

client alert | explanatory memorandum

November 2007

Decision Impact Statement — Cajkusic & Ors v. Commissioner of Taxation [2006], FCAFC 164

The Tax Office recently released a Decision Impact Statement regarding the Federal Court decision in *Cajkusic v. Commissioner of Taxation* [2006] FCAFC 164 (24 November 2006).

In this case, the taxpayers were beneficiaries of a family trust which carried on a business. In the 1997 and 1998 income tax years, the trust claimed deductions in respect of contributions made and implementation costs in respect of an employee benefit trust arrangement.

The Commissioner issued amended assessments to each of the applicant's for the income years ended 30 June 1997 and 1998, disallowing the deductions to the trust, and increasing assessable income by the corresponding amount.

The Full Federal Court held that although contributions made by the trustee of a family trust to various employee benefit trusts were not deductible, the default beneficiaries of the family trust were not assessable on the resulting increase in the net income of the trust.

Under the trust deed, the trustee had the power to determine distributable income of the trust. During the 1997 and 1998 years, the trustee treated the outgoings as on revenue account. As the trust had carry forward loss in the 1997 year, that loss was properly applied to reduce the income of the trust in the 1998 year. No profits could be distributed until the prior year losses were replaced. The prior year revenue losses should not be replaced by the capital of the trust. As the 1997 year losses were greater than the 1998 year income, there was no income of the trust to which the beneficiaries could be presently entitled and therefore assessable. Subsequently, the High Court refused the Commissioner's application for special leave to appeal.

In the Tax Office's decision impact statement, the Commissioner has indicated that he accepts the decision as an application of conventional tax law principles in determining when a beneficiary of a trust is presently entitled to the income of a trust estate.

However, he indicated that he does not consider the case to be authority for the proposition that the terms of a trust instrument can govern what is income, for the purposes of section 97(1) of the *Income Tax Assessment Act 1936* (ITAA 1936), in the hands of the trustee (section 97(1) effectively defines the taxable income of the trust to which either the trustee or the beneficiaries are assessed).

Given that the observations made by the Full Federal Court have created some uncertainty in relation to this issue of section 97 income, the Commissioner will seek to further test the issue on appeal as soon as the opportunity arises. The Commissioner intends to continue to follow what he understands to be the reasoning of the High Court in *Commissioner of Taxation v. Australia and New Zealand Savings Bank* (1998) 194 CLR 328.

The Tax Office notes the view expressed by the Full Federal Court that losses in one year must, in the absence of any contrary direction in the trust instrument, come out of profits of subsequent years and not out of capital. However, this view is subject of the taxpayers appeal to the High Court in *Rafiland Pty Ltd v. Commissioner of Taxation* [2007] FCAFC 4 (31 January 2007).

The Commissioner has added that the Tax Office does not propose to conduct active compliance targeted at these issues. However, if the issue arises in an audit or if the Tax Office is asked to rule on a specific case in the context of a private or class ruling, then it will have no alternative but to apply the law as it understands it to operate.

Penalty for Incorrectly Claimed Input Tax Credits

In a recent decision in *Keitac Pty Ltd ATF McNamara Property Development Trust v. Commissioner of Taxation* [2007] AATA 1206 (4 April 2007), the Administrative Appeals Tribunal (AAT) affirmed the Commissioner's decision to impose a 25% administrative penalty on a property developer for failing to take reasonable care in claiming input tax credits relating to the GST incurred on a land acquisition. However, the AAT set aside the Commissioner's decision not to remit the penalty and reduced the penalty on the basis that the property developer's advisors played a part in giving rise to the liability.

The taxpayer was negotiating the purchase of two blocks of land for property development purposes and sought advice from its accountants and tax agents in relation to whether the supply of the land would be a GST-free going concern. In June 2005, the accountants advised that the exemption would not apply and that the supply would be taxable for GST purposes.

The taxpayer subsequently entered into a contract in July 2005 in which a special condition had been mistakenly inserted in the final version of the contract. This special condition stated that the 'Margin Scheme is to be applied to the Supply of the Property'. As a consequence of applying the margin scheme, the recipient of the supply is not entitled to claim input tax credits for any GST liability assessed under the margin scheme. The taxpayer was not aware of this special condition when he signed the contract and therefore did not advise his accountants of this.

The accountants prepared the Business Activity Statement (BAS) for the period ended 30 September 2005 and claimed an input tax credit of \$95,455 in respect of the purchase (i.e. all of the GST incurred). The Tax Office subsequently reviewed the transaction in December 2005 and issued a penalty of \$23,863.75 (25% of \$95,455) for failure to take reasonable care to comply with taxation law.

In reaching its conclusion, the AAT considered the following issues.

Imposition of the administrative penalty of 25% of the shortfall amount

According to Item 3 of subsection 284–90(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA), where there has been '...a failure by you or your agent to take reasonable care to comply with a taxation law', the base penalty amount is equal to 25% of the shortfall amount or part.

The AAT considered whether reasonable care had been taken by the taxpayer and concluded that 'while there are some mitigating factors, there is clearly negligence on the part of the applicant from a legal point of view' and that there had been a 'lack of reasonable care in a number of respects by the applicant', including failing to review the final contract which he signed.

In relation to whether the accountants had taken reasonable care, the AAT concluded they had not, as even though they requested a copy of the contract, they did not contact the taxpayer to request the complete contract after only receiving the first page. Further, the accountants (or the taxpayer) did not hold a valid tax invoice for the transaction as is required by the GST law in order to claim an input tax credit.

Specifically, the AAT concluded that the accountant 'demonstrated a lack of reasonable care in a number of respects in relation to its legal obligation of demonstrating 'reasonable care'. As a consequence, the administrative penalty has been lawfully imposed.'

Quantum of penalty

The total input tax credit claimed in respect of the property purchase was \$95,455, which the Commissioner determined to be the shortfall amount. The penalty for exercising a lack of reasonable care is 25% of the shortfall. On this basis, the AAT concluded that the quantum of the penalty, \$23,863.75 (i.e. 25% of \$95,455), was correctly calculated by the Commissioner.

Discretionary decision not to remit the penalty

The Commissioner has the power to remit a penalty under subsection 298–20(1) of Schedule 1 of the TAA. The Tax Office’s Practice Statement PS LA 2006/2 details the circumstances in which the Commissioner may remit all or part of a penalty. It provides that tax officers may remit the penalty where it is clear that:

- an isolated book-keeping or record keeping mistake was made;
- the mistake is not associated with an event or transaction which is extraordinary for the entity during the accounting period;
- the mistake was honest and unintended; and
- the entity has a good compliance history.

The AAT was satisfied that the applicant met all the above factors and therefore concluded that ‘relief in the form of remission of part of the penalty is therefore justified to reflect the contribution of professional advisers to the applicant’s liability and on whose advice he was entitled to rely’.

Practice Statement PS LA 2006/2 also contains statements that detail the Tax Office’s view of a judgement regarding a similar case.

The full text of *Keitac Pty Ltd ATF McNamara Property Development Trust v. Commissioner of Taxation* can be accessed on the Australasian Legal Information Institute’s website at: www.austlii.edu.au/au/cases/cth/aat/2007/1206.html.

The Tax Office has also issued a Decision Impact Statement on this case. This document is not a public ruling, but provides a statement of the Commissioner’s position in relation to the decision and how the law will be administered as a consequence of the decision. This can be accessed on the ATO website at: <http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/QT2006/329/00001>.

Payments for Overseas Volunteer Work not Assessable — Travel Expense Deductions Denied

In a recent decision in *Grant v. Commissioner of Taxation* [2007] AATA 1783 (21 September 2007), the AAT dismissed a taxpayer’s appeal and held that neither a payment received by the taxpayer from the Rotary Club, nor salary or wages received for employment, were assessable income. As a result the taxpayer was not entitled to a deduction for work-related travel expenses claimed for overseas trips for the year ended 30 June 2005.

By way of background, the applicant employed as a physiotherapist took leave without pay to volunteer in Vietnam. The applicant was offered \$3,300 by the Rotary Club to fund the airfares and accommodation costs.

During her time as a volunteer, the applicant was offered employment as a physiotherapist in Vietnam with an initial salary of USD \$1,000 per month. In addition, the applicant’s package included a return economy class flight, accommodation, car servicing, etc. In the first year of her employment the applicant earned a total of USD \$3,300 (AUD \$4,054). Subsequently, she argued that this income would be assessable income under the provisions of the *Income Tax Assessment Act 1997* (ITAA 1997) on the basis that the exemptions contained in section 23AG (2) did not apply because her income was exempt from tax in Vietnam.

On the basis that the income was assessable, the taxpayer claimed airfares for the first and second trip to Vietnam, travel insurance visas, police check costs, travel doctor costs, meals and incidentals and accommodation as travel expenses totalling \$21,069.

Rotary Club payment

The first issue the AAT considered was whether the payment of \$3,300 received by the applicant from the Rotary Club was assessable income under section 6–5 of ITAA 1997 or any provision rather than the payment of a reimbursement of an expense already incurred.

In Taxation Ruling TR 92/15, the Tax Office explains the difference between an allowance and a reimbursement. This distinction is important as it determines whether the payment is a fringe benefit or assessable income under ITAA 1997. A payment will be a reimbursement where the provider considered the payment to be its own and the recipient incurs that expenditure on behalf of the provider. In this case, the AAT was satisfied that the payment of \$3,300 did not constitute a reimbursement.

Salary and wage income

The second issue was whether the salary and wages the applicant received during her employment in Vietnam was assessable income under section 6–5(2) of ITAA 1997.

The applicant was overseas for a continuous period in excess of 91 days. As such, the question arose as to whether the exemption in section 23AG of ITAA 1936 applied. Broadly section 23AG (1) operates where a resident, being a natural person, has been engaged in foreign service for a continuous period of not less than 91 days. However, section 23AG (2) provides that the exemption does not apply if any foreign earnings derived by the person are exempt from tax in the foreign country in certain circumstances listed in that section.

The taxpayer claimed that, as she was undertaking charitable work in Vietnam, her income was exempt in Vietnam and therefore taxable in Australia. Section 23AG could not apply where her income was not subject to tax in Vietnam.

However, the AAT held that section 23AG did apply. The exclusions contained in section 23AG(2) provided that income would not be exempt under section 23AG where the Vietnamese exemption from local tax covered income derived in the capacity of an employee. As the taxpayer's income was exempt in Vietnam on the basis that it was charitable work, rather than income derived in the capacity of an employee, section 23AG(2) did not apply. On that basis, the exemption in section 23AG(1) did apply and the taxpayer was not assessable on the salary and wage income.

Availability of deductions

The final issue relates to the availability of a deduction in relation to the work related travel expenses incurred by the applicant. Section 8–1 of ITAA 1997 indicates that you can deduct from your assessable income any loss or outgoing to the extent that:

- it is incurred in gaining or producing your assessable income, or
- it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.

As the AAT had determined that the payment from the Rotary Club and the salary and wages received in Vietnam were not assessable income, the taxpayer was not entitled to a deduction for her travel costs as they were not incurred in deriving assessable income. Furthermore, the expenditure did not relate to her current employment income in Australia and was therefore not deductible on that basis.

The full text of this case can be accessed on the Australasian Legal Information Institute's website at: <http://www.austlii.edu.au/au/cases/cth/aat/2007/1783.html>.

Lump sum Compensation Held to be Income

In the recent case *Life Interest Beneficiary v. Commissioner of Taxation* [2007] AATA 1791 (21 September 2007), the AAT held that a lump sum payment received by a taxpayer, for breach of a life trust, was income.

The taxpayer was granted a life interest in four trusts, with her son as the sole remainderman. This meant that the taxpayer was entitled to the income of the trusts for her life, and upon her death the all of the assets in the trust would go to her son.

During the 1994 year, the taxpayer entered into a deed of release in relation to the trusts. Under the deed, the taxpayer was paid a substantial lump sum in addition to her entitlement to the income of the trust.

The taxpayer claimed that the lump sum amount was compensation for the failure of the trustee to balance her entitlement to the income of the trust as opposed to the interest of the remainderman in the capital off the trust. She argued that as the bulk of the assets of the trust were shares, the trustee was biased towards capital gains income to which she would not be entitled.

The Commissioner assessed the lump sum as a receipt of income. This was upheld by the AAT.

In order to determine whether the payment is income of capital, it is its character in the hands of the taxpayer recipient that is determinative. If the payment is made under an agreement, the agreement and all the surrounding circumstances must be determined. The AAT referred to the decision in *Tindal v. Federal Commissioner of Taxation* (1946) 72 CLR 608 (23 August 1946) and noted that if the payment received is on revenue account, its nature is not changed merely because the source of the payment was capital.

The AAT held that as the taxpayer's entitlement was to the income of the trust, any entitlement arising out of the trustee's failure to properly administer the trust was compensation for lost income. On that basis, the receipt was assessable as income.

The full text of this case can be accessed on the Australasian Legal Information Institute's website at: <<http://www.austlii.edu.au/au/cases/cth/aat/2007/1791.html>>.

General Interest Charge (GIC) and Shortfall Interest Charge (SIC) Rates Released

The Tax Office has released updated general interest charge and shortfall interest charge rates for the October to December quarter 2007, which are as follows:

Rate	Annual	Daily
GIC	13.75%	0.03767123%
SIC	9.75%	0.02671233%

For more information about the GIC, visit the ATO website at: <<http://www.ato.gov.au/print.asp?doc=/content/2832.htm>>.

For more information about the SIC, visit the ATO website at: <<http://www.ato.gov.au/print.asp?doc=/content/65367.htm>>.

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