

tax alert

The Grant Thornton Tax Alert
for businesses and individuals

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This tax alert looks at the **ATO's report of Compliance Program** which outlines the areas of interest that will be addressed in the coming 12 months.

On 4 August 2005 the Australian Taxation Office ("ATO") released the 2005/06 Compliance Program. This program outlines the ATO's activities and performance over the past 12 months and the expected activities for the coming 12 months. The report is broken up into sections based on taxpayer sizes. This Tax Alert will summarise the important issues for the Small to Medium Enterprises ("SME") sector for the 2005/06 year.

The Commissioner has recognised that the additional funding received by the ATO in the 2005 Federal Budget enables them to more properly address a number of risks, including:

- Dealing more firmly with deliberate non-lodgement and non-payment
- Clearing outstanding debt
- Detecting identity crime to evade tax
- Dealing with serious fraud and tax evasion
- Monitoring capital gains tax
- Reviewing service entity arrangements
- Checking rental property and work-related expenses
- Identifying non-compliance by self managed superannuation funds.

The SMEs are enterprises with turnover between \$2m and \$100m and the sector consists of approximately 85,000 enterprises, being some 72,600 single entities and 12,400 groups (containing around 42,000 members). More than 83% of these enterprises have a turnover of less than \$10m.

The ATO has discovered that business owners and operators require different information to that of their tax agents and that many SMEs rely upon their tax agents for complex advice whilst addressing routine issues themselves. In the coming year the ATO will be providing SMEs with practical tools to manage their own affairs, whilst ensuring they are aware of when to approach their tax agents to obtain advice.

With regard to the upcoming compliance activities, the priorities for the 2005/06 financial year include the following:

- Balancing the compliance program to effectively address income tax risk across the whole SME segment while strengthening the ATO's focus on businesses with a turnover of between \$50 million and \$100 million. This year will see a

- greater emphasis on tax audits
- Monitoring compliance with recently introduced legislation, including consolidation and demergers
- Improving compliance with international tax obligations, including issues such as global profit shifting, non-resident withholding tax and the use of tax havens
- Increasing our focus on the use of shareholder loans.

The ATO is anticipating the conduct of 1,000 reviews, involving the examination of financial statements and may include various interviews with the taxpayer and/or the tax adviser. Where the ATO's concerns are not adequately addressed, it is likely that the review will be escalated to an audit. It is expected that at least 650 audits of SMEs will arise this year. It should be noted, particularly in the SME sector, where the ATO investigates the business operations, this may lead to an investigation of the business owners and any other related entities.

The ATO has noted the following specific areas which will be receiving attention:

Goods & Services Tax ("GST")

The GST has just had its 5th anniversary and it has been discovered that accounting software and internal controls of rapidly growing businesses with income over \$20m have not kept up with their growth. As a result, some of the common mistakes that are arising include the following:

- Misclassifying supplies
- Incorrect recording of transactions between associates
- Incorrectly applying the financial supply rules.

The ATO has also identified a potential risk in the way part payments and security deposits are treated. GST attribution rules allow attribution of a security deposit to be delayed to the tax period when the deposit is either actually applied as payment for the supply or it is forfeited by the purchaser. Part payments, on the other hand, trigger attribution to the tax period when the payment is made.

The ATO is concerned that the failure to correctly differentiate between a part payment and a security deposit can lead to a significant delay in collecting GST. Furthermore, if part payments

are incorrectly treated as security deposits, the deferral of the GST payable may lead to an unfair competitive advantage in the market place. The ATO is undertaking further analysis and consultation to understand the extent of this risk and develop appropriate strategies, including clarifying any issues that might lead to the law being applied incorrectly.

Large one-off or unusual transactions

ATO analysis shows that some small to medium businesses are not correctly reporting and paying GST on unusual or infrequent transactions. Examples of transactions where the ATO are concerned that businesses are not correctly accounting for GST include:

- Disposing of a capital asset (such as trading in motor vehicles)
- Claiming input tax credits for an asset that has been acquired from a non-registered entity
- Imposing GST on the sale of a business as a going concern, when it is actually GST-free, and not remitting the GST to the ATO.

Numerous letters of enquiry will be sent to taxpayers in the coming year and the ATO expects that 350 audits will arise in relation to these issues.

Tax Consolidations

In the small to medium enterprise segment, over 2,400 groups comprising more than 12,600 entities have consolidated. The ATO has previously focussed its compliance activities on membership reviews, which compared its data and Australian Securities and Investments Commission data with group notifications to ensure that consolidated groups included all eligible entities. Through this review program the ATO identified:

- A significant number of incorrect consolidation memberships
- The incorrect application of loss rules such as the continuity of business rules, the same business test and the use of group losses
- The incorrect application of the cost setting rules, which has led to an uplift of asset values, resulting in inflated depreciation claims or reduced capital gains.

The program of comprehensive reviews and audits, focusing on the issues identified last year, will continue this year. There will also be an expansion of the scope of the program to examine issues identified in the large business segment, which, in particular, included various market valuations that resulted in unintended outcomes for the consolidated group.

Demergers

Based on research undertaken by the ATO, it has been identified that a number of restructures may be the result of demerger activity. The ATO is interested in examining cases where it is discovered that a demerger has been implemented, not to improve the efficiency of the business, but to obtain tax benefits such as capital gains tax relief. It is noted that the ATO has previously expressed views that various anti-avoidance measures, including those within section 45B of the Income Tax Assessment Act 1936, may apply to demerger activity. However, we are still awaiting clear guidance from the ATO in relation to this matter.

The ATO is also undertaking specific issue reviews to further understand the compliance risks relating to demergers, as well as communication and education activities to help tax agents and their clients comply with their obligations.

International income tax issues

Over the years, the Australian economy has increased its globalisation, and the SME sector is increasing activities with various foreign jurisdictions. As a consequence, there is a risk to the revenue of various profits being shifted offshore, and avoiding Australian taxation.

The ATO will be focussing on income tax risk review and audit work involving profit-shifting arrangements. The ATO has previously conducted reviews on wholesale distributors. It now intends to broaden the focus of the review program by examining transfer pricing issues in other areas of the SME segment.

This year the ATO expects to conduct 40 reviews and commence 25 audits focusing on profit-shifting arrangements. It also anticipates entering into advance pricing arrangements with 12 SMEs.

The ATO will also be focusing more on the inappropriate use of tax havens and bank secrecy regimes. A range of information sources, including AUSTRAC data, return forms and information from other tax administrations, play an important role in helping it identify appropriate cases for audit.

Should you have any queries in relation to the 2005/06 compliance program, or would like further information as to how the program may affect your business, please do not hesitate to contact your Grant Thornton advisor.

Source: Compliance Program 2005-06, Australian Government/Australian Taxation Office.

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