Federal Court emphasises role of tapayer's intention in characterising losses

PRICE STREET PROFESSIONAL CENTRE PTY LTD V FCT [2007] FCA 345

INTRODUCTION

In *Price Street Professional Centre Pty Ltd v FCT,*[1] the Federal Court heard an appeal from the decision of the Administrative Appeals Tribunal ("AAT") concerning the amended assessment issued to the taxpayer by the Commissioner disallowing losses incurred upon the sale of real property in the 1993 income year. The Tribunal affirmed the Commissioner's decision to issue amended assessments to the taxpayer and impose penalties after disallowing a claim for deductions for losses incurred upon the sale of real property. The Federal Court confirmed the Tribunal's decision that the losses from the sale were on capital account and not allowable deductions, and upheld the penalties imposed. The decision of the Federal Court highlights the need for taxpayers involved in the acquisition and sale of real property to understand fully the nature of the transaction and the characterisation of the profits and losses generated thereafter, in order to avoid the risk of amended assessments and the imposition of penalties.

FACTUAL BACKGROUND

The taxpayer was a company incorporated in 1982 as a shelf company. Two shares were issued, one of which was issued to a Mr Paul Doumany ("Doumany"), principal of Paul Doumany & Co, solicitors ("the firm"). In 1991, the firm began acting on behalf of Mr Toshiaki Iwasaki ("Iwasaki"), a non-resident business man, who had purchased vacant land in Rockhampton, Queensland for $940,000 ("the land"). The land was adjacent to a tertiary education institution. According to correspondence between the firm on Iwasaki's behalf and the Foreign Investment Review Board ("FIRB"), Iwasaki intended to develop the land to provide accommodation to overseas students attending the institution.

On 28 November 1991 Iwasaki paid to Doumany $1,449,998. At a meeting of the directors of the taxpayer, the directors resolved to allot Doumany 1,449,998 ordinary shares fully paid to $1.00 each. Doumany paid for the shares using the money received from Iwasaki. Iwasaki then transferred the land to the taxpayer for $1,450,000, which the taxpayer paid for using the money it had received from Doumany.

On the same day Doumany signed a written acknowledgment of his indebtedness to Iwasaki for the amount of $1,450,000, which Doumany was to repay by the transfer of 1,450,000 ordinary shares in the taxpayer to Iwasaki or his nominee. It was a condition of the agreement that while Doumany held the shares, he would not allow the taxpayer to declare any dividend or make any distribution without the written consent of Iwasaki or his nominee. Iwasaki also signed a deed of conditional forgiveness of the debt of $1,450,000, releasing Doumany from any further obligations regarding the debt, subject to the transfer of Doumany's shares to Iwasaki or his nominee.

Thereafter, having presumably constructed accommodation on the land (it is unclear from the facts), the taxpayer entered into a lease of dormitory accommodation on the land with a third party for a period of three years commencing on 15 December 1991. By letter dated 20 December 1991 addressed to Iwasaki's accountants, Piper & Holmes Pty Ltd ("Piper & Holmes"), the firm noted that Doumany held 1,449,999 ordinary shares and Mr GD Hyland ("Hyland") held one ordinary share, on trust for Iwasaki.

In early 1992, discussions were held to consider the further development of the land. However by 30 September 1992, the taxpayer had decided to sell the land instead and by contract of sale dated 14 October 1992, the taxpayer did so for a price of $1,105,000. After payment of certain amounts, including an unregistered mortgage, the taxpayer was left with $720,794 from the sale, which it subsequently paid to Iwasaki.

As at 1 May 1993, Doumany and Hyland were the directors of the taxpayer. However, soon after Hyland resigned as director and transferred his share to Doumany's wife, who was subsequently appointed as a director. The taxpayer then changed its name to Price Street Professional Centre Pty Ltd in July 1993.

In August 1993, Piper & Holmes lodged a tax return on behalf of the taxpayer which indicated a nil tax liability for the year ending 30 June 1993, due to an accumulated trading loss and a capital gains loss. On 17 September 1993 Iwasaki authorised the firm to wind up the taxpayer, and relinquished any claim he had to the beneficial ownership of the 1,450,000 shares held in the taxpayer.

However, the taxpayer then appointed new accountants, Lee, Garvey Hunt & Fearnsley ("LGHF"), sometime prior to 14 July 1994. On 14 July 1994, LGHF sent a letter to the Australian Tax Office ("ATO") advising that on review of the accounts an error had been made regarding trading stock. LGHF requested that the taxpayer's tax return for the year ended 30 June 1993 be amended to treat the loss of $755,377 as a revenue loss and not a capital one as originally treated. That loss was then carried forward in the taxpayer's accounts into the 1995, 1996, 1997 and 1998 financial years.

The facts of the case do not reveal the purpose to which the taxpayer was put following the change to its name. However, given the advice of LGHF to characterise the loss of $755,377 as a revenue loss, it is assumed that Doumany sought to inject income into the taxpayer in order to soak up the losses. If the loss was characterised as a revenue loss, then any income of the taxpayer could be offset against those losses.

In July 1999, the ATO audited the taxpayer and issued notices of amended assessment for the years ended 30 June 1995, 1996, 1997 and 1998, excluding the claims for the losses carried forward from the 1993 financial year. A penalty of 75 per cent was also imposed for those same years. The taxpayer's objection to the Commissioner was disallowed and the taxpayer appealed to the AAT.

RELEVANT LEGISLATION

As the relevant loss occurred in the 1993 year of income, the former s 51(1) of the *Income Tax Assessment Act 1936* ("ITAA 1936") applied in this case. The section provided:

> All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

The section specifically excludes capital losses as an allowable deduction.

Section 226J of ITAA 1936 applied in relation to the imposition of penalties by the Commissioner. At the relevant time the section provided that a taxpayer, whom has a tax shortfall for a year, which was caused by the *intentional disregard* of the taxpayer of the Act or the regulations, is liable to pay a penalty of 75 per cent of the amount of the shortfall.

Section 14ZZK(b) of the *Taxation Administration Act 1953* (Cth) ("TAA 1953")provides that when lodging an objection, the taxpayer bears the onus of proving that a decision of the Commissioner "should not have been made or should have been made differently".

TRIBUNAL'S DECISION

In support of its objection to the amended assessments, the taxpayer argued that the activities in which it engaged were in the nature of a profit-making venture and as a result the losses incurred were revenue losses. The taxpayer further submitted that the penalty of 75 per cent was inappropriate because the taxpayer had acted in accordance with advice of senior counsel.

In dismissing the taxpayer's appeal, the Tribunal held that, contrary to the taxpayer's submissions, the land was a capital asset and thus the loss incurred on the sale of the property was not a revenue loss but a capital one. Senior Member McCabe also concluded that the 75 per cent penalty imposed on the taxpayer under s 226J ITAA 1936 was appropriate. In delivering its decision, the Tribunal noted that the onus of proving the objection decisions were wrong, lay with the taxpayer as per s 14ZZK(b) TAA 1953. The Tribunal considered that, although it was not prepared to draw an adverse inference from the failure of Doumany to give evidence at the hearing, this failure meant that it was more difficult for the taxpayer to discharge its onus.

ISSUES ON APPEAL

The relevant issues before the Court on appeal were as follows:

(a) Was the loss incurred by the taxpayer an allowable deduction under s 51(1) ITAA 1936?

(b) If the taxpayer was wrong in claiming the deductions, were penalties correctly imposed under s 226J ITAA 1936?; and

(c) Did the Tribunal err in instructing itself as to the taxpayer's onus of proof? [2]

The Court addressed five other grounds on appeal. These related to particular findings of the Tribunal on the materials before it, the Tribunal's decision as to the "continuity of ownership" test in s 80A ITAA 1936 and the "same business test" in s 80E ITAA 1936 and an apparent error of fact made by the Tribunal concerning the criminal prosecution of Doumany. For the purposes of this paper these grounds will not be addressed and their outcome does not bare weight on the Court's reasoning and decisions on the issues as discussed in this paper.

Was the loss an allowable deduction under s 51(1) ITAA 1936?

Justice Collier stated that the question to be answered was whether the relevant loss should be characterised as capital or income; if the loss was capital in nature it was not an allowable deduction in accordance with s 51(1) of ITAA 1936. His Honour stated that despite the number of cases concerning this issue, the outcome of each case will essentially depend on the facts. Collier J then outlined some of the general legal principles relevant to the question of whether the loss was on revenue or capital account.

His Honour noted that historically, the courts have answered this question "in terms of whether the taxpayer was merely realising the asset (in which case the gain is characterised as a capital gain), or whether the gain was made in the operation of business in carrying out a scheme of profit-making (in which case the gain is characterised as income or revenue)"[3]. Turning to the relevant purpose required to evidence a profit-making scheme, Collier J affirmed that it is only necessary that the intention or purpose of profit-making by sale be one aspect of a profit-making scheme in existence at the time of the acquisition of the asset. Citing *Cooling*[4] and *Selleck v Commissioner of Taxation*[5], his Honour added that such a purpose, however, must be a "not insignificant" aspect of the taxpayer's activities. With regard to the acquisition and sale of land, Collier J cited with approval Justice Hill's statement in *Westfield*[6]at 333-345 that:

> (I)t is difficult to conceive of a case where a taxpayer would be said to have made a profit from the carrying on, or carrying out, of a profit-making scheme, where, in the case of the scheme involving the acquisition and resale of land, there was, at the time of acquisition, no purpose of resale of land, but only the possibility (present, one may observe, in the case of every acquisition of land) that the land may be resold.

Applying the facts as founded by the Tribunal, Collier J concluded that the Tribunal had correctly decided that the relevant loss was a capital loss and not an allowable deduction under s 51(1) ITAA 1936. His Honour said that contrary to the submissions of the taxpayer, it was clear the Tribunal had applied the correct test, which was whether the taxpayer had acquired the land with a profit-making purpose. However, the Tribunal found no such purpose on the evidence, either as "the" purpose of the scheme or one of many purposes. As shown by the correspondence between Iwasaki's solicitors and the FIRB, the land was acquired in order to construct accommodation. Thereafter, the land was transferred to the taxpayer and used to supply student accommodation in generating income.

Further, Collier J emphasised that the mere consideration of a profit-making purpose or activity is not enough to evidence the requisite intention. His Honour stated:

> … in my view the law is **not** that, in the absence of a clear intention of a taxpayer in acquiring the property that it be used for a profit-making purpose, **any** subsequent consideration by the taxpayer of exploitation of a capital asset (for example by the possible options of either subdivision or on-selling) results in the immediate creation of a profit-making scheme and the resultant characterisation of profits or losses made in respect of subsequent dealings with that asset as revenue[7].

Collier J maintained that the surrounding circumstances must be considered in determining the true intention of the taxpayer. A bare claim that the taxpayer had an intention to use the land for a profit-making purpose, without further evidence such as steps to progress those options, does not sustain a finding that the taxpayer was engaged in a profit-making scheme.

For these reasons, the taxpayer's consideration of the prospect of further development of the land, without any further action to progress those prospects, was insufficient to conclude that the taxpayer had subsequently acquired a profit-making purpose, capable of turning the activity into a profit-making scheme.

Were the penalties correctly imposed under s 226J ITAA 1936?

Collier J stated that the taxpayer bears the burden of proving that there was no intentional disregard of the ITAA 1936 or the regulations such that a penalty under s 226J should not have been imposed. The question of whether the taxpayer's conduct constitutes an intentional disregard is a matter of fact. What is required for such a finding is, among other things, "an understanding by the taxpayer of the effect of the relevant legislation or regulations, an appreciation by the taxpayer of how that legislation or regulation applies to the circumstances of the taxpayer, and finally, deliberate conduct of the taxpayer so as to flout the ITAA 1936 or regulations"[8].

Justice Collier affirmed the Commissioner's decision to impose a 75 per cent penalty on the taxpayer on the basis that Doumany was the legal adviser of Iwasaki, held the majority of the shares in his name and was fully aware of the circumstances leading both to the sale of the land and to the taxpayer claiming a tax offset for the losses incurred. Given the taxpayer had the benefit of advice provided by the previous accountants, Piper and Holmes, that

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Doumany was a solicitor and had complete knowledge of the history of the transaction, Justice Collier found the Tribunal's decision that the taxpayer's conduct amounted to an intentional disregard of the legislation was not an unreasonable one. That the taxpayer had sought to rely on the oral advice of counsel did not persuade the Tribunal or the Federal Court. His Honour thus preserved the penalties imposed.

Did the Tribunal err in instructing itself as to the taxpayer's onus of proof and as to its role in reviewing the objection decision?

The taxpayer submitted that "the onus of proof provided for in s 14ZZK TAA 1953 operated against the taxpayer only where the balance of probabilities was against a finding of fact required by the taxpayer or was evenly balanced for and against such a finding of fact".[9] However, Collier J stated that such a limited approach to the section greatly misconceived the obligation placed on taxpayers when challenging a determination of the Commissioner. His Honour cited with approval the statement of Jacobs J in *McCormack*[10] at 314 that there is, "by virtue of the section, a rebuttable presumption of law that an assessment is not excessive, and the onus is on the taxpayer to rebut that presumption". Thus, where the evidence in a particular case is equivocal, the taxpayer fails to discharge its onus.

The taxpayer also contended the Tribunal erred in law by correctly finding that the rule in *Jones v Dunkel*[11] did not apply, but then incorrectly proceeded to apply that rule. The rule provides that an adverse interest *may* be drawn from the unexplained failure by a party to call evidence or witnesses which might be expected to support the case being put by that party.

Collier J concluded that the Tribunal had neither erred in finding that the taxpayer had not discharged the onus, nor had it in fact applied the rule in *Jones v Dunkel* as the taxpayer submitted. Although the Tribunal stated that the task of discharging its onus was more difficult for the taxpayer given that Doumany did not appear before the Tribunal to give evidence, his Honour found that the Tribunal had made its decision on the evidence before it, and not on adverse inferences drawn from Doumany's failure to give evidence.

Collier J maintained that given Doumany's involvement in the taxpayer from the outset, his evidence was clearly important, and without it, the Tribunal had good reason to conclude that the taxpayer's failure to call Doumany as a witness made discharging the burden of proof more difficult in these proceedings. The lack of evidence resulted in the taxpayer failing to rebut the presumption that the Commissioner's assessment was not excessive.

FEDERAL COURT'S DECISION

The Federal Court upheld the Commissioner's decision and dismissed the appeal. The loss was held to be a capital loss and thus not an allowable deduction under s 51(1) ITAA 1936. As the onus lay on the taxpayer to rebut the presumption that the penalties imposed by the Commissioner were not excessive, the Court upheld the penalties imposed on the taxpayer under s 226J ITAA 1936

COMMENT AND CONCLUSION

The decision of the Federal Court reinforces the need for taxpayers involved in the acquisition and sale of real property to understand fully the nature of the transaction and the characterisation of the profits and losses generated thereafter, in order to avoid not only the risk of amended assessments but also the imposition of penalties. With regard to profit-making schemes, the intention or purpose of profit making by sale, while not required to be the sole purpose of the relevant activity, must not be an insignificant purpose. Further, where the purpose for which land is put is subsequently changed to one of profit making by sale, the later purpose must be more than a bare intention. The intention must be acted upon in order to stamp the activity with the requisite profit-making purpose for the proceeds or losses to be characterized as being on revenue account.

The case also highlights that taxpayers who claim deductions or losses in the face of legislation, regulations or professional advice to the contrary, may expose themselves to severe penalties. Once the Commissioner imposes a penalty, arguing against that decision is a formidable task, as the onus rests with the taxpayer to rebut the presumption that the penalties are not excessive.

> *A bare claim that the taxpayer had an intention to use the land for a profit-making purpose, without further evidence such as steps to progress those options, does not sustain a finding that the taxpayer was engaged in a profit-making scheme.*

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Reference notes:

1. *[2007] FCA 345.*
2. *Ibid note 1 at [6].*
3. *Ibid note 1 at [20].*
4. *FCT v Cooling (1990) 22 FCR 42 at 57.*
5. *[1997] 799 FCA .*
6. *Westfield Ltd v Commissioner of Taxation (1991) 28 FCR 333.*
7. *Ibid note 1 at [34].*
8. *Ibid note 1 at [43].*
9. *Ibid note 1 at [52].*
10. *McCormack v Commissioner of Taxation (1979) 143 CLR 284.*
11. *(1959) 101 CLR 298.*