real and substantial, but not remote" relationship must exist between a liability and the CGT assets of the taxpayers;

- an inquiry as to the "purpose" of incurring the liability (as underpinned the taxpayers' arguments) does not necessarily answer and, in fact, "may distract from the enquiry required by the legislation – is the liability related to the assets of the entity"?
- the decision in *Bell v FCT* [2013] FCAFC 32 (where it was held that a loan taken out to fund distributions, instead of using existing trust resources, was not "related to" CGT assets of the trust) was to be distinguished on a number of grounds, including that in that case "the cash that represented the borrowing had been disposed of…", whereas in this case, "the strategy seems to have been to avoid actually disposing of cash until after settlement of the sale in the following financial year"; and
- the resulting calculation after taking into account relevant "liabilities" needs to reflect the economic value of the business and, in the ordinary course of events, the balance sheet of a business should demonstrate the economic value of a business – which in this case indicated the liabilities did "relate to" the CGT assets of the unit trust.

On the basis of finding that the MNAV test had in fact been passed, the AAT then addressed the issue of whether Pt IVA applied to cancel the tax benefits obtained by the taxpayers as a result.

After finding that the steps undertaken to "restructure" the business constituted a "scheme", the AAT then found that tax benefits had been received, not by any of the family trusts beneficiaries, but by the primary individual beneficiaries of those trusts. It did so essentially on the grounds that in terms of determining the "alternative postulate" under the tax benefit test, "it was reasonable to postulate that the distributions would have been made [to these beneficiaries], in substance at least, on the basis of the resolutions that were seemingly prepared" in the relevant income year that the unit trust resolved to make the original distributions.

The AAT then found, by reference to the relevant "dominant purpose" factors in s 177D(b) of the ITAA 1936, that the taxpayers entered into the scheme for the dominant purpose of obtaining a tax benefit and not for any asset "protection purpose". In this regard, the AAT also emphasised that the taxpayers failed to discharge the onus of proving such and stated that it was "unable to see how the scheme could be regarded as having any purpose other than obtaining a tax benefit".

Finally, the AAT affirmed the 50% shortfall "scheme" penalties, noting also there were no grounds to claim that a "reasonably arguable" position had been taken.

Re Track and Ors and FCT [2015] AATA 45, www.austlii.edu.au/au/cases/cth/AATA/2015/45.html.

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