the Spry Roughley report

explanatory memorandum

April 2011

Cash Economy Letters Encouraging Compliance, says Tax Office

The ATO has released details of its cash economy letter program. The program entails the ATO sending "advisory" letters to taxpayers who may be participating in the cash economy. The ATO said it will mostly send the letters to business operators reporting outside the small business benchmarks for their industry, or to those who, in the ATO's view, have reported insufficient business income to meet their expected living expenses. The ATO says these letters identify potential compliance risks and prompt taxpayers to review their records, returns and income. Tax agents will receive an advance copy of the letters.

The ATO said, to date, the results from the program "have been encouraging, indicating a positive impact on compliance levels". The ATO said many of the businesses that have received letters have responded by:

- reporting more GST payable on activity statements they lodged after receiving a letter;
- explaining why they are operating outside the benchmarks;
- making a voluntary disclosure;
- making self-amendments to their previous activity statements and/or income tax returns.

The ATO noted that over 24,000 letters were sent to taxpayers between 1 July 2010 and 30 September 2010. Of those taxpayers, 97% use a tax agent. Common responses to those letters included:

- the taxpayer is in a different industry to the one the ATO identified;
- after reviewing their records, the taxpayer is satisfied their records are correct;
- the taxpayer operates a business in more than one industry so the application of one benchmark does not apply;
- the cost of goods sold ratio is outside the benchmark because the taxpayer has included amounts such as wages and other expenses in this ratio.

TIP: The benchmarks are published on the Tax Office website available at: http://www.ato.gov.au/businesses/content.asp?doc=/content/00214689.htm. The benchmarks can be used by businesses to help assess if they are likely to be selected for an audit or review.

Source: ATO publication, "Small business benchmarks and the cash economy letter program"

Director's Penalty Notice Given when Delivered, not Posted

The NSW Court of Appeal has unanimously held that a previous decision of the Court was clearly wrong and has held that the 14-day period within which a director is required to take specified action in response to a director's penalty notice ran from the date of the delivery of the notice, and not from the date of its posting.

Background

The taxpayer, a director of several companies, was assessed by the ATO to be liable for directors' penalty tax of over $1m under s 222AOC of the ITAA 1936 for non-remitted withholdings of PAYG deductions from the salaries and wages of company employees. Before the Commissioner could recover the penalty, he was required to give a notice to the director under s 222AOG which gave the director 14 days to take one of a number of steps (including for example placing the company under administration).

On 29 November 2007, notices were sent by post to the director at her home address. The notices were delivered on 30 November 2007 and received by the director on 1 December 2007. On 14 December 2007, an administrator was appointed to the companies. The Commissioner sought to recover the penalty on the basis that the companies had not been put into administration within the 14-day period as required.

At first instance, in *DCT v Soong* [2009] NSWSC 495, the Supreme Court followed the majority decision of the NSW Court of Appeal in *DCT v Meredith* (2007) 69 ATR 876 and concluded that the 14-day period ran from the date of sending by post and that therefore the director remained liable for the penalty.

Decision

However, the Court of Appeal unanimously held that the 14-day period ran from the date of delivery of the notices, and not their posting. In doing so, it noted that s 222AOF provided that one way the Commissioner may "give" a s 222AOE notice was by sending it by post. It then found that in terms of s 29 of the *Acts Interpretation Act 1901* (which specifies what conduct that will constitute postal service in the absence of a contrary intention, and the date of service unless the contrary is proved), "service" is deemed to have been effected at the time at which the document would be delivered in the ordinary course of post.

In arriving at this conclusion, the Court of Appeal held that the decision in *Meredith* should not be followed as it was "clearly wrong". Instead, the Court said that *Meredith* should have found that s 222AOF was subject to the first limb of s 29 of the *Acts Interpretation Act 1901* unless a contrary intention was established, and that in the absence of proof to the contrary, the second limb of s 29 was invoked such that service of the notice was deemed to have been effected at the time of delivery in the ordinary course of post.

Source: *Soong v DCT [2011] NSWCA 26, Supreme Court of NSW, Court of Appeal , Gzell J, Allsop P, Giles, Hodgson, Tobias JJA, 25 February 2011*

GIC and SIC Rates

The Tax Office has advised that the General Interest Charge (GIC) and Shortfall Interest Charge (SIC) rates for the 4th quarter of the 2010–11 financial year (i.e. 1 April 2011–30 June 2011) are as follows:

- GIC annual rate is 11.92%;
- GIC daily compounding rate is 0.03265753%;
- SIC annual rate is 7.92%;
- SIC daily compounding rate is 0.02169863%.

The Tax Office also says the Interest on Overpayments, Interest on Early Payments and Delayed Refunds Interest rate is 4.92%.

Source: ATO publications, "General Interest Charge (GIC) rates", 4 March 2011 <http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/2832.htm> and "Shortfall Interest Charge (SIC) rates", 4 March 2011 <http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/65367.htm>

Labour Hire Firms and Splitting Income Warning

On 2 March 2011, the ATO issued Taxpayer Alert TA 2011/2 warning taxpayers against an arrangement where a labour hire firm utilises a discretionary trust for the purpose of alienating income from personal services and splitting it between the individual taxpayers who perform the services and their associates (e.g. a spouse or partner).

The ATO claims there is limited economic rationale for the use of the arrangement, aside from attempts to circumvent the personal services income (PSI) regime. The ATO says the arrangement, or certain steps in it, may constitute a sham at general law. The Commissioner also reminded firms entering into such arrangements that they may not be withholding the appropriate amount of tax and providing the correct superannuation support to the individual participants, and may be liable for penalties and charges under the *Taxation Administration Act 1953* (TAA) and the *Superannuation Guarantee (Administration) Act 1992* (SGAA).

The arrangement

The Alert applies to arrangements with features substantially equivalent to the following:

1. A firm (the labour hire firm) offers remuneration structures for individuals who perform work or provide services (the service provider).
2. The service provider enters into an agreement to become a beneficiary of a discretionary trust (discretionary trust) which is associated with the labour hire firm. This agreement also identifies additional beneficiaries (e.g. the service provider's spouse) and the basis on which the trustee will allocate discretionary distributions. No assets are transferred to or held by the trust.
3. The service provider or the labour hire firm enters into a contract to provide services for a client of the labour hire firm (the end user).
4. In some cases, the end user may use a recruitment agency (the recruitment agency) as an intermediary to contract with the service provider via the labour hire firm to provide services to the end user.
5. In either situation, the labour hire firm may either enter into contracts in its own capacity or in its capacity as trustee of the discretionary trust.
6. The service provider then performs work or services for the end user.
7. Once work is performed or services provided, the labour hire firm invoices either the recruitment agency or the end user.
8. Payment for work performed or services provided are paid by the labour hire firm via the discretionary trust. Although the service provider is not guaranteed to receive any distributions from the discretionary trust, the discretionary trust makes payments on a regular basis to any one of, or a combination of, the following: a) the service provider; or b) an associate or associates of the service provider, typically a spouse or partner.
9. Although distributions are purportedly discretionary, in reality, the total amount of the payments are consistent with the service provider's set rate of remuneration less the management fees deducted by the labour hire firm.
10. There is limited economic rationale for the use of the arrangement, aside from the attempted avoidance of taxation or superannuation guarantee obligations.

ATO concerns

The ATO considers that arrangements of this type give rise to the following issues relevant to taxation laws, being whether:

- the arrangement, or certain steps within it, may constitute a sham at general law;
- there may be an agency relationship between any of the entities involved;
- any entity may be considered an employer;
- the service provider is an employee or independent contractor either at general or statutory law;
- the alienation of the personal services income regime in Pt 2-42 of the ITAA 1997 may apply;
- any income that has been alienated may be income of the service provider under s 6-5 of the ITAA 1997;
- any expenses incurred may be deductible under s 8-1 of the ITAA 1997;
- the arrangement may constitute a scheme to which the general anti-avoidance rules may apply;
- amounts should be withheld under the PAYG(W) rules in Pt 2-5 of Sch 1 to TAA;

- a minimum level of superannuation support may be required under the SGAA;
- the arrangement may constitute an arrangement which avoids payment of the superannuation guarantee charge to which s 30 of the SGAA may apply;
- any entity involved in the arrangement may be a promoter of a tax exploitation scheme.

TIP: The Commissioner has given anyone who has participated in such arrangements until 30 April 2011 to contact the Tax Office for guidance. Mr D'Ascenzo said taxpayers will be entitled to a reduction in any penalties that might apply if an arrangement is proved to be ineffective.

TIP: Tax agents with information about people or companies who may be promoting arrangements covered by the Alert or other arrangements of concern should also call the ATO on 1800 177 006.

Source: ATO Taxpayer Alert TA 2011/2 <http://law.ato.gov.au/pdf/tpa/tpa1102.pdf>

Calculating Distributable Surplus when Tax Bill Amended

The ATO has released a Decision Impact Statement on the Full Federal Court's decision in *FCT v H* [2010] FCAFC 128. The case concerned when income tax and GIC assessed by an amended assessment are "present legal obligations" for the purposes of calculating a company's net assets and distributable surplus.

The case involved a taxpayer who was a director and shareholder of a company. In 2004, the taxpayer made a voluntary disclosure of an arrangement whereby the company had understated its income. In addition, under the arrangement, payments were made by the company to the taxpayer's bank account. The years in question were the income years ended 30 June 1999 to 30 June 2003. In 2007, the Commissioner issued amended assessments to the company for tax on the undeclared income plus penalties and interest. At the same time, the ATO issued assessments to the taxpayer for deemed dividends pursuant to s 109C(1) of the ITAA 1936 in respect of the payments made to him or on his behalf.

In calculating the company's distributable surplus for the purposes of Div 7A, the Commissioner did not subtract any amount of tax payable by the company under the amended assessments made in 2007 from its net assets, as the tax payable under the amended assessments was not considered to be a present legal obligation of the company as at the end of the relevant income years. Similarly, the Commissioner did not subtract any amount of GIC in calculating the company's net assets.

The Full Federal Court dismissed the Commissioner's appeal from the decision of the AAT and held that the obligation to pay tax at the amount subsequently properly ascertained, assessed and determined was a "present legal obligation" as at the end of the financial year in respect of which the income is derived. It also held that GIC becomes a "present legal obligation" on each day on which tax that should have been paid remains unpaid.

ATO view of decision

The ATO said the decision applied the following principles in calculating the distributable surplus for the purposes of s 109Y(2) of the ITAA 1936.

Income tax: The obligation to pay income tax for a particular year of income is a present legal obligation of a company at the end of that year of income. That obligation is to pay tax that is subsequently properly assessed.

If an amended assessment is made in relation to a particular year of income, the calculation of distributable surplus (where relevant) in relation to that year is similarly amended to reflect the tax payable on the amended assessment. That is, an amended assessment is a present legal obligation of the year to which it relates, rather than the year in which it is made.

While the Full Federal Court referred specifically to years of income ending on 30 June, the ATO says the decision will also apply to companies which have a substituted accounting period.

GIC and SIC: The Court and the Tribunal considered that, because liability to GIC accrues on a daily basis as a direct consequence of the fact that tax remains unpaid after the due date, GIC is considered to be a present legal obligation on each day the amount remained unpaid.

GIC payable due to an amended assessment is treated as a present legal obligation in the year in which it accrues (unless it is subsequently remitted).

The Commissioner notes that the assessments before the Court were for the years ended 30 June 1999 to 30 June 2003 (inclusive), and that amendments were made to the GIC regime by the *Income Tax Amendment (Improvements to Self Assessment) Act (No 1) 2005*. Those amendments revised the due date for tax payable under amended assessments, and introduced the Shortfall Interest Charge (SIC).

Tax shortfall penalty: The Tribunal's decision on tax shortfall penalty was not appealed to the Federal Court and it accordingly stands. Tax shortfall penalty is not a present legal obligation of a company until an assessment of shortfall penalty is made.

ATO administrative treatment: The ATO said it is reviewing Taxation Determinations TD 2007/28 and TD 2008/28, and will administer s 109Y in accordance with the decision of the Full Federal Court.

Source: ATO Decision Impact Statement on *FCT v H*
http://law.ato.gov.au/atolaw/view.htm?docid=%22LIT%2FICD%2FNSD211of2010%2F00001%22

Watch Out for Scammers, says Tax Office

The Commissioner has reminded taxpayers to be aware of scam behaviour and to report anything suspicious. The ATO says scammers use phone calls, letters, text messages, emails, bogus websites and even job advertisements to try to obtain personal information. It adds that once scammers have this information they can steal an individual's identity and commit fraud. Victims of scams can contact the ATO on 13 28 61 (8.00am to 6.00pm, Monday to Friday). Suspect emails can be forwarded to the ATO at ReportEmailFraud@ato.gov.au.

Source: ATO media release No 2011/17, 7 March 2011
<http://www.ato.gov.au/corporate/content.asp?doc=/content/00272234.htm >

Eye Glasses Discount Deal Throws New Light on GST Calculation

In a unanimous decision, the Full Federal Court has dismissed the Commissioner's appeal and affirmed that the value of a supply that is partly taxable and partly GST-free should be calculated based on the actual consideration received for the taxable component.

Background

The facts were not in dispute. The taxpayer is the representative member of a GST group. The members of the group are retailers of spectacles. During the relevant tax periods, the taxpayer ran various promotions. Under these promotions, spectacle frames were offered at a discount but on the condition that customers acquired lenses for those frames. However, no discounts were offered for the lenses.

The contentious issue between the taxpayer and the Commissioner was whether the discount should be apportioned between the frames and the lenses when calculating the value on the frames, bearing in mind that the supply of the frames attracts GST whereas the supply of the lenses is GST-free. The approach to be adopted would impact on the amount of GST payable.

The Commissioner contended that the discount on the frames should be deducted from the combined purchase price of the frames and the lenses when calculating the value on the frames pursuant to s 9-80 of the GST Act. Conversely, the taxpayer submitted that the discount should be deducted from the price of the frames only.

At first instance, the AAT in *AAT Case [2010] AATA 22, Re Luxottica Retail Australia Pty Limited and FCT* (2010) 75 ATR 169 agreed with the taxpayer.

Decision

In arriving at its decision, the Full Court considered whether the sale of spectacles (comprising of a frame and lenses) was a single supply or two supplies. The Court agreed with the AAT that the sale of spectacles was a single supply. While the Court acknowledged the term "supply" is defined broadly, it said the term "nevertheless invites a commonsense, practical approach to characterisation". It said the difference in GST-treatment of the lenses and frames did not alter that characterisation. Having concluded that the sale of spectacles was a single supply, the Court noted that s 9-80 of the GST Act prescribes a formula to be used in calculating the value of a supply that is partly taxable and partly GST-free.

The Full Federal Court said the difficulty with the formula is that "it uses the concept of the 'value of the actual supply' on both sides of the equation". It acknowledged the Commissioner's suggestion that the difficulty might be overcome by dividing the value of the taxable supply by the value of the total supply when calculating the "taxable proportion" (a component in the denominator of the formula). However, the Court said this suggestion suffered from the "same defect as the formula". It also said the Commissioner's comment that the formula appears to use the concept of value of the actual supply on both sides of the equation was "unnecessarily coy". Through a series of mathematical notations, the Full Court concluded that the formula in s 9-80 could not "be made to work" and was "impenetrably circular".

The Full Federal Court noted that the contentions of both the taxpayer and the Commissioner placed an emphasis on price. The Commissioner focused on each price for which the frames and lenses were sold separately as a fair and reasonable measure of their value when sold as a complete pair of spectacles, whereas the taxpayer focused on the price agreed between itself and its customers.

In the Court's view, the Commissioner's contention meant that the value of the frames was calculated on a "notional price" which was never agreed between the taxpayer and its customers. It observed that while the Commissioner asserted that this price was a fair and reasonable measure of the value of the frames, no explanation was provided as to why it was a better measure of the value of the taxable supply than the agreed price between the taxpayer and its customers.

The Full Court stated that the value of a supply was generally a matter of fact and not of law. It examined the AAT's findings and concluded that the Tribunal made a "considered decision" based on the findings of fact. Therefore, the Court said the Commissioner's position amounted to a "disagreement with the factual basis of the Tribunal's decision".

Source: *FCT v Luxottica Retail Australia Pty Ltd [2011]* FCAFC 20, Full Federal Court, Ryan, Stone and Jagot JJ, 23 February 2011 <http://www.austlii.edu.au/au/cases/cth/FCAFC/2011/20.html>

TIP: The Court's method may result in a lower amount of GST payable than the method contended by the Commissioner in the case.

The Full Court's decision in *Luxottica* is a departure from the Commissioner's established views regarding the apportionment of a discount on a mixed supply. In GST Ruling GSTR 2001/8, the Commissioner states, at [98] to [100]:

98. Where it is possible to determine the price for which each part would have been supplied if it was supplied separately (for example, the general retail market price for which the goods are sold), then an apportionment on this basis may be reasonable. If you use this method, the GST you pay is the same as if you supplied the taxable parts separately in the same market.

99. Where you cannot establish an appropriate market price for which particular goods are sold, then it may be reasonable for you to use a relevant market price for a similar supply (or an industry standard), to determine the appropriate price of the particular goods.

100. In many cases, you may make a mixed supply for a package price. The package price for the mixed supply may be discounted. It may be reasonable for you to apply the discount to the usual market selling price of each part, unless special circumstances exist. On this basis, you may discount the price of each item proportionately according to the consideration for the mixed supply.

Potentially, the Full Court's decision has opened up Pandora's box. It is not difficult to imagine many taxpayers have complied with the Commissioner's view as set out in GSTR 2001/8. However, caution should be exercised before taxpayers seek to amend their Business Activity Statements lodged to claim a refund for overpayment of GST. The Tax Office has yet to issue a Decision Impact Statement on the decision (at the time of going to press), so there remains uncertainty in this respect.

Tax Office's Approach to Self-Managed Super Funds Affected by Floods

In a recent speech, the Commissioner noted that self-managed super funds (SMSFs) that own flood or cyclone-damaged buildings under the limited recourse borrowing arrangements in ss 67A and 67B of the SIS Act may be prevented from making improvements. While the Commissioner does not have a discretion to treat an improvement as a repair, he said the Tax Office will not be seeking to make fine distinctions having regard to what is available to repair what has been damaged.

Where an SMSF trustee needs to borrow funds to finance repairs that contravene the limited recourse borrowing provisions due to a natural disaster, the Commissioner said he would be favourably inclined to exercise his discretion under s 42A(5) of the SIS Act to continue to treat the super fund as complying. Mr D'Ascenzo said the Tax Office is currently reviewing this matter with APRA and Treasury to ensure no unintended consequences arise.

Source: Commissioner's address to the SPAA National Conference in Brisbane on 23 February 2011

CURRENCY: *This issue of The Report takes into account all developments up to and including 22 March 2011.*