Ibbotson + Moscatelli

Client Information Newsletter
- Tax & Super

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Managing tax disputes can be like wrestling with a superhero

It is sometimes said that a superhero like the DC Comics character Superman can be uninteresting because he is, for all practical purposes, indestructible. Critics have said the knowledge that he will most likely win can make Superman's adventures monotonous.

A similar accusation could be levelled at the Federal Commissioner of Taxation (the flesh and bone personification of the ATO). To most people, including a hefty majority of small and medium businesses, the Commissioner appears to be immune from defeat. He has extraordinary powers – he can require a taxpayer to produce almost any documents even if he doesn't know whether the taxpayer has done any wrong; his assessments (or amended assessments) are generally valid even if he doesn't follow the requirements of the taxation legislation; and, perhaps most worryingly to taxpayers, he can often (but not always) enforce those assessments and recover tax debts even if that tax is subject to a dispute.

About this newsletter

Welcome to Ibbotson + Moscatelli's client information newsletter, your monthly tax and super update keeping you on top of the issues, news and changes you need to know. We invite you to read our monthly update and contact our office if you have any queries.

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Managing tax disputes can be like wrestling with a superhero *continued*

But despite all his powers, our real life superhero (or supervillain, depending on where you stand) can sometimes be successfully opposed, if not entirely defeated. But to do this you must move quickly, know the rules of engagement and have a clear vision of the outcome.

Starting the process: Speed is key

Except in the extremely rare scenario where an amended assessment is invalid, the only way to challenge a taxation decision is to commence so called "Part IVC proceedings" (which is the part of the tax act that permits a taxpayer dissatisfied with an ATO decision to have that decision reviewed).

To do this, it is necessary to lodge an objection in the approved form and within the relevant time period (generally either two or four years for an amended assessment). This may seem a trite observation, but it is crucial that these formal requirements are met. If they are not, you may be left with no recourse against the ATO, regardless of the facts of the matter.

Even though you may in theory have up to four years to challenge a decision, in practice the time to act may be much shorter. Unless you are willing and able to pay the disputed tax before the issue is resolved (and not many people are willing to do that) you may find that the ATO can begin to insist upon payment even while you are contemplating an objection.

It is important to remember one of the ATO's most specific "superpowers" — a notice of assessment, including an amended assessment, is conclusive of the correctness of the amount shown on it. In other words, the Commissioner could sue for the amount of disputed tax at any time after it becomes due (generally 21 days after the date of the amended assessment) and the fact that you intend to dispute the assessment would be no defence to the action.

In practice the Commissioner will usually give the taxpayer a reasonable amount of time to consider their position and (if appropriate) lodge an objection before commencing recovery action. But once recovery action has commenced, it gathers a momentum that can be difficult to stop. Unless an objection is lodged in a timely manner, you will soon find yourself dealing with debt recovery officers who have no interest in hearing about upcoming objections. So if you intend to object, or even if you just intend to get advice on whether to do so, act as quickly as you can and keep the ATO informed of your intentions.

Dealing with factual disputes

Balancing the need to act quickly is the necessity of properly considering what is really at issue. This is because the notice of objection and materials that support it must properly deal with the matter in dispute. There are essentially two kinds of disputes relating to taxation decisions — factual disputes, and disputes regarding a point of law.

The first kind is a factual dispute. This may arise where an auditor or other ATO officer simply does not accept your version of events. Often people can get indignant about the resulting amended assessment and will want it rectified as a matter of principle. But, before blindly charging into an objection, consider whether there is any further evidence that can be produced to support your position.

Are there any further documents that could prove your case? Are there any independent witnesses that could provide evidence on the matter? Could the existing materials be better explained or presented? If not, you may find that the decision maker to the objection comes to the same conclusion as the original decision maker (a different tax officer to the original one is generally appointed to preside over objections).

Disputes regarding points of law

The second kind of dispute is where the facts are agreed, but there is a dispute as to the application of the relevant law. These sorts of disputes can be less emotive, but are often harder to have successfully changed on objection. This is because the objection decision maker will be bound by the ATO's position on the application of the law, as stated in its public rulings. Objection decision makers may also be influenced by so-called "non-binding decisions" that the ATO may have issued, such as "interpretative decisions".

If you are involved in this kind of dispute and wish to have any chance of succeeding at the initial objection stage (as opposed to, say, a subsequent review by the Administrative Appeals Tribunal (AAT)) you will need to demonstrate that the outcome you are looking for does not deviate from the ATO's publicly stated views.

If you can't distinguish your position from the Commissioner's public rulings, then in practice it may be necessary to accept that the initial objection decision by the ATO will be unfavourable to your preferred outcome. In such a case you should only object if you are willing to follow up with an application to the AAT for a review of the objection decision or an appeal to the Federal Court.

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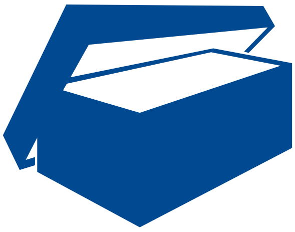

Unpacking statute-barred debts

Various tax implications can arise when a debt becomes statute-barred. So what is statute barring and when can it be a problem?

In simple terms, a debt is statute-barred when it has reached a statutory limitation period where it can no longer be legally recovered by creditors.

Specifically, each state and territory in Australia contains its own "statute of limitation" provisions that provide a procedural basis for a lawsuit for non-payment of a debt, including a time limit, which can be used as a defence against the claim from creditors.

For debts that arise from "simple contracts", the limitation period is six years, with the exception of the Northern Territory where it is three years.

Very broadly, a "simple contract" in respect of a debt typically includes unsecured personal loans, credit card debts or debts sold or referred to a collection agency. The limitation period will be different for secured debts and debts arising "out of deed".

As the laws vary from state to state, to ensure that the debt is deemed "statute-barred", it would be prudent to seek legal advice as these laws can be complex. Once this is determined, the application of the relevant tax laws will follow. The table below summarises the broad application of the statute of limitations in each Australian state and territory.

WHAT SHOULD YOU CONSIDER?

Some general points to consider when dealing with statute barred debts include:

1. Identify the governing jurisdiction

Generally, the place of the debtor's residence at the time of entering into the contract is relevant in determining the governing jurisdiction (although this can be varied in the contract itself).

2. Determine the start time for the debt

For most debts, a creditor must begin court action to recover the debt within six years (or three years in the NT) of the date:

- on which the debt became due and payable
- the last time that a payment was made, or
- that there is acknowledgement in writing that the debt is owed.

The limitation period starts from the latest event as shown in the table. As a general principle, a loan arrangement that does not expressly include repayment terms is taken to be repayable on demand. Such a loan creates an immediate debt, with the clock ticking for statute of limitations purposes from that time.

STATE BY STATE: STATUTE OF LIMITATIONS IN A NUTSHELL

State or territory	ACT	NSW	QLD	SA	Tas	Vic	WA	NT
Limitation period	6 years	6 years	6 years	6 years	6 years	6 years	6 years	3 years
Extinction of right and/or title	Title	Title & right	N/A	N/A	N/A	N/A	N/A	N/A
Limited period extended by confirmation?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Can period restart if there is a confirmation after initial period expires?	No	No	Yes	Yes	Yes	Yes	No	No

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Unpacking statute-barred debts *continued*

3. Confirmation of debt and renewal of limitation period

The limitation period is renewed and recommences upon confirmation of the debt. However, the relevant state legislation should be considered for correct application of the renewal period. In the ACT, NSW, WA and the NT, renewal does not occur if the confirmation happens after the initial limitation period expires. In all other states, the limitation period is renewed on confirmation irrespective of whether the limitation period has expired.

4. Acknowledgement of the debt

As noted, confirmation can be through acknowledgement in a written form and signed by the debtor or an agent. There is a body of case law that considers the issue of whether a debt has been acknowledged. For example, a debtor's signed balance sheet was held by one court to be sufficient acknowledgment of a debt. Alternatively, a payment of interest on principal or part payment of principal can also be treated as an acknowledgement.

5. Defence against creditor claims

The expiration of a limitation period precludes a remedy from being available, such that if a lawsuit is brought against the debtor then they can claim the statute as an absolute defence.

Note that the expiration of a limitation period for the debt does not mean, in most cases, that the debt ceased to exist. There may have been acknowledgement at some stage during the period, which would typically restart the limitation period. ■

Managing tax disputes can be like wrestling with a superhero *continued*

Litigation and compromise

If you have been unsuccessful in your objection, all is not lost. An application to the AAT for review of the objection decision is open to you, whether the dispute is factual or regarding a question of law. Such an application may be particularly appropriate if there are large amounts of penalties involved, even where the principal amount of tax is not in dispute. The AAT can sometimes be more reasonable in deciding the appropriate level of penalty or in exercising the discretion to remit penalties.

If there is a question of law at stake, an appeal to the Federal Court is also possible, however it is outside the scope of this brief article to cover the litigation process itself. However a quick word of caution is warranted — litigation tends to highlight the Commissioner's "superpowers".

First, the burden of proof is shifted; it will be up to you to prove the ATO's assessment is excessive. In practice, this means that if facts are in dispute you will rarely be able to rely on bare assertions. Documentary evidence is strongly preferable.

Further, compared to almost every ordinary taxpayer, the Commissioner has practically infinite resources. He is also required to administer the tax law according to its terms. This means that the ATO cannot, and will not, simply compromise on an arbitrary figure for the sake of saving further legal costs.

But this does not mean the Commissioner cannot compromise at all. Like every government agency, the ATO is very aware that litigation costs money that can sometimes be put to better use elsewhere. If you can demonstrate that there is a real risk to the ATO that it will lose on a particular issue, it may be willing to compromise by amending assessments in relation to that particular issue if, for example, you agree to withdraw your application in relation to other issues. There may also be some scope to compromise by reducing penalties or remitting interest in appropriate circumstances.

Do the good guys ever win?

Many taxpayers (and indeed a lot of accountants) agree that the Commissioner is, in fact, "overpowered". But successive governments have chosen to accept, and often further entrench, this situation. Debating its merits is no more useful than entering into an twitter argument over whether the Incredible Hulk could defeat Superman. The best we can do is to keep what small amount of kryptonite we can get and use it very strategically once in a while. ■

The **proportioning rule** and your **SMSF: It’s all about balance**

When calculating a super benefit, it is necessary to identify and determine the value of the various components that make up the benefit. The law around superannuation dictates that the tax-free component and taxable components of a member’s payment must be paid in the same proportion as the tax-free and taxable components of the member’s interest. This requirement is known as the proportioning rule.

Think of the proportioning rule as a sort of integrity measure that prevents the “cherry picking” of the tax-free and taxable components when a payment is made from superannuation.

The tax-free component includes the contributions segment and the crystallised segment. The contributions segment generally includes all contributions made after 30 June 2007 that have not been, and will not be, included in your fund’s assessable income.

The contributions segment is made up of what is commonly known as non-concessional contributions (and also includes the CGT exempt component, superannuation co-contribution benefits, and contribution splitting benefits). The crystallised segment broadly includes numerous tax-free components that existed prior to 30 June 2007 and are becoming increasingly uncommon.

The taxable component is broadly the total value of the member’s superannuation interest less the value of the tax-free component. Contributions that would form part of the taxable component are generally amounts included in the assessable income of the fund. Broadly, the taxable component consists of concessional contributions, earnings, and capital appreciation from investments in the fund.

Calculating the components

The value of the superannuation interest and the amount of tax-free and taxable components of the member’s interest is determined as follows:

- Determine whether the benefit is a lump sum or a pension.
- Work out the total value of the superannuation interest and the proportion of tax-free and taxable components as at the applicable time, which means:
  - if the benefit is a lump sum — just before the benefit is paid; or
  - if the benefit is a pension — on the date the pension commences (in other words, you lock in the proportion of the tax-free and taxable components on the date the pension commences, and future growth and earnings are shared proportionally between these components.)
- Apply the same proportions to the amount of benefit paid (this part is the essence of the proportioning rule).

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The proportioning rule and your SMSF *continued*

When a pension is commenced

In an accumulation interest, the tax-free component is normally comprised of a static amount (that is, the crystallised segment and the contributions segment). Whereas the taxable component can change regularly as the investments supporting the superannuation interest fluctuate with investment markets and earnings (or losses) accrue, in some cases on a daily basis.

However, when a pension is commenced with a certain proportion of a tax-free component and the pension assets increase over time, the tax-free component will effectively grow. This is because at the time of paying pension benefits, the proportioning rule will use the same proportion of tax-free component that was locked in at the commencement of that pension.

To illustrate how the proportioning rule works in practice, in respect of pensions, look at the following example:

> In January 2017, Christopher is 66 years old, still working and is a member of an SMSF. In his SMSF, Christopher's superannuation interest consists of a tax-free component of $300,000 and a taxable component of $200,000. His total superannuation balance is $500,000. This means the proportion of his superannuation interest that consists of the tax-free component is 60% and the taxable component is 40%. Christopher commences an account-based pension with just $250,000 of his total superannuation interest. At the commencement of this pension, the tax-free component is $150,000 (or 60%) and the taxable component is $100,000 (or 40%) since his total superannuation interest before commencing the pension was 60% tax-free component and 40% taxable component.
>
> If the value of the assets supporting the pension were to rise, the percentages representing the tax-free and taxable components do not change. Thus if Christopher's pension balance, which started at $250,000, were to rise to $400,000 after three years due to his savvy investment decisions, his tax-free and taxable components would retain the same proportion as at the pension's commencement and will be as follows: a tax-free component of $240,000 (or 60%) and a taxable component of $160,000 (or 40%). Of course, if the value of the assets supporting the pension were to fall to say $100,000, then the proportion of the tax-free and taxable components will remain the same as at commencement ($60,000 tax-free and $40,000 taxable).

Accordingly, the following general rules should be noted:

- Where assets are going to increase in value, the tax-free component is maximised by commencing a pension sooner rather than later (locking in the tax-free component to grow proportionately).
- Where assets are going to decrease in value, the tax-free component is maximised by commencing a pension later rather than sooner (allowing the decrease in assets to erode the taxable component).

With an accumulation interest

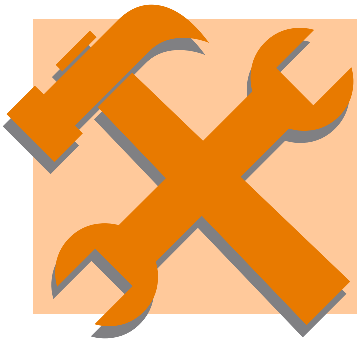
To illustrate further the above general principles about the proportioning rule, consider this further example:

> Again the same facts as above, but this time let us focus on Christopher's accumulation interest. Recall that he commenced his pension with $250,000 of his total superannuation interest; he therefore has $250,000 remaining in his accumulation interest. That $250,000 in accumulation would comprise of a tax-free component of $150,000 (or 60%) and the taxable component is $100,000 (or 40%). Like his pension interest, the value of his accumulation interest rises to $400,000 after three years due to his savvy investment decisions. Unlike his pension interest, his tax-free component remains static and the proportion of his taxable component increases. Christopher's tax-free and taxable components in respect of his accumulation interest are now as follows: a tax-free component of $150,000 (or 37.5%) and a taxable component of $250,000 (or 62.5%).

As the above example shows, there is no change to the tax-free component if investments in the accumulation interest increase in value. Hence, the decision to commence a pension with some or all of your benefits at the right time can make a significant difference to a member's interest over the course of time.

Strategic importance

Understanding the proportioning rule is important as it forms the basis of many strategies that leverage off it. For example, where there is a significant tax-free component, a pension should generally be commenced as soon as practicable where the fund expects to see some growth in the value of its assets. Further, when contributing or rolling back a pension into accumulation, stay alert to the effect on what will happen to the tax-free and taxable components — since these two components cannot be separated to maximise your position once these amounts are mixed together. ■



Builders: Get your taxable payments report ready before August 28

Businesses in the building and construction industry, take note – the deadline is August 28, 2018 to report the total payments you made to each contractor you enlisted the services of in 2017-18. You will need to report these payments to the ATO on the *Taxable payments annual report*.

The taxable payments reporting system was initially introduced to address longstanding compliance issues by contractors in the building and construction industry. Tax compliance issues that were identified included non-lodgement of tax returns, income being omitted from tax returns that were lodged, non-compliance with goods and services tax (GST) obligations, failure to quote an Australian business number (ABN), and use of an invalid ABN.

Note: The most recent Federal Budget announced that from 2019-20 three additional industries on top of building and construction will be required to lodge taxable payments reports with the ATO — security providers and investigation services, road freight transport, and computer system design and related services.

The pointers below will help employers in building and construction, and from next financial year the above mentioned businesses, adequately prepare for the looming deadline.

WORK OUT IF YOU NEED TO REPORT

You need to report if all the following apply:

- you are a business that is primarily in the building and construction industry
- you make payments to contractors for building and construction services, and you have an Australian business number (ABN).

Contractors can be sole traders (individuals), companies, partnerships or trusts.

Examples of what is considered to be "building and constructions services" is broad. You are considered to be a business that is primarily in the building and construction industry if any of the following apply:

- for the financial year, 50% or more of your business income was derived from providing "building and construction services", or
- 50% or more of your business activity related to "building and construction services", or
- in the financial year immediately before the current financial year, 50% or more of your business income was derived from providing "building and construction services".

continued overleaf ⇨

! Contractors who pay other contractors for building and construction services may also be required to report if they are carrying on a business that is primarily in the building and construction industry. Remember – a contractor can be an individual, partnership, company or trust.

Builders: Get your taxable payments report ready *continued*

WHAT TO REPORT

1) Details you need to report

For each contractor, you need to report the following details each financial year:

- ABN, if known
- name
- address
- gross amount you paid for the financial year – this is the total amount paid, including GST
- total GST included in the gross amount you paid.

The details you need to report will generally be contained in the invoices you receive from your contractors. It is important to check the way you keep your contractor payment information to ensure you have the details you need to complete the *Taxable payments annual report*.

2) Payments you need to report

You need to report payments you make to contractors for their building and construction services. Examples of occupations and activities covered by the *Taxable payments annual report* regime can be found on the ATO website at ato.gov.au/taxablepaymentsreporting.

If invoices you received included both labour and materials, whether itemised or combined, you report the whole amount of the payment unless the labour component is only incidental.

For instance, if a concrete truck is used to deliver concrete, and the driver merely directs the pouring of the concrete into the trenches, the driver's labour component is incidental, or minor, to the supply of the concrete. You are paying for concrete and you do not need to report the amount paid.

If however the driver is a go-getter who pours the concrete, levels and does the formwork, then this is more than incidental. You are paying for the concrete as well as the building and construction service, and the total amount paid is reported.

3) Payments you do not report

You do not need to report:

- payments for building supplies and materials only – also, maintenance of equipment and tools is not a building and construction service
- unpaid invoices as of June 30 each year – for example, if you receive an invoice in June 2018, but you do not pay that invoice until sometime in July 2018, you report that payment in the 2018-19 *Taxable payments annual report*
- pay-as-you-go (PAYG) withholding payments – for example, payments to employees, workers engaged under a voluntary agreement to withhold, workers engaged under a labour-hire or on-hire arrangement. If amounts are withheld because a contractor didn't quote an ABN, you can choose to report the details in the *Taxable payments annual report* instead of reporting them separately in the PAYG withholding where ABN not quoted – annual report. If you make this choice, only report the information in one report.
- if you are a home owner making payments to contractors for building and construction services – for example, if you are building or renovating your own home. ■

ⓘ Consult this office for assistance on how to lodge your *Taxable payments annual report* before August 28 this year. Penalties may apply for not lodging the annual report by the due date.

This information has been prepared without taking into account your objectives, financial situation or needs. Because of this, you should, before acting on this information, consider its appropriateness, having regard to your objectives, financial situation or needs.