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DIVISION 7A BREACHES OUTSIDE THE AMENDMENT PERIOD

The law and ATO interpretations around the application of Division 7A (loans from private companies) are complex. Whilst the "spirit" of Division 7A was to stop individuals from accessing "corporately taxed" funds, its reach goes much further than that. As a result, it is not uncommon for private companies and their shareholders to unknowingly fall foul of these provisions.

Once it has been determined that there has been a Division 7A breach, it is necessary to consider whether the tax implications of that breach are outside the relevant amendment period for the borrower's tax return.

The Tax Act provides the ATO with the power to amend an assessment, either on its own volition or upon a request by taxpayer, but this power is subject to time limits. Broadly the time limits are 2 years from the original assessment for most individuals and small business entities and 4 years for other taxpayers. That is, the 4-year amendment period is reserved for large business taxpayers, taxpayers with complex tax affairs, certain "high risk taxpayers" and where the ATO relies on an anti-avoidance provision. However, the ATO may amend at any time in the event of fraud or evasion.

The amendment period commences on the day the notice of assessment is given to the taxpayer (which presumably means the date upon which it is issued to the taxpayer or their agent).

The Tax Act provides that if the 2-year amendment period does not apply, a 4-year amendment period applies. The category of taxpayers to which a 4-year amendment applies includes:

a) a business taxpayer (individual or corporate) which is not a small business entity;
b) a partner (individual or corporate) in a partnership which carries on a business and the partnership is not a small business entity;
c) the beneficiary (individual or corporate) of a trust which carries on a business and the trust is not a small business entity, or the trustee is not a full self-assessment taxpayer;
d) a trustee which is a partner (in their capacity as trustee) in a partnership and the partnership is not a small business taxpayer; and

e) a trustee which is a beneficiary (in their capacity as trustee) of another trust and the other trust is not a small business taxpayer, or the trustee of the other trust is not a full self-assessment taxpayer.

Where you have identified a Division 7A breach, the first step should be to determine whether the breach has occurred within the borrower's respective amendment period as it may be that you (and the ATO) are unable to make amendments to deal with the breach or attempt to rectify the breach.

Amendments involving fraud or evasion extend beyond 4 years

For all taxpayers the ATO may amend an assessment at any time where there has been an avoidance of tax that, in its opinion, is due to fraud or evasion.

Neither the terms fraud nor evasion are defined in the legislation. At common law, fraud exists where a person makes a false statement or representation either knowing it is false, or without a genuine belief in its truth, or is recklessly careless whether it is true or false. The test is as to the genuine belief of the person making the statement.

Evasion is probably something less than fraud but more than intentional avoidance. The Courts have taken the view that evasion involves something more than a mere omission or neglect to pay duty but rather involves the intentional avoidance of payment in circumstances indicating to the party that they are or may be under some obligation to pay it.

ATO guidance

The ATO has released Practice Statement Law Administration PS LA 2008/6 – Fraud or Evasion. It provides instruction to ATO staff on how to deal with taxpayers that have committed or are suspected of having committed fraud or evasion.

For the unlimited amendment period to be enlivened the ATO must form an "opinion" that there has been fraud or evasion. For the ATO to form such an opinion there would need to be evidence that there was either a false statement or representation made by a taxpayer either knowing it is false, or without a genuine belief in its truth, or is recklessly careless whether it is true or false, or in terms of evasion, a blameworthy act or omission on the part of the taxpayer where they had knowledge of the breach of Division 7A and its implications in an earlier year, yet failed to include the deemed dividends as assessable income.

In this regard, the ATO provided an example in PSLA 2010/4 "*Division 7A – trust entitlements*" at paragraph 147 through 156 that highlighted a not dissimilar mistake whereby a 2008 year distribution from a trust to a private company was not properly treated as being subject to Division 7A and the ATO stated at paragraph 156:

> *In such a situation, subject to other contributing factors, it would not be unreasonable for a taxation officer to conclude that the Commissioner's discretion should be exercised in the taxpayer's favour. In this context it is noted that a significant number of tax agents have made similar mistakes as there has been a degree of confusion as to the correct*

application of Division 7A to transactions between private companies and entities such as trusts.

We are aware that the ATO have previously accepted these breaches as “honest mistakes” or “inadvertent omissions” in favourably exercising their discretion to disregard the application of Division 7A to a prior breach, subject to corrective action being undertaken by the taxpayer. As a result, questions of “Evasion” were never raised nor considered.

Whether the ATO would still form that opinion some 14 years after their 2009 change of interpretation with respect to a more recent unpaid distribution from a trust to a private company is a more challenging proposition.

If you would like to discuss the above matters further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

ATO FINALISES ITS VIEW ON DEDUCTIBILITY OF LABOUR COSTS ON CONSTRUCTING OR CREATING CAPITAL ASSETS

In November 2019, the ATO issued TR 2019/D6 which looks at the deductibility of certain labour costs related to constructing or creating capital (tangible or intangible) assets under s8-1 of the Income Tax Assessment Act 1997. The ATO’s view is that labour costs incurred specifically for constructing or creating capital assets are of a capital nature and therefore, cannot be deducted. This extends to include other on-costs such as leave, bonuses and allowances.

In June 2022 this view was finalised as TR 2023/2. The final ruling made some small changes to the Draft and includes additional examples but the ATO continues to maintain its view that labour costs can be prevented from being deductible where they are on capital account and there is no presumption that they will always be on revenue account.

Notwithstanding the ATOs view that labour costs incurred specifically for constructing or creating capital assets are of a capital nature and therefore, cannot be deducted, Example 1 of the Ruling does provide good guidance with respect to the salaries of employees who are employed in the ‘ordinary recurrent working operations of the business’.

14. “Australian Head Co has a long-standing general manager. Under the employment contract, the general manager has responsibility for the day-to-day operations of all the Australian operations, as well as developing strategy and plans for future operations. The general manager is not required to time-write their work hours. However, for accounting purposes, a portion of their labour cost is capitalised as part of overhead allocations. During the construction of the facility by Australian Sub Co, the general manager spends approximately one day a week discussing aspects of the construction project with other managers and contractors involved, and preparing reports on the progress of the construction project for Offshore Parent Co.

15. The salary of the general manager of Australian Head Co will be immediately deductible under section 8-1 as they are not considered to be specifically employed for the construction or creation of a capital asset. Rather, they are specifically employed in the ordinary recurrent working operations of the business. There is nothing in the

circumstances of their employment, including their roles, responsibilities, time recording or the accounting treatment that changes the essential character from being an ordinary working expense. The fact that some of their time is spent on activities related to the construction of the facility is an ordinary incident of the general manager role and does not change the essential character of, or call for apportionment of, their salary.

16. A similar outcome would arise for support functions, such as human resources or legal staff who are employed in the ongoing business of the Australian operations but devote an infrequent or incidental amount of their time to supporting the construction project."

The ruling also seeks to 'apportion' labour costs of employees to a capital asset where work is done for construction of the asset provided the apportionment occurs on a 'fair and reasonable basis'.

"72. Section 8-1 prevents a deduction for an amount to the extent that it is capital or capital in nature. If the essential character of a loss or outgoing can be said to be in part on capital account, then the words 'to the extent that' require apportionment on a fair and reasonable basis.

73. As noted by the Full Court of the High Court of Australia in Ronpibon Tin NL v Commissioner of Taxation (Cth) [1949] HCA 15 (Ronpibon):

...

74. The extract in paragraph 73 of this Ruling supports the view that section 8-1 contemplates apportionment and where expenditure is in respect of services (such as labour services) of which distinct or several parts are devoted, that may provide a basis for apportionment."

Additionally, from paragraph 80:

"The accounting treatment is not a determinative factor of the character of expenditure incurred for income tax purposes. However, there is substantial case law indicating that the way the expenditure is classified and treated for accounting purposes and how the accounting systems record expenditure may be a useful indicator of the facts and circumstances surrounding the expenditure and can therefore assist in ascertaining its true nature when completing the full and complete assessment of all the relevant facts and circumstances. Accounting treatment may also be a useful indication of a reasonable basis for apportionment of expenditure."

Whilst this is welcome, there remains considerable complexity in first determining when a labour cost should be treated as incurred specifically for construction or creation of capital assets and must be capitalised rather than deducted outright.

If you would like to discuss the above matters further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.

PAYROLL TAX – SHOULD WA MEDICAL PRACTITIONERS BE CONCERNED?

In the aftermath of two landmark payroll tax cases against medical centres in the eastern states, and Revenue NSW and the State Revenue Office Victoria each releasing a Ruling on payroll tax on medical centres, it is understandable WA's medical and allied healthcare practitioners are getting nervous.

Payroll tax is payable by employers on all taxable wages paid to a common law employee. However, where there is no common law employer–employee relationship, if it is established that amounts are paid under *"a relevant contract"* to a contractor, these payments will still be considered wages for the purposes of payroll tax liability.

The courts concluded that a relevant contract will often exist between medical centres (and other allied health clinics) and each practitioner operating from the clinic in the recent decisions in the NSW case, *Thomas and Naaz Pty Ltd v Chief Commissioner of State Revenue [2021] NSWCATAD 259* ("the Thomas and Naaz case") and the Victoria case, the *Commissioner of State Revenue (Vic) v The Optical Superstore Pty Ltd [2019] VSCA 197* ("the Optical Superstore case").

Both state revenue authorities confirmed their interpretation of existing payroll tax laws to medical centres by issuing Revenue Ruling PTA-041 (Ruling) on 11 August 2023, stating that payroll tax may apply to payments made by medical practices to their practitioners where the agreement between the practitioner and clinic can be properly characterised as a 'relevant contract'.

The Ruling has adopted the view that if a medical centre engages a practitioner to practise from its premises, or holds out to the public that it provides patients with access to the medical services of a practitioner, it is likely that a relevant contract exists.

PTA-041 considers an entity that conducts a medical centre business (referred to as a 'medical centre'), includes dental clinics, physiotherapy practices, radiology centres and similar healthcare providers who contract with medical, dental and other health practitioners or their entities ('practitioners') to provide patients with access to the services of practitioners.

As the payroll tax legislation in each of the States and Territories is relatively similar (due to harmonisation), the substance of these rulings in the context of medical centres is the same. The NSW and Victorian Rulings are also essentially similar to earlier rulings issued by the revenue authorities in Queensland (PTAQ000.6.1) and South Australia (PTA SA003) respectively.

Medical practices typically operate a 'service entity' model whereby the practice collects consultation income on behalf of doctors and then distributes it to individual doctors after deducting a service fee. If the contract provides, either expressly or by implication, that a practitioner is engaged to supply work-related services to the medical centre by serving patients for or on behalf of the medical centre, the contract is a 'relevant contract'. Where a service entity is used to pay the practitioners amounts owed (as opposed to payments coming directly from the medical centre structure), the third-party payment provisions of the relevant Payroll Tax Act can apply to assess the medical practice for payroll tax on those payments.

All Australian state revenue offices (***except Western Australia***) have confirmed that they will adopt this application of existing payroll tax laws to encompass medical practices operating 'service entities'. Unsurprisingly, this opens the floodgates for payroll tax audits and assessments that may be issued for the last 5 years to medical practices operating a typical

service fee arrangement. In the face of this significant potential impact, most states have announced amnesty periods on this application of the payroll tax rules.

Where does this leave WA health practitioners?

The West Australian government has confirmed that it will maintain its' current payroll tax provisions applying to GPs operating in medical centres. The Royal Australian College of GPs (WA chair) Dr Ramya Raman raised concerns with the WA state government on this matter and said that it had a written assurance from WA's new deputy premier and Treasurer, the Hon. Rita Saffioti that the West Australian government **did not** intend to follow other states in making medical centres liable for payroll tax.

The letter said that under WA's existing payroll tax provisions, most GPs working in medical practices under independent agreements *"are considered contractors running an independent business*". Furthermore, "*The $1 million tax free threshold means the majority are not subject to payroll tax. The Western Australian Government does not intend to change these provisions."*

Although the WA government has confirmed that it will maintain its' current interpretation of payroll tax laws, it is important to note that not every medical practice and practitioner arrangement in WA will automatically be outside of the current WA payroll tax rules (and not subject to payroll tax). Each contract must be considered on a case-by-case basis.

The recent cases are a timely reminder for medical centres to review their service agreements and operating arrangements with their medical practitioners. The agreements in Thomas and Naaz contained a high level of control exercised by the Medical Practice over the practitioners. It is more difficult for State Revenue authorities to assert a relevant contract exists, where the practitioners carry on their own business without any control or influence by the Medical Practice. Exemptions may also apply on a practitioner-by-practitioner basis but must be supported by relevant evidence.

The key takeaway is that WA Medical Practice owners cannot afford to overlook the genuine possibility that payroll tax may apply on the payments that their Medical Practices make to practitioners.

If you would like to discuss the above matters further, please contact Andrew Lowry or Leonard Tebbutt on 08 9444 9711.