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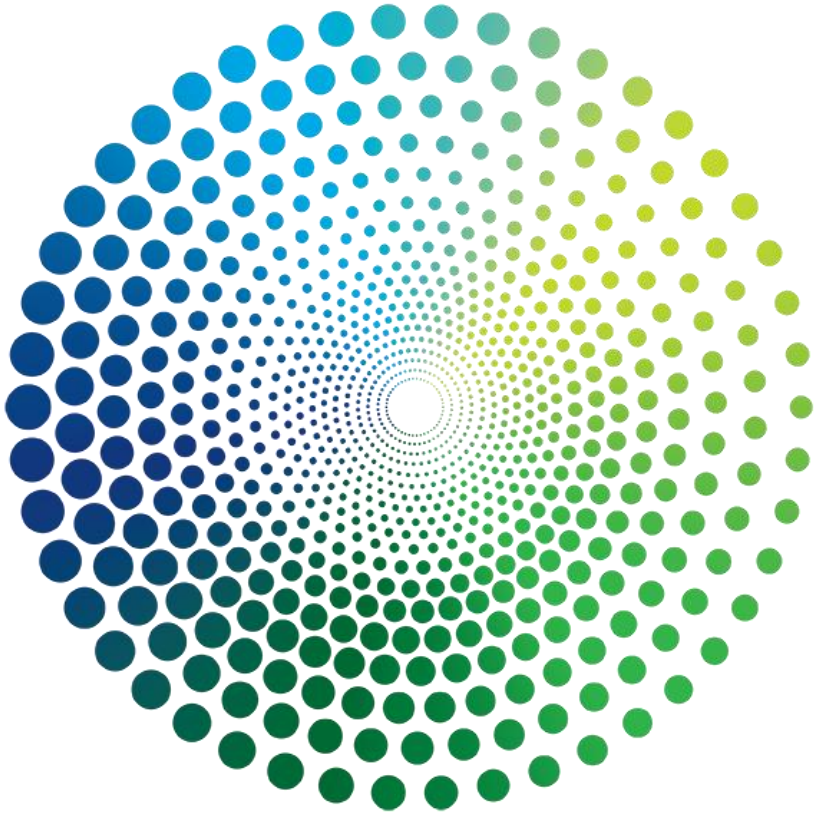

# Tax Insights

# Federal Court recognition of the commercial reality of small and privately owned businesses

## Snapshot

Some refreshing judicial commentary was handed down by the Federal Court on 19 August 2022, where His Honour Justice Logan recognised the comparative informality concerning small and privately-owned business taxpayer groups, in contrast to the behaviour expected of larger corporate taxpayers. Below are some key insights arising out of two simultaneous decisions handed down by Logan J, the *Anglo American Investments Pty Ltd (Trustee) v Commissioner of Taxation [2022] FCA 971* (the AAI Case) and the *Melbourne Corporation of Australia Pty Ltd v CoT [2022] FCA 972* (the MCA Case).

### A snapshot of the cases

Three corporate entities that were associated with Mr Vanda Gould (Mr Gould) appealed an Objection Decision made by the Commissioner of Taxation (Commissioner) which denied deductions for purported bad debts, management fees and interest costs on purported loans under s 8-1 of the Income Tax Assessment Act (ITAA 1997). For practical reasons and to reduce risks of bias, the AAI Case dealt with one of the three entities, Anglo American Investments Pty Ltd (AAI), while the remaining two entities,

Melbourne Corporation of Australia Pty Ltd (MCA) and Photo Advertising (International) Pty Ltd (PA) were addressed in the MCA Case.

The common thread between the three corporate entities was that they each relied on the evidence of the principal witness, Mr Gould, who recorded a number of fees, interest expenses and bad debts ex post facto to the general ledgers after the end of each income year. The primary issue for both cases was whether the entities could claim these as allowable deductions under s 8-1. Logan J rejected the taxpayers' arguments, finding that the asserted expenses were a sham (he noted that a number of the journal entries recording these liabilities were a 'mere charade' or 'façade', contrived to obtain fiscally advantageous results). With respect to the interest expenses on purported loans, Logan J was not satisfied that the loans existed at all, or if so, were used for income producing purposes. Crucial to this determination was the pattern of 'closing adjustments' made by Mr Gould at the end of each financial year.

The purpose of this publication is not to comment on the Court's approach to the substantive issues but rather to highlight a number of features noted in the judgement as relevant to small and privately-owned taxpayers.

## Recognition of informality among small and closely-held businesses – a common sense approach

Determining the credibility of Mr Gould in the absence of formal documentation and records was a central issue in both cases. While the Federal Court ultimately held that the taxpayer's asserted claims for deductions were a sham, Logan J nevertheless recognised that informal practices were not unusual for small and closely-held taxpayers.

At paragraph 41 of the MCA Case, His Honour stated:

> *"There is nothing remarkable about informality attending either the internal managerial affairs of Melbourne Corporation or any other of the other entities which Mr Gould controlled or the relations between those entities."*

His Honour also stated that for closely-held and controlled groups of private and family companies, it is not surprising for internal arrangements to be made informally (*Electrical Enterprises Retail Pty Ltd v Rodgers (1988) 15 NSWL 473 at 489*). For example, the alleged making of a loan may only be supported by book entries and oral testimony as opposed to requiring a formal loan agreement (*VL Finance Pty Ltd v Legudi (2003) 54 ATR 221* at 30).

Moreover, Logan J called on the Commissioner to recognise the informal nature of smaller businesses, in the course of administering taxation laws. At paragraph 43, His Honour stated:

> *"A great disservice can be done to the Australian business community, especially the small business community, by a failure on the part of the Commissioner, in his administration of national taxation laws, to recognise, as the courts do in cases great and small and in circumstances extending across a wide range of controversies, these ordinary features of Australian commercial life."*

While the Commissioner's conduct was not a pertinent issue in this case, Logan J in obiter acknowledged the informal practices of the small business community and did not attribute any disadvantage based on informality alone. This was reinforced by Logan J in the AAI Case at paragraph 54 where His Honour stated:

> *"In relation to small business, it is an unremarkable given (although, with respect, the Commissioner's submissions in this case suggest he is unable or unwilling to accept or even understand this) that great informality can and often does attend the formation of legal relations… Even more this is so where the relevant corporate actors are or are represented by the same*

> *individual acting in different capacities or by individuals who are close family members or business associates."*

The recognition of informality however is limited by the key qualification outlined by Nettle J in *VL Finance Pty v Legudi*, where only *'…in the absence of any suggestion of sham, there is no reason why [agreements] made by a family company to members of the family cannot be created orally or by conduct and sufficiently evidenced by book entry…'*. Where there is any evidence to suggest that there may be a sham, the recognition of informal practices afforded to small businesses in evidencing certain transactions or dealings will not hold, as demonstrated in both the MCA Case and the AAI Case.

Overall, Logan J encourages a commonsense approach to documentation, recognising that in terms of business practicality, the expectations of larger corporations are not always relevant to small business. For example, in the AAI Case, His Honour was critical of the Commissioner's "one-size-fits-all" approach in assessing the taxpayer's bad debt. The Commissioner made a priori assumptions that appropriate steps 'such as obtaining and enforcing judgment against a debtor' should have first been taken. Logan J rejected this view in stating that this approach inevitably reduces the issue of irrecoverability into a generalised rule. Moreover, His Honour stated this approach failed to recognise the common reality of small business taxpayers at paragraph 100 where:

> *"In commercial practice, especially with small business, many a reasonable decision is taken for practical business reasons that even to initiate court proceedings in respect of a given debt, much less to prosecute them to judgement and attempted execution on a judgement is, given the costs of litigation and the amount of the debt, likely to be an exercise in throwing good money after bad."*

Against this backdrop of recognising the interests of small taxpayers, in the AAI Case, Logan J also commented on the incorrect use of public rulings by the Commissioner. The Commissioner cited a taxation ruling published by himself, to support the position that a number of the expenses were not deductible. While taxation rulings serve an important public interest to allow for greater consistency in ATO decision-making, His Honour clarified that taxation rulings are not substantive law and cannot be relied upon as such.

At paragraph 340, His Honour, with respect to taxation rulings stated that:

> *"…in relation to substantive taxation liability issues in a taxation appeal in this Court, they are no more than an expression of opinion by a party to such an appeal, as irrelevant as is an opinion furnished by counsel, solicitor or accountant to a taxpayer. On such issues, views expressed in a ruling may well, subject to the exercise of an independent value judgment by counsel in keeping with a duty owed to the Court, inspire a submission by counsel but the appropriate support for any such submission must be found by the citation of the text of legislation, related supporting materials and case law, not a taxation ruling."*

The judicial commentary in both cases not only acknowledged the informal processes and practical matters of the small business community, but also called upon the Commissioner to employ a more practical approach in ensuring that, in the course of administrating his duties, he does not apply unrealistic standards to this group of taxpayers.

## Key Takeaway

The key takeaway for small and privately-owned businesses is that where formal documentation and records are absent, the courts will then look to the taxpayer's accounts and any representations made in business records created under the taxpayer's supervision or approval (MCA Case, para [41]).

Moreover, in dealings with the ATO and where demands for certain documents and information are made (for example under a Request for Information), a degree of flexibility should be afforded by the Commissioner. This is in recognition that it is common practice for small and privately-owned businesses

to engage in transactions or arrangements that have taken place informally or as a matter of business practicality.

Whilst it is always advisable to document agreements in writing and keep formal and contemporaneous records, the recent decisions handed down by the Federal Court provide some leeway for this particular taxpayer group in recognising informality as a commercial norm.

For further information, a link to the full judgement for the MCA Case is available here and the AAI Case is available here. Alternatively, feel free to reach out to the Deloitte contacts below for any questions.

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