

client alert | explanatory memorandum

October 2007

Part IVA applied to investment in scheme AAT Case: Leggett & Ors v. FCT [2007] AATA 1624

In a recent Federal Court decision, *Leggett and Ors and Commissioner of Taxation* [2007] AATA 1624 (1 August 2007), the court applied Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) to disallow deductions for license fees, management fees and marketing fees paid by investors. These deductions were disallowed to the extent that they exceeded the actual cash outlays.

The facts of this case relate to the 1994, 1995 and 1996 income tax years. In the 1994 income year the applicants formed a partnership (CECK partnership) including a company (CE Pty Ltd), four owner operators and the company's accountant.

The taxpayers had been involved in a number of projects which were concerned with the promotion and sale of a travel information system. The system involved the electronic storage on CD-ROMs of travel information including holiday destinations and accommodation prices. The CD-ROM would then be provided to travel agents for a fee.

The business was named the Travel Vision system and was designed for the travel industry and travel agents. The aim of the project was to provide the requisite travel information faster and at less cost than a printed brochure.

As part of their involvement in the project, each of the partners paid license fees, management fees and marketing fees. The license fees were in respect of each partner's ability to use and to commercially exploit the 'Intellectual Property' and the 'Product' as defined in the agreement within the relevant overseas territory for a term of one year.

Under the management agreement entered into by the partnership, a separate company acted as manager and agent in respect of the partners' rights and obligations under the license agreements. The separate company was paid management fees under the agreement.

The marketing fee was paid in relation to an agreement the partners entered into with a separate company, Plutora. The agreement provided that Plutora act as marketer and agent in respect of the licensees' rights and obligation under the licenses.

Deductions were claimed by the partnership in relation to the license fees, management fees and marketing fees.

Application of ITAA 1936 & ITAA 1997

Division 243 of the *Income Tax Assessment Act 1997* (ITAA 1997) operates to prevent taxpayers from obtaining deductions for certain capital expenditure on property in excess of the amounts actually outlaid if the property was acquired under limited recourse finance.

The limited recourse finance agreement in place under this arrangement saw amounts loaned to the partnership to substantially fund the payment of the management, license and marketing fees.

Funds were lent to the partnership under an agreement with a separate trust, the M&M Trust. The funds were lent to enable the partners to pay the various license, management and marketing fees. Under the agreement, the lender had access to one asset as security, being 50% of the gross income from exploiting the licenses in overseas territories after deducting certain expenses.

In each year of the scheme, the partnership paid some cash to fund the initial license fees and part of the management fees. The balance of the fees owing were paid via the loan from the M&M Trust and in some years involved a series of 'round robin' cheques.

As a result, the full amount of all fees were claimed as deductions by the partnership, on the basis that they were incurred in carrying on a business for the purpose of gaining assessable income and were therefore allowable under section 51(1) of the ITAA 1936. The deductions claimed by each partner were in respect of their individual interest in the partnership and the deductions totalled almost \$1.43 million in the 1994 income tax year, just over \$768,000 in the 1995 income tax year and \$1.08 million in the 1996 income tax year.

The Commissioner disallowed these deductions relying on Part IVA of the ITAA 1936.

Broadly, section 177D is the general provision that defines the schemes to which Part IVA applies. This states that a scheme will be a scheme to which Part IVA applies if:

- a taxpayer has obtained a tax benefit in connection with the scheme, or would have obtained that benefit but for Part IVA; and
- it would be concluded that at least one person who entered into or carried out the scheme (or any part of the scheme) did so for the purpose of enabling the relevant taxpayer (alone or in association with others) to obtain a tax benefit in connection with the scheme.

The Federal Court held that the license fees, management fees and marketing fees paid by the taxpayers were deductible under section 51(1) of ITAA 1936. The Court then turned its attention to the application of Part IVA.

The Court was satisfied that the taxpayers entered into the arrangement with the dominant purpose of trying to obtain a tax benefit. The Court further added that the size of the management fee seemed non-commercial and the lack of any documentation as to how the management fee was calculated raised questions as to whether the arrangement was set up to provide tax benefits.

In conclusion, the Court established that Part IVA applied but it also held that the taxpayers would be able to claim a deduction only to the extent to which the deductions did not exceed actual cash outlays.

Shortfall penalties for recklessness in preparing BAS AAT Case: Barakat & Ors v. FCT [2007] AATA 1564

In a recent decision in *Barakat and Ors and Commissioner of Taxation* [2007] AATA 1564 (19 July 2007), the Administrative Appeals Tribunal (AAT) has set aside a decision regarding shortfall penalties of approximately \$134,000 imposed on the taxpayer for recklessness in preparing two business activity statements (BASs).

The taxpayer claimed to misunderstand the advice given to it by the Tax Office and indicated that there was no intention to mislead or avoid any payment of GST. As the relevant law and the calculation of the liability was complex, the AAT held that, under the circumstances, the taxpayer was not reckless and reasonable care was taken by the taxpayer in relation to the BASs.

The taxpayer was a partnership that carried on a project management and construction business, which acquired land upon which it constructed townhouses. The taxpayer commenced the construction of nine townhouses in 2000. Over the period August 2000 to June 2002, contracts of sale for the townhouses were entered into and these contracts were settled during the period May 2004 and June 2004. The taxpayer was registered for GST during the period 2 June 2000 and 1 July 2004, during which it lodged BASs and accounted for GST on a monthly basis. Mr Barakat (one of the partners) had the responsibility of preparing the BASs on behalf of the partnership.

In May 2004, the taxpayer settled contracts of sale for two of the townhouses and the remaining seven were settled in June 2004. However, these sales were not accounted for in the BASs for either May or June 2004. This resulted in shortfall amounts of \$60,752 in May 2004 and \$208,590 in June 2004. Consequently, the Australian Taxation Office (Tax Office) imposed penalties of \$30,376 and \$104,295 in respect of these periods in accordance with section 284-75(1) of Schedule 1 of the *Taxation Administration Act 1953* (TAA 1953) on the basis that the taxpayer was reckless in the conduct of its GST affairs.

The taxpayer appealed against the Commissioner's decision. The taxpayer claimed that in July 2004, Mr Barakat called the Tax Office to cancel the partnership's GST registration as the construction activities were drawing to a close and sales of the townhouses were complete and therefore there was no need for the partnership to remain in existence. During this telephone conversation, Mr Barakat also queried the outstanding GST liability in respect of the townhouses and was told by the Tax Office that 'any adjustment or tax liability could be assessed through annual reporting' in the partnership's final income tax return.

Reasonable care

The AAT was satisfied that Mr Barakat did not act unreasonably in the circumstances in which he found himself. He did obtain advice from the Tax Office, even though this was misunderstood by him. He believed that any outstanding liability arising from the sale of the townhouses was dependent upon valuations being obtained by professional advisors and calculations would then be done. The reason for this was that some of the land on which the townhouses were built had been acquired before 1 July 2000 (when GST commenced) and the margin scheme therefore applied to the property sales.

For real property acquired before 1 July 2000 that is sold in a taxable supply, a taxpayer can choose to apply the margin scheme in working out the GST on sale. Once the margin scheme is chosen, the GST will be one-eleventh of the difference between the selling price and the price paid to acquire the real property (referred to as the 'consideration method'). Alternatively, a taxpayer can choose to pay GST on the difference between the selling price and a valuation of the real property as at the relevant valuation date.

Recklessness

The AAT notes that 'recklessness' is something more than mere inadvertence or carelessness. It involves running what a 'reasonable person' would regard as an unjustifiable risk. The AAT concluded that Mr Barakat acted reasonably in all the circumstances and did not knowingly run an unjustifiable risk of a tax shortfall in failing to take steps, at the time of lodging the BASs, to determine the GST treatment to be afforded to the sales.

The AAT also notes that the 'penalty regime is to penalise non-compliance with the requirements of the legislation'. This implies disregard or reckless behaviour, which does not exist in this case. The AAT found that there was a 'genuine and honest mistake as to the pre-requisites of compliance with the legislation'.

PSI provisions income attributed to electrical engineer — AAT Case: Skiba v. FCT [2007] AATA 1705 [2007]

In a recent decision in the case of *Skiba and Commissioner of Taxation* [2007] AATA 1705 (27 August 2007), the Administrative Appeals Tribunal (AAT) held that consultancy income derived by a company was personal services income (PSI) as contained in Division 86 and 87 of the *Income Taxation Assessment Act 1997* (ITAA 1997). The income was earned by the company for the provision of the services of an engineer, who was also the sole director of the company.

The taxpayer, an electrical engineer, was the sole Director of a company called Marketcroft Pty Ltd (Marketcroft), which conducted engineering consultancy services. Marketcroft entered into contracts with agencies for the provision of the taxpayer's electrical engineering services to clients of the agencies.

The taxpayer claimed that his business was a personal services business on the basis that it satisfied two of the four personal services business tests (discussed below).

The Commissioner attributed the company's income to the taxpayer directly. In his view the company was unable to prove that the contracts were a part of a genuine personal services business and therefore the personal services income rules applied.

Broadly, under the PSI rules, where income is derived mainly as a reward for an individual's personal efforts or skills, this represents the individual's PSI, irrespective of whether or not that income is derived in another entity, such as a company. Section 86-15(2) of ITAA 1997 states that a **personal services entity** is a company, partnership or trust whose ordinary income or statutory income includes the personal services income of one or more individuals.

The taxpayer contended that the company derived income which was not attributable to him under an exception contained in section 86–15(3) of ITAA 1997. As a threshold test, the section applies where 80% or more of an individual’s PSI is from the same entity. In such circumstances, if either the entity or the individual does not meet the results test, depending upon which entity has included the personal services income in their assessable income, the income is not taken to be from conducting a person services business.

It is noted that the test outlined above will not apply where there is a personal services business determined to be in force as granted by the Commissioner. However, neither the taxpayer nor the individual in the case had applied for such a determination.

In the absence of a determination, the Commissioner argued that Marketcroft did not conduct a personal services business within the meaning of section 87–15 of the ITAA 1997 because it did not meet the results test in section 87–15(3). The income was therefore properly attributed to the taxpayer under section 86–15 of the ITAA 1997.

The AAT agreed with the Commissioner, and rejected the taxpayer’s argument that he was operating a personal services business. The AAT held that the results test was not satisfied because the income derived by the company was not income for producing a result but rather income for ongoing performance for work assigned to him. To satisfy the results test, the personal services entity is required to supply the plant and equipment, or tools of trade, needed to perform the work required. The personal service entity should also be liable for the cost of rectifying any defect in the work performed. Marketcroft was not required to do either under the contracts with the agencies.

The AAT also held that the unrelated clients test did not apply on the basis that 80% or more of Marketcroft’s income came from one source, as the two clients were associates.

Links:

AAT case: *Leggett and Ors and Commissioner of Taxation* [2007] AATA 1624 (1 August 2007)

<<http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/aat/2007/1624.html?query=1624>>

AAT Case: *Barakat and Ors and Commissioner of Taxation* [2007] AATA 1564 (19 July 2007)

<<http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/aat/2007/1564.html?query=Barakat>>

AAT Case: *Skiba and Commissioner of Taxation* [2007] AATA 1705 (27 August 2007)

<<http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/aat/2007/1705.html?query=skiba>>

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