THE TAX INSTITUTE

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Solving Inherited Problems

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1 Introduction

This paper addresses what to do when you take on a client that has pre-existing 'tax issues'. In this case such pre-existing issues could be a past incorrect treatment of an item or transaction, a structure currently in place that does not work as promised or expected, or potentially advice that the client has received that they expect you to act on in future.

In deciding how to deal with such issues you need to:

- Identify the issue(s);
- Identify the taxpayer(s);
- Identify what year the issue relates to;
- Determine when an issue is out of time to be looked at;
- Consider what the ATO's administrative practices are, particularly in relation to trusts;
- What might enliven an open ended assessment – particularly 'evasion' and what this might mean.

While the overall focus of the paper is on issues that are adverse to a taxpayer, there may be times where the 'issue' is that an item or transaction has been treated incorrectly in the past so that the taxpayer is due a refund. Much the same process applies in dealing with either adverse or beneficial issues (identification of the issue, the taxpayer, the year, whether you are within time to request an amendment, etc.).

As a final point I have set out some comments on what to do if you are the cause of the pre-existing tax issues.

References in this paper are to the *Income Tax Assessment Act 1936* (Cth) (ITAA1936), *Income Tax Assessment Act 1997* (Cth) (ITAA1997), *A New Tax System (Goods & Services Tax) Act 1999* (Cth) (GST Act), the *Fringe Benefits Tax Assessment Act 1986* (Cth) (FBT Act) and the *Taxation Administration Act 1953* (Cth) (TAA1953).

2 Issue(s) and taxpayer(s)

This paper is directed towards a situation where you have recognised that a client has a tax issue that needs to be dealt with. It needs to be emphasised however that, given the complexity of taxation law, the first issue that gets identified may not be the only issue that may need to be dealt with.

Examples of where I have found that the issue initially identified was not the only issue that needed to be dealt with include:

- Where the derivation of personal services income and a failure to properly apply the PSI rules was identified as the issue, but if the PSI tests were satisfied Part IVA became an issue.
- Where Division 7A was identified as the relevant issue, but there were also interest deductibility issues.
- Where interest deductibility for a trust was considered to be an issue, but on review distribution minutes had not been prepared within the time prescribed by the deed.

As well it is not always clear who the taxpayer is that is affected by the issue identified. Usually this occurs in relation to trusts, where a change in the tax law income of the trust does not necessarily impact on the beneficiary that received a distribution that year, but may impact instead upon the trustee or another beneficiary. In relation to a trust where its taxable income is adjusted it is necessary to:

1. Review the deed to determine what the income of the trust is;
2. Review the distribution resolution or minute for the year in question and determine whether it dealt with the trust income in such a way that you can determine where an adjustment to the tax law income will flow.
3. Determine which beneficiary, or the trustee, will bear the tax impact of the adjustment and in what proportion.

It is the case however that mistakes are made in relation to identifying the entity that is impacted by an issue. For instance, I have had it said to me that Division 7A operating to deem a loan to be a dividend has negative implications for the private company concerned, but this has not been the case since 1 July 2006 when the requirement debit to the franking account when a deemed dividend arose was removed.

3 Identify the year

Tax returns are lodged for a year of income and usually an assessment is issued as a result of the lodgement. GST returns are lodged for a BAS period, and FBT returns are lodged for an FBT year.

Tax law provides limits on the period within which the Commissioner can amend an assessment.

If an issue has an impact on an assessment that is out of time for amendment, then the issue is, in effect, a non-issue. To determine that this is the case however it is necessary to identify the year to which the issue relates.

While it is usually easy to identify which year of income an issue relates to, it is not always obvious. As two examples, consider Division 7A (a common SME issue) and CGT (a common issue for most taxpayers).

3.1 Division 7A

Division 7A of the ITAA1997 contains a set of provisions governing the dealings between a private company (and some limited liability companies treated as private companies) and their shareholders and associates of their shareholders.

Division 7A is aimed at preventing a private company from making tax-free distributions to its shareholders or their associates by way of loans, payments and debt forgiveness, and can treat such transactions as deemed unfranked dividends.

If the issue was that someone had been loaned an amount by a private company, that a forgiveness had occurred in relation to a debt owed to a private company, or that a private company had made a payment to or for the benefit of the person, the starting point in identifying how to deal with the Division 7A issue is to consider in which year the Division 7A issue arose.

Division 7A operates on a year-by-year basis.

In relation to a loan by a company or a trust it is the amounts loaned in a particular year that can be treated as deemed dividends.

As an example the starting point in considering whether a 'debit loan' balance of $1 million at 30 June 2012 is an issue it is necessary to determine whether that loan came about in the 2012 financial year, or whether it has built up over a number of years. If it has built up over a number of years it is necessary to determine in which years it arose. Note that this point is complicated by the operation of section 109R (dealing with repayments)[1].

The year in which a deemed dividend arises is also important as it can impact on distributable surplus even if there is no amount shown as a deemed dividend in someone's return.

[1] I covered this point in my paper 'Division 7A' at the 6th NSW Annual Tax Forum in 2013.

Where Division 7A operates on the forgiveness of an amount, it operates at a point in time when a loan is forgiven. Legal forgiveness is not necessary for the forgiveness of an amount to be treated as a trigger for a Division 7A deemed dividend. Under Division 7A it is only necessary that (section 109F(6)):

> An amount of debt an entity (the ***debtor***) owes a private company is also ***forgiven*** for the purposes of this Division if a reasonable person would conclude (having regard to all the circumstances) that the private company will not insist on the entity paying the amount or rely on the entity's obligation to pay the amount. (The amount is forgiven when a reasonable person would first reach that conclusion.)

In relation to forgiveness there is also an ordering rule that provides that it is the earliest time that a debt could be taken to be forgiven that is the time at which the debt is forgiven.

In relation to payments the potential for a deemed dividend arises at the point when a payment is made.

3.2 CGT

In relation to capital gains tax events the time that an event is taken to occur is set out in the section providing for the CGT event. For instance, in relation to CGT event A1 the law provides in subsection 104-10(3):

> (3) The time of the event is:
>
> (a) when you enter into the contract for the * disposal; or
>
> (b) if there is no contract--when the change of ownership occurs.
>
> Example: In June 1999 you enter into a contract to sell land. The contract is settled in October 1999. You make a capital gain of $50,000.
>
> The gain is made in the 1998-99 income year (the year you entered into the contract) and not the 1999-2000 income year (the year that settlement takes place).

While it is widely accepted by tax practitioners that for an ordinary disposal to which CGT event A1 applies that contract date is the relevant date, sometimes there is difficulty in determining when the contract was formed. For example in *Scanlon and Commissioner of Taxation* [2014] AATA 725 the time of contract was found to be at the time that a binding letter of offer was signed, and not when a formal contract was entered into.

In addition there will be confusion about the timing of disposal where the acquirer of an asset is the trustee of a trust. The Federal Court consider that the time of the CGT event where the acquirer is a trustee is the time of transfer (as CGT event E2 applies) as set out in *Healey v Commissioner of Taxation* [2012] FCA 269. The Commissioner however only considers this to be the case if the acquirer of an asset is a trustee and a related party as set out in ATO ID 2003/559.

4 Time limits

There are time limits on the Commissioner amending an assessment in relation to income tax, FBT and GST. In relation to income tax the relevant provisions are found in section 170 of ITAA 1936. For GST the relevant provisions are in section 105-50 of Schedule 1 to the TAA 1953 (for periods that started before 1 July 2012) and in section 155-35 of Schedule 1 to the TAA 1953 (for periods starting on or after 1 July 2012). For FBT the relevant provision is section 74 of the FBT Act.

An amended assessment is an assessment for these purposes, and note that an amendment can extend the time for further amendments to the assessment (subsection 170(3) of ITAA 1936). From 2004-05 subsection 170(1) also applies for nil assessments.[2]

Taxpayers are afforded the ability to extend the time periods for amendment, and the Commissioner is entitled to apply to the Courts for an extension of time if he does so within the limited time periods.[3]

4.1 Income tax

The time limits in subsection 170(1) are set out separately for individuals, companies, and entities assessed as trustees. The provisions for an individual are:

Amendment of assessments	
Time of amendment	Qualification
The Commissioner may amend an assessment of an individual for a year of income within 2 years after the day on which the Commissioner gives notice of the assessment to the individual.	This item does not apply: (a) if the individual carries on a business at any time in that year unless the individual is a small business entity for that year; or (b) if the individual is a partner in a partnership that carries on a business at any time in that year unless the partnership is a small business entity for that year; or (c) to an individual in the capacity of a trustee of a trust estate at any time in that year (see item 3 for this case); or (d) if the individual is a beneficiary of a trust estate at any time in that year unless the trust is a small business entity for that year or the trustee of the trust (in that capacity) is a full self-assessment taxpayer for that year; or (e) if it is reasonable to conclude that any person entered into or carried out a scheme (either alone or with others) for the sole or dominant purpose of the

[2] There are special provisions concerning 2003-04 and earlier years assessments where no tax was payable set out in section 171A of ITAA1936.

[3] See subsection 170(7) of ITAA 1936 and subsection 155-35(3) of the GST Act.

> individual obtaining a scheme benefit in relation to income tax from the scheme for that year; or
>
> (f) in any other circumstance prescribed by the regulations.
>
> This item is subject to items 5 and 6.

The provisions for companies and trusts are almost identical and are in item 2 and 3 of the table.

If the 2-year time limits in items 1 – 3 do not apply then the time limit becomes 4 years under item 4.

Item 5 provides that the Commissioner can amend at any time if he or she is of the opinion there has been fraud or evasion. Item 6 then provides for an unlimited period of amendment where it is necessary to give effect to a decision on review or appeal, and where it is necessary to give effect to an objection decision or a pending review or appeal.

In relation to items 1 – 3 the following observations need to be made:

1. It is not always easy to determine whether an entity is a small business entity, given the need to take into account the turnover of the entity, its affiliates, and entities connected with the entity.
2. Simply being a potential beneficiary of a trust is enough to give the Commissioner 4 years to amend - *Yazbek v Commissioner of Taxation* [2013] FCA 39.
3. While the words 'if it is reasonable to conclude that any person entered into or carried out a scheme (either alone or with others) for the sole or dominant purpose of the individual obtaining a scheme benefit in relation to income tax from the scheme for that year' appear to mirror Part IVA, it is not necessary for Part IVA to apply for an amendment to occur in these circumstances - *Kocharyan v Commissioner for Taxation* [2015] FCA 13.
4. The time period begins from the time that the Commissioner 'gives' the notice of assessment to a taxpayer, meaning that the time will begin from the time that the letter would have been delivered in the ordinary course of post (assuming that is the method of delivery)[4], and can be presumed to have been received on the fourth working day after having been posted[5].

Following the decision in *Yazbek* the Commissioner issued a decision impact statement[6] setting out that he would not change his compliance approach in relation to individuals and would only amend outside of the 2 year period for a person that is merely a beneficiary of a trust unless the individual's case is 'complex'. The ATO give three examples:

> in audits of high wealth individuals and family groups (whether or not the individual received a distribution from the trust in that income year), particularly where there is a close familial relationship between the beneficiary and the trust, the beneficiary is actively involved in the administration of the trust and / or the beneficiary is able to influence the distribution of income or capital from the trust; or

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[4] Section 29, *Acts Interpretation Act 1901* (Cth).
[5] Section 160, *Evidence Act 1995* (Cth).
[6] http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/NSD1471of2012/00001

> where there is an adjustment to the taxable income of the individual emanating from compliance action in respect of the trust; or
>
> in other circumstances involving complexity, including complex audits relating to claims for work-related expenses which cannot be concluded within two years.

The ATO do not seek to limit themselves to two years in the case of companies.

It is important, depending upon the issue, to also consider the implications of the regulations made for the purposes of Section 170 – Regulation 20 of the *Income Tax Regulations 1936* (Cth). Some of the more relevant of the 8 items set out in regulation 20 are:

- Where there is a non-arm's length dealing between associates the Commissioner has 4 years to amend.
- Where Division 7A applies and the company is subject to a 4 year period of review the Commissioner has 4 years to include an amount in the assessable income of a shareholder or associate under Division 7A.
- Where 'taxpayer has not identified income (ordinary or statutory) from one or more foreign transactions for the purposes of, or in the course of, an assessment' and the income is not from a resident investment vehicle the Commissioner has 4 years to amend an assessment.
- If Section 45B (demergers and capital benefits), 177E (dividend stripping), section 177EA (franking credit streaming), section 270 of Schedule F (income injection test), section 165-180 – 165-205 (schemes around COT), Division 175 (schemes to use losses) or Subdivision 207-F (not qualified person for franking credits, dividend strips, etc.) apply then the Commissioner has 4 years to amend an assessment.

In most cases once the year that the issue relates to has been identified, and section 170 has been reviewed it becomes clear when the issue will be out of time. If the issue is already out of time then nothing more can be done – unless you want to do something, as it is possible for a taxpayer to request that the Commissioner treat an objection as if it has been lodged within time. If the issue is not out of time (because there is no amendment period or because it has not yet expired) then it is necessary to consider what action to take.

It is noted that in relation to transactions where an assessment includes an estimate of profits (such as in a long term construction contract) or profits and gains of a capital nature the Commissioner is given 4 years from time that the overall profit or loss is ascertainable to amend an assessment to reflect the correct position (subsection 170(9)).

As well, for transfer pricing purposes, there is a 7 year amendment period (subsection 815-150(1)).

4.2 GST

The position in relation to GST is complicated by the fact that until periods beginning on or after 1 July 2012 the GST law did not give rise to an assessment unless the Commissioner raised such an assessment.

For periods beginning prior to 1 July 2012 section 105-50 provided that an unpaid net amount ceased to be payable 4 years after it became payable. Rather than being a barrier against the Commissioner

raising an amended assessment or an assessment outside of this time, it operated as a barrier against collection if an assessment was raised outside of the 4 year period. The Commissioner has an unlimited period of time where fraud or evasion has occurred, or where he has given a notice under section 105-50.

For periods beginning on or after 1 July 2012 a deemed assessment is received when a BAS is lodged (section 155-15 of Schedule 1 to the TAA 1953). That assessment cannot be amended after 4 years have passed since the Commissioner gives a taxpayer a notice of assessment unless fraud or evasion occurred.

For GST, it is also possible that unclaimed credits will become out of time. Section 105-55 of the GST Act provides that you are not entitled to a refund or credit unless you have notified the Commissioner of your entitlement to the refund or credit within 4 years of the end of the tax period to which the refund or credit relates. If you do want to give notice within 4 years then the standard for a notice is not high – refer to *North Sydney Developments Pty Ltd and Commissioner of Taxation* [2014] AATA 363 where a letter to the Commissioner identified the period and merely stated that the '…letter was to "provide notice that substantial GST refunds are due for these months".'

In relation to GST, it is important that where a matter is within time for a refund that the Commissioner is notified promptly. In relation to amounts payable, as with income tax, if it has been identified that an amount is out of time, there is no more to be done. Where the issue is within time to be dealt with however consideration needs to be given as to what to do.

4.3 FBT

The lodgement of an FBT return gives rise to a deemed assessment under section 72 of the FBT Act where an assessment is deemed to have been given on the day the return is furnished.

The provisions dealing with the amendment of FBT returns do not accurately reflect the current system of self-assessment, so that the time given to the Commissioner is 3 years, unless 'an employer does not make a full and true disclosure of all the material facts necessary for an assessment of the tax payable by the employer' and there is an avoidance of tax, in which case the Commissioner has 6 years. Given the self-assessment system only involves completing the fields set out in an FBT return and lodging it, there is effectively a 6-year amendment period for FBT.

A reduction in the FBT liability is not permitted 3 years after the date of the original assessment.

The Commissioner has an unlimited time to amend an assessment for FBT where there is fraud or evasion.

As a practical aside, it is always worth lodging an FBT return so that the 6-year period begins to run from the time the return is furnished to the Commissioner.

5 No time limits

There are a number of instances where there will be no time limit on a taxpayer or the Commissioner dealing with a tax issue.

The most obvious of these is where the issue has not been the subject of an assessment, so that an original assessment can be raised.

5.1 Trustee assessments

Where a trustee lodges a return it only receives an income tax assessment if it is liable to tax on the income of the trust on behalf of a beneficiary, or on income to which no beneficiary is presently entitled.

If a trustee does not receive an assessment for a year of income then it will always remain open to the Commissioner to raise an original assessment for the particular year. The Commissioner, in PS LA 2015/2 recognised that the potential unlimited time period is inconsistent with the outcome contemplated by the *Report on Aspects of Income Tax Self Assessment* of August 2004 that taxpayers lodging returns that give rise to a nil liability should be subject to a limited period of review.

PS LA 2015/2 sets out the Commissioner's non-binding administrative position that he will not issue an original trustee assessment more than four years after the relevant trust tax return was lodged. In addition for the year ended 30 June 2014 he intends to limit himself to two years for a trust that is a small business entity in circumstances where, had an assessment been issued, he would have been limited to 2 years.

The time limits will not apply if the Commissioner is of the opinion that fraud or evasion has occurred, where the amendment would otherwise not be limited in time, or where the time limit is extended.

The practice statement acknowledges that the Commissioner wants to 'escalate' cases where a trustee might be out of time to be assessed based on his administrative practice, in situations where there is a tax adjustment but there will be no ability to tax a person. He gives the example of a beneficiary within four years of their assessment being given to them asking for a refund of tax on the basis that they are not presently entitled, at a time when the relevant trustee would be out of time to be assessed.

5.2 Statutory provisions

There are provisions of both the ITAA 1936 and the ITAA 1997 that, if they operate, give the Commissioner an unlimited period of time to amend an assessment. Those provisions are in section 170(10) and 170(10AA) of ITAA 1936. Some of the more interesting items when the Commissioner is given unlimited time are in relation to:

- Section 100A of ITAA 1936 – the 'reimbursement agreement' provision.

- Section 26-25(3) of ITAA 1997 – where a deductions is disallowed if withholding tax is not paid, an amendment can be made at any time to allow the deduction once the withholding tax is paid.
- Section 83A-310 – which allows for a refund of tax paid if shares or rights are forfeited in some circumstances.
- Any CGT provision where the time of the CGT event is decided by the time that a contract is entered into.
- Giving effect to the non-receipt and repaid rules for capital proceeds for CGT.

In relation to the indefinite period for CGT events that are determined by the time that a contract is entered into, the decision in *Metlife Insurance Limited v Commissioner of Taxation* [2008] FCAFC 167 confirms that the Commissioner does not have an indefinite period where a contract has settled before an assessment has been made.

Additionally there are some circumstances where the Commissioner is given an extended period of time for reasons that appear to be or are beneficial to a taxpayer:

- Where a ruling is applied for before the end of a period of review, and the Commissioner makes a private ruling, the Commissioner can amend to give effect to the private ruling (subsection 170(6));
- Where the amendment is necessary to reflect for CGT purposes that a contract is void *ab initio* (subsection 170(9D)); and
- Where an amendment is made to reduce an assessment because of a transfer pricing adjustment (subsection 170(11)).

The ruling point is the one that only appears not to be beneficial as the outcome of the ruling may be positive or negative for a taxpayer.

5.3 Fraud or evasion

In the case of income tax, GST and FBT the Commissioner is given an unlimited period of review where he is of the opinion that fraud or evasion has occurred.

The Commissioner's views on what constitutes fraud or evasion are contained in PS LA 2008/6.

5.3.1 Fraud

Of the two types of conduct that might give rise to an unlimited period of review fraud is the easiest to understand, and, potentially, to recognise. Though the term fraud is not defined for tax purposes it meaning for the purposes of former section 170(2)(a) of ITAA 1936 (where an assessment could be amended at any time if the Commissioner was of the opinion that there was fraud or evasion) was confirmed as being something in the nature of fraud at common law in *Kajewski & Ors v FC of T* [2003] FCA 258:

> Fraud within s 170(2)(a) involves something in the nature of fraud at common law, ie, the making of a statement to the Commissioner relevant to the taxpayer's liability to tax which the maker believes to be false or is recklessly careless whether it be true or false.

Common law fraud occurs where a false representation has been made knowingly, without believing it to be true, or recklessly, without care as to whether it is true or false.[7]

It appears clear that for fraud to have occurred the fraud needs to occur at the time that the representation is made, that is when the relevant return or statement was made.

5.3.2 Evasion

Evasion is more difficult to define than fraud, and in *Denver Chemical Manufacturing Co. v Commissioner of Taxation* 79 CLR 296 Dixon CJ said 'I think it unwise to attempt to define the word 'evasion''.

In *Regina v Meares Matter No Cca 60468/97* [1997] NSWSC 458 Gleeson CJ stated (emphasis added):

> Although on occasion, it suits people, for argumentative purposes, to blur the difference, or pretend that there is no difference, between tax avoidance and tax evasion, the difference between the two is simple and clear. Tax avoidance involves using, or attempting to use, lawful means to reduce tax obligations. Tax evasion involves using unlawful means to escape payment of tax. Tax avoidance is lawful and tax evasion is unlawful. Although some people may feel entitled to disregard that difference, no lawyer can treat it as unimportant or irrelevant. It is sometimes said that the difference may be difficult to recognise in practice. I would suggest that in most cases there is a simple practical test that can be applied. If the parties to a scheme believe that its possibility of success is entirely dependent upon the revenue authorities never finding out the true facts, it is likely to be a scheme of tax evasion, not tax avoidance.

In *Barripp v Commissioner of Taxation* (1941) 6 ATD 69 Mr Barripp did not return income from the sale of his property in 1927 because he said he had received advice from his accountant that the amount was not assessable until the mortgage on the properties on which the profit was made were paid off. An amended assessment including the profit was issued in 1938. It was the case that he had received funds in prior years from similar transactions and paid tax on them. Mr Barripp did not contend that he had not informed his accountants of the profit, he said he had but that the advice was that the profit did not need to be included. The Board of Appeal and the NSW Supreme Court did not believe that Mr Barripp had received the advice he said he had. In the High Court, McTiernan J stated:

> The facts proved come down to these. The taxpayer received the omitted income in that year. He knew that he received it in that year. He omitted it from his income. He knew or the knowledge ought to be imputed to him that it was omitted. He gave as an explanation that he believed that it was not taxable in that year. But the question whether the excuse offered could change the complexion of the facts proved is only an abstract one because the reality of the excuse was not established. The case therefore stands in this situation. The appellant intentionally omitted the income from the return and there is no credible explanation before the court why he did so. His conduct in my opinion answers to the description of an avoidance of taxation at any rate by evasion.

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[7] *Derry v Peek* (1889) 14 App. Cas 337 at 373.

It is clear that, in finding that evasion occurred, it was the lack of excuse for why the amount was excluded from income when the relevant return was lodged that grounded the finding of evasion.

In *Denver Chemical Manufacturing Co. v. Commissioner of Taxation* 79 CLR 296 the Commissioner of Taxation had adopted a basis for assessing income tax to the company otherwise than on its profits. Tax was levied on a percentage of the sales of product in Australia by the company (which was incorporated in New York). This arrangement had been entered into in 1917. The manager of the Australian branch, as the result of a suggestion by a friend named Mr Wrigley, from 1923 only included sales made to persons in NSW in the company's returns. Nothing was communicated to the Tax Department concerning the change in reporting. In 1928 the Commissioner asked for profit and loss statements and balance sheets for the company. Despite obtaining these from the New York head office in 1929 the brank manager decided to withhold it from the Commissioner. In around 1941 the ATO began an audit and discovered the change in reporting. In 1941 the assessments for 1923 – 1934 were amended on the basis that there had been an evasion of tax.

In *Denver Chemicals,* Dixon CJ, after stating it was unwise to attempt to define evasion stated that (emphasis added):

> The context of s. 210 (2) shows that it means more than avoid and also more than a mere withholding of information or the mere furnishing of misleading information. It is probably safe to say that some blameworthy act or omission on the part of the taxpayer or those for whom he is responsible is contemplated. An intention to withhold information lest the commissioner should consider the taxpayer liable to a greater extent than the taxpayer is prepared to concede, is conduct which if the result is to avoid tax would justify finding evasion.

Having stated the above Dixon CJ noted that the Board of Appeal had concluded that Denver Chemicals intentionally omitted the income and that there was no credible explanation as to why, which fit the description of avoidance by evasion. His honour also noted that the majority of the Board expressed their conclusion by adopting the expressions used by McTiernan J in *Barrip* and he stated that this was a conclusion exhibiting no error of law.

His honour did not spell out what blameworthy acts amounted to evasion for him, though presumably this was the intentional omission of income without explanation.

The Commissioner, however, in summarising the *Denver Chemicals* case said that there was evasion as[8]:

> 64. Matters of a blameworthy nature before Dixon J included:
>
> · the Commissioner had provided advice to Denver on how to calculate its liability for tax and Denver's Mr Woodward chose to ignore this advice after receiving different advice from his neighbour
>
> · no clarification of the new method of returning sales income in 1923 or later years was sought by Denver from the Commissioner, and
>
> · Denver withheld profit and loss and balance sheet information from the Commissioner for the 1927 and 1928 financial years, which would have revealed sales income from outside NSW.

[8] PSLA 2008/6.

While the above points are consistent with the facts, they were not in fact set out as blameworthy acts by the High Court. Whether the 'no clarification of the new method' is in fact a blameworthy act of the kind referred to by the Chief Justice is in fact of paramount importance in considering what should be done in a case where a prior year issue is discovered or inherited.

In a case where someone becomes aware, after having lodged a return considering it to be correct, that it was in fact incorrect, the Commissioner's interpretation seems to suggest that choosing not to ask the Commissioner his view on what should be done would be grounds for a finding of evasion.

If the *Denver Chemicals* decision is read in context however, it is clear that it was the intentional omission of the income, without credible explanation, **at the time that the returns were lodged**, that was what led the Board, the Supreme Court, and ultimately the High Court to consider that a finding of evasion was not in error at law.

In *Australasian Jam Co Pty Ltd v Federal Commissioner of Taxation* [1953] HCA 52, another case on evasion referred to by the Commissioner in his practice statement, a company lodged returns on the basis that its closing stock could be valued at a standard cost established before or in 1914, even though this bore no relationship to real cost. On appeal in the High Court, Fullagar J did not consider what constitutes evasion, he merely examined whether the Commissioner had entertained the view that there was evasion, and whether that view was based on a misconception of law. It was found to be a view the Commissioner held, and one not based on a misconception. The Second Commissioner gave evidence on his views as to whether evasion occurred, which are recorded in the judgement as being summed up as:

> There has been, says the Commissioner, no deliberate attempt to deceive, and therefore the case is not one of fraud. On the other hand, it would be unreasonable to suppose, and it has not really been suggested, that those responsible for the company's income tax returns were ignorant of the requirements of s. 31. They continued to use in their accounts a figure which had once represented cost but which no longer represented cost. They returned, for income tax purposes, the accounts of the company as quite correctly and properly kept by it for its own purposes, but not adjusted so as to comply with s. 31. They would have supplied further true information, if they had been asked for it, but they hoped, says the Commissioner, that they would not be asked for it, and they allowed, if they did not actually invite, my assessors to make an assumption which they must have known was unfounded. I think, says the Commissioner, that there has been here more than a mere withholding of information which might or might not be relevant: I think that there has been an intentional withholding of information lest I should hold the company liable to tax to a greater extent than it was prepared to concede, and I regard this as "evasion".

Despite the above being quoted in the ATO practice statement as to what was 'held' by his honour, the judgement goes on:

> It is not for me to say whether the view outlined above is right or wrong. I am satisfied that the Commissioner did entertain such a view, and that such a view is not based on any misconception of law. And I am not able to say that it was an unreasonable view - still less that it was arrived at "capriciously or fancifully or upon irrelevant or inadmissible grounds". The result is that, in my opinion, all the amended assessments were authorized by the Act, and all the appeals fail.

As in *Denver Chemicals,* this was a case where at the time that returns were lodged the taxpayer was considered to have knowledge that the returns it was submitting were incorrect, and this was the basis for finding that there was evasion.

5.3.3 Is a failure to correct evasion?

Following the case law, failing to correct for an issue that has been discovered, if it is discovered after lodgement of the return, should not result in a finding that evasion has occurred. This is on the proviso that there is no evasion at the time the return was lodged, that is, that there is a credible explanation as to why the impact of an issue was omitted.

It will likely be necessary to determine as well that there was no evasion on the part of the agent concerned, as it is reasonable to consider that a taxpayer is responsible for the evasive conduct of their agent in the same way they are responsible for their fraudulent conduct.[9]

Delaying in responding to the Commissioner should he make enquiries could be a 'blameworthy act' in the *Denver Chemicals* sense according to the Commissioner's interpretation of the decision, but it is not clear that this should be the case.

It is not clear however, given the Commissioner's summary of *Denver Chemicals* in his Practice Statement whether he might assert (successfully or not) that failing to request an amendment or seek his guidance might amount to blameworthy conduct on which he could ground an opinion of evasion.

[9] *Kajewski & Ors v FC of T* [2003] FCA 258

6 Commissioner's determinations

There are instances in tax law where the Commissioner must make a determination before there is an amount that is assessable to a taxpayer, or before there is another tax consequence for a taxpayer.

For example, in Division 7A, if a loan is made through an interposed entity, the amount of the deemed dividend is the '… amount (if any) determined by the Commissioner …' (section 109W of ITAA 1936 as it operates with section 109T). Without the Commissioner having made a determination there is no amount that is a deemed dividend.

In section 45B of ITAA 1936, in its dealing with demerger benefits, the Commissioner may determine that section 45BA applies to the whole or part of a demerger benefit.

Under Part IVA of ITAA 1936 the Commissioner may make a determination to, inter alia, include an amount in assessable income, deny a deduction, disallow a capital loss or foreign tax offset.

From the way these and other provisions requiring the Commissioner to make a determination are couched, it is clear that they cannot apply without a determination by the Commissioner. In a self-assessment system, where no statutory obligation is imposed upon a taxpayer to ask the Commissioner what determination he may make, it is not clear why a taxpayer would ask the Commissioner to make a determination, save for the desire for certainty.

It is noted that there are other circumstances where advisers commonly make the determination that the legislation requires be made by the Commissioner without a second thought. For instance, in determining the tax residency of an individual subject to either the 'domicile test' or '183 day test' a person is only a non-resident if '… the Commissioner is satisfied that …' the person has a permanent or usual place of abode outside of Australia. Anecdotally advisers commonly 'self-assess' whether the Commissioner would be satisfied. While whether the Commissioner might be satisfied in a particular taxpayer's circumstances might be inferred from the Commissioner's rulings, without asking the Commissioner whether he is satisfied about the relevant place of abode, arguably, no determination on residency can be made.

Where the 'issue' that has been inherited is one that only has a tax consequence where the Commissioner makes a determination it is possible to form the view that there is in fact no issue to deal with until the Commissioner examines the circumstances of a client's position, forms a view, and makes a determination that some tax consequence should flow from the position.

7 Penalties

While the tax law imposes no positive obligations on a person to amend a return once it has been lodged to reflect the correct position (assuming that the position was thought to be correct at the time the return was lodged so that there is no fraud or evasion at that point) it does provide incentives for amending returns to reduce the potential exposure to penalties.[10]

Penalties can be imposed under tax law at levels based upon the culpability of the relevant person, being the taxpayer or their agent. Penalties apply at the level of:

- 25% for a failure to take reasonable care or where the tax shortfall is more than the greater of $10,000 and 1%[11] of the income tax payable by the taxpayer for the year;
- 50% where there is recklessness; and
- 75% where there is intentional disregard.

Where Part IVA is applied the penalty is 50% unless it is reasonably arguable that Part IVA does not apply in which case there is a 25% penalty.

Penalties can be increased by 20% in the instance where (subsection 284-220(1) of Schedule 1 to the TAA 1953):

- you prevent or obstruct the Commissioner from finding out about a shortfall amount, or about the false or misleading nature of a statement; or
- you become aware of the false or misleading nature of a statement after the statement is made (e.g. a return is lodged) and you do not tell the ATO about it within a reasonable time.

In addition the penalty is uplifted by 20% where the penalty is imposed across multiple years.

The potential for a penalty to be uplifted by 20% if you do not tell the Commissioner about an issue within a reasonable time is incentive for rectifying an issue by telling the Commissioner of it.[12]

7.1 Voluntary disclosures

If you 'voluntarily tell' the Commissioner in the 'approved form' about the shortfall amount or the false or misleading nature of a statement before being advised of an 'examination' of your tax affairs then the reduction is 80%[13] in the penalty that would otherwise apply.

The ATO accept that as long as you provide sufficient information in a disclosure that your disclosure will be accepted as being in the approved form.[14]

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[10] An excellent paper on penalties is 'The Penalty Provisions and their Administration: Living Meaning or Dead Letter?' By Paul Sokolowski in March 2014.

[11] Note these thresholds are higher where a trust or partnership is concerned – see subsection 284-90(3) of Schedule 1 to the TAA 1953

[12] The Commissioner also has the power to remit penalties under subsection 298-20 of Schedule 1 to the TAA 1953

[13] The penalty will be nil where the shortfall is less than $1,000 – this does not apply to scheme shortfalls.

The ATO consider[15] that as the term 'examination' is not defined it takes its ordinary meaning, and can encompass not only audits but any examination of an entity's affairs. Nonetheless, experience has shown that the ATO will commonly treat anything short of an audit as being a situation where you can be treated as making a disclosure prior to being notified of an examination. They state in PS LA 2012/5 that:

> 60. Because the phrase 'examination ... of your affairs' is so broad it may result in circumstances where it is harsh to not allow the higher reduction in penalty, for example where the Commissioner is merely identifying and/or assessing risks. In these cases, the Commissioner will generally exercise the discretion under subsection 284-225(5) (see paragraph 133 in Appendix 1 of this Ruling), the effect of which is to provide the entity with an 80% or full reduction in the penalty otherwise attracted.

Paragraph 133 then provides:

> 133. As a general rule, the Commissioner's discretion will be exercised in the following circumstances:
>
> (i) where the Commissioner is merely identifying and/or assessing risks, for example a risk review, notwithstanding that this is considered to be an examination;
>
> (ii) where the disclosure is not within the scope of the examination as notified to the entity (that is, it is outside the risk(s) or issue(s) covered by the examination);
>
> (iii) where the tax officer invites the entity to make a voluntary disclosure within a specified period or by a specified date, and the entity makes a full disclosure within that period or by that date;
>
> (iv) where, during the initial notification of the examination, the tax officer advises the entity that the examination will commence at a subsequent date (known as the formal date of commencement), and the entity makes a full disclosure on or before that date; or
>
> (v) where a company is undertaking its own review of its affairs (often called 'a prudential audit') at the time the Commissioner notifies the entity of the examination and it could reasonably be concluded that the entity was going to disclose the outcome of its review irrespective of the Commissioner's examination.

In relation to whether you 'voluntarily tell' the Commissioner states in MT 2012/1 that[16] [17]:

> 72. ... The word 'voluntary' is defined in the Australian Oxford Dictionary as 'done, acting, or able to act of one's own free will; not constrained or compulsory, intentional'. It is seen as an act done without persuasion or compulsion on the part of the Commissioner.
>
> 73. A disclosure will not be regarded as being made voluntarily where the entity merely 'came clean' when caught. In other words, where the facts or reasonable inferences indicate that the entity:
>
> · was aware of the shortfall amount, the scheme shortfall amount or the false or misleading nature of the statement; and

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[14] Paragraph 144 of PS LA 2012/5.
[15] Paragraph 47 of MT 2012/3.
[16] Judicial guidance on what was meant by 'voluntarily told' under the old penalty provision section 226E of ITAA 1936 (repealed) can be found in *British American Tobacco Australia Services Ltd v FC of T* [2009] FCA 1550.
[17] The Commissioner has a discretion in subsection 284-225(5) to treat a disclosure after being notified of an examination as having been made before notification.

· would have been highly unlikely to have made the disclosure had it not become aware the Commissioner had uncovered, or was about to uncover, the shortfall amount, scheme shortfall amount or false or misleading nature of the statement (this includes where an entity intentionally disregards a taxation law).

74. However, mere suspicion that the entity would not have come forward will not be sufficient. In addition, the fact that the Commissioner has notified the entity that an examination will be conducted in relation to a particular issue, or that an issue has been identified as a high risk, will not, of itself, mean that a disclosure in relation to that issue is not made voluntarily.

If the disclosure is made after being notified of an examination of a taxpayers tax affairs, the penalty reduction is only 20%, and in addition to having to voluntarily tell the Commissioner of the shortfall or false or misleading nature of the statement in the approved form it is necessary for the disclosure to be reasonably estimated to save the Commissioner a significant amount of time or resources in the examination.

The disclosure needs to provide sufficient information for the Commissioner to adjust the tax related liability. The Commissioner accepts that in some instances it may not be possible to quantify every adjustment, and that a voluntary disclosure in these circumstances will be accepted if the taxpayer has done everything reasonably necessary to enable or assist the ATO in identifying the shortfall amount.[18]

Note that where you are concerned about an issue and make a voluntary disclosure, there is no need to admit liability (for instance where the issue results in an unclear tax position). The ATO note that[19]:

108. The entity need not admit liability in respect of the shortfall amount or scheme shortfall amount disclosed, or admit that the statement they made was incorrect. The entity is eligible for the reduced penalty rates whether or not the entity maintains an opinion contrary to that of the Commissioner or disputes:

· the adjustment made by the Commissioner to the entity's tax-related liability; or

· any action taken, or not taken, by the Commissioner as a result of finding that a statement was false or misleading in a material particular.

7.2 Safe harbour and importance of agent's conduct

If the issue that has been inherited has resulted from the conduct or advice of the previous tax agent it may be of assistance to take advantage of the 'safe harbour' provisions applicable to statements made on or after 4 June 2010 (subsection 284-75(6) of Schedule 1 to the TAA 1953). That section provides:

You are not liable to an administrative penalty under subsection (1) or (4) if:

(a) you engage a *registered tax agent or BAS agent; and

(b) you give the registered tax agent or BAS agent all relevant taxation information; and

[18] Paragraph 105, MT 2012/3.
[19] MT 2012/3.

(c) the registered tax agent or BAS agent makes the statement; and

(d) the false or misleading nature of the statement did not result from:

(i) intentional disregard by the registered tax agent or BAS agent of a *taxation law (other than the *Excise Acts); or

(ii) recklessness by the agent as to the operation of a taxation law (other than the Excise Acts).

There are two hurdles to be overcome in relation to the above provision, one being that you need to have provided your tax agent (or BAS agent) with 'all relevant taxation information'. As well, where an issue has simply been missed (for instance an omitted sale of a rental property) there will usually have been incomplete information leading to the omission.

As well it must be the case that the false or misleading statement did not result from recklessness or intentional disregard by the agent. My personal experience is that the ATO can characterise behaviour leading to a shortfall as being reckless in the first instance where the quantum of the tax involved is large, or where the issue is complex so that the adviser 'should' have obtained further advice.

The safe harbour provisions may therefore offer an opportunity to deal with an issue without the imposition of penalties if the requirements of the section can be met.

8 What to do

Issues that are discovered to be out of time are common, but issues will be encountered where the time limit for an amendment of an assessment has not yet expired.

The decision to be made in relation to an issues that are within time and that results in a tax shortfall, or an issue that results in no shortfall but that results from a false or misleading statement, is one to be made in consultation with the client, that will consist of balancing:

- A client's desire for certainty about their taxation position;
- A client's desire to often pay the least tax possible;
- The desire to mitigate any penalties that may apply if the Commissioner examines the issue; and
- The risk that the Commissioner may consider 'doing nothing' in relation to an issue to be evasion.

If the decision is made to make a disclosure to the ATO, depending upon the nature of the issue, it may be prudent to obtain legal advice. Any disclosure should also be made in such a way that privilege in legal advice is not waived unintentionally.

If the issue is the common issue for Small to Medium Enterprises, Division 7A, then some comfort may be found in applying for the Commissioner to exercise his discretion under section 109RB of ITAA 1936 if the requirements of the provision can be met (an inadvertent mistake or honest omission).

9 You gave the bad advice

In the case where the issue has been caused by bad advice given by you or your firm as advisers, it likely goes without saying that you have a conflict of interest with your client.

Solicitors have a duty to avoid conflicts between their duty to act in the best interests of a client and their own interest – see for example Rule 12 of the NSW Solicitor's rules.

Tax agents have a requirement to have in place arrangements to deal with conflicts of interest, and TPB Information Sheet 19/2014 recognises that in some cases it will not be possible to ensure that objectivity is not impaired by a conflict of interest and it will be necessary to decline to act.

The accounting bodies APES 110 Code of Ethics for Professional Accountants has similar requirements to avoid and manage conflicts of interest.

In a situation where your client has obtained bad advice from you, let them know that there is a conflict, advise them to get independent advice, and do the best you can to see the issue resolved in their favour.