

Reliability of evidence in tax disputes

by William Calokerinos, CTA,
Barrister, Wentworth Chambers

Taxpayers and their advisers face constant crossroads in disputes with the ATO. These crossroads include, inter alia, the making of ongoing assessment of the probative value of contemporaneous documentation in support of the client taxpayer's position. The recent cases of *Mingos v FCT* and *SDRQ and FCT* serve as a timely reminder of the importance of having access to contemporaneous records to support factual propositions in tax positions being adopted. Taxpayers and their advisers should prudently make value judgements regarding the probative value of documentary evidence held in support of the taxpayer's position with the contextualisation of the documents against the uncontroversial facts of the dispute.

Introduction

During the lifecycle of an ATO investigation, taxpayers prudently need to gauge the precise nature of the information being sought in order to prevent escalation of the dispute.

The ATO is well resourced in the event of litigation and frequently uses statutory notices¹ as a pre-litigation strategy. This is especially important as the ATO has increased the use of evidence-gathering processes to gather evidence prior to litigation.

The consequences of failing to respond to the ATO's use of statutory notices in the pre-litigation phase of a dispute are:

- significant, as there are penalties for non-compliance with statutory notices;² and
- critical, as statutory notices are appropriately drafted and have identified and addressed the risk hypothesis for the tax dispute.

Taxpayers will need to assess the reliability of their evidence collected in support of the position adopted within their tax affairs. As a general proposition, the following will hold true for taxpayers' records:

- the more contemporaneous the documents to the alleged set of facts, the more likely the asserted facts will be persuasive;
- taxpayers need to be aware of their obligations, particularly their burden of proof; and

- in the absence of contemporaneous records, the support and the representations of tax agents and lay witnesses will be subject to the court's assessment and rigour.

The above may sound obvious. Case law suggests that it is not obvious to all and this article argues that it is prudent for taxpayers to demonstrate to their advisers as early as possible that one can prove the asserted tax position with reliable, contemporaneous documentary evidence. This evidence will hopefully ultimately minimise the risk of adverse amended assessments.

The process of collecting relevant documents will require taxpayers and their advisers to engage proactively and meaningfully with the ATO so that the taxpayers and advisers understand what risks the ATO has identified.

In order to assess the veracity of the evidence collected to support the tax position of a taxpayer, an objective assessment is needed in identifying the tax risk.

This objective assessment will include:

- characterising documents by contemporaneity to clearly demonstrate the asserted facts, which is critical in marshalling evidence to support the tax position; and
- applying an understanding of relevant judicial considerations.

Taxpayers and their advisers also need to be mindful of relevant judicial considerations. Courts will apply judicial considerations to the taxpayers' evidence that include:

- hearsay consideration of the evidence; and
- in the event of an appeal, the difficulties in attacking (or overturning) the credit findings for witnesses.

Judicial considerations

There is judicial support for the proposition that the more contemporaneous the document and the statements are, the better. The closer the document is to the timing of the asserted fact, the more reliable the evidence will be viewed.

This proposition has been adopted from the relevant legal principles from the High Court case in *Pollitt v R*,³ citing with approval the passage from *Walton v R*⁴ and the remarks of Deane J.

The High Court in *Walton v R*⁴ opined that, in the context of a phone conversation, the existence of a contemporaneous document will support the asserted words within the conversation (notwithstanding considerations of hearsay), as the contemporaneous document will have the flavor of reliability:

"There is plainly something to be said for the view that, at least in some circumstances, the hearsay rule should be qualified so as not to preclude the receipt of evidence of *contemporaneous statements made by one party to a telephone conversation (either in the course of the actual conversation or immediately before or after it) which disclose that the other party to the conversation was the person against whom it is sought to lead otherwise relevant and admissible evidence of that part of the conversation which was overheard.*" (emphasis added)

Ultimately, taxpayers need to be mindful of the fact that, should a tax dispute matter proceed to hearing, it will be difficult on an appeal to challenge an adverse credibility

finding for a particular witness. An example is the appeal case of *Lemongrove Services Pty Ltd v Rilroll Pty Ltd*.⁵

In the *Lemongrove* case, the appellant sought to challenge the factual findings of a lower court by attempting to demonstrate that a primary judge's finding about a critical issue was "glaringly improbable" or "contrary to compelling inferences".

In effect, the taxpayer was attempting to challenge the factual findings of a court by diminishing the relevance of particular credit findings. The appeal in the *Lemongrove* case was dismissed with costs, but the lessons from that case are:

- Payne J reasoned⁶ that, for an appellant to be successful in attacking credit findings of a lower court, it will be "necessary to point to evidence having a quality which seriously calls into question the integrity of the primary judge's critical finding of fact";
- the attack on credit findings involves a determination of the reliability of the documentary evidence when put in the context of the dispute and the differing versions of witness testimony; and
- Payne J provided a useful factual matrix that applied to testing the probative value of evidence:⁷

"[45] Returning then to the critical question, the primary judge gave close consideration to the conflicting accounts and saw all three participants at the meeting cross-examined. His Honour had the advantage of seeing each witness respond to cross-examination about the critical conversation here in issue. His Honour took into account the contemporaneous documents. This is not a case where the conclusion of the primary judge is shown by uncontroversial facts or uncontested testimony to be erroneous. The contemporaneous and apparently reliable documentary evidence supports the Hanshaws' account [the respondents' account of events]. The primary judge did not fail to deal in a satisfactory way with a substantial amount of evidence.

[46] I would reject the challenge to his Honour's finding that at the 27 November meeting the Hanshaws were not told of that the vendors had rejected a 'subject to finance' clause. It follows that ground 1-4 of the notice of appeal must be dismissed."

The genesis of this article is that taxpayers should support tax positions with contemporaneous representations captured within documentary evidence. Taxpayers are best advised to use best endeavour to capture contemporaneous representations.

Case law has consistently illustrated the importance of utilising "contemporaneous documents" to capture representations in the event of a tax dispute. The alternative to this approach would be summarised as follows:

- missteps in the tax dispute could easily result in the Commissioner utilising compulsive powers or moving straight to amended assessment;
- the ATO does not have to be correct in the tax imposed in the assessment;
- the burden of proof imposed on taxpayers is onerous; and
- while very few disputes result in litigation, the ATO is well resourced and aware that it is a taxpayer's job to convince a court that an assessment is excessive.

Recent case law

The case of *Mingos v FCT*⁸ involved an appeal by the taxpayer pursuant to Pt IVC of the *Taxation Administration Act 1953* (Cth) (TAA) against the disallowance of his objection to the inclusion of the capital gain in his assessable income for the 2014 income year.

The capital gain related to a gain made by a discretionary trust (and distributed to the taxpayer) from the disposal of a dwelling (the property being a residential house) that was asserted by the taxpayer to be exempt from CGT due to the main residence exemption in CGT.⁹

Although the subject property in this dispute was recorded as a trust asset, the taxpayer's case, in short breadth, was that the property was not an asset of the trust but was owned by him beneficially.

The material facts of the case were as follows:

- the property was originally acquired in 1992 by a company (Unique Planning Pty Ltd) on trust for the benefit of the taxpayer absolutely. The taxpayer and his wife and their two children took up occupation of the property as the family's main residence;
- on 16 November 2006, the company transferred the property to the taxpayer, the consideration expressed in the transfer being "entitlement in equity";
- by another transfer of land on 16 November 2006, the taxpayer also transferred the estate in the property to his then wife, the consideration being "natural love and affection". The wife held the interest in the property;
- shortly thereafter in 2006, the marriage started to fail, and the taxpayer moved out of the property into temporary accommodation;
- in November 2010, the taxpayer and his wife entered into a property settlement as a result of the divorce proceedings in the Federal Magistrates Court;
- on 23 December 2010, final orders in the Federal Magistrates Court were entered into by consent in relation to the settlement of property that included, inter alia, the following:
 - the wife was to do all such acts and things and sign such documents at the expense of the taxpayer to transfer to him, or his nominated entity, all her right title and interest in the property; and
 - the taxpayer was obligated to discharge mortgages secured over the property;
- on 27 May 2011, the wife, at the taxpayer's direction, transferred the property to the Lemnian Investment Trust and not to the taxpayer;
- the property was sold by the trust in May 2014; and
- it is the sale of the said property that the taxpayer claimed the main residence exemption under taxation law.⁹

The substantive tax issues in the proceedings were as follows:

- whether or not the taxpayer had an "ownership interest" in the property at the time it was sold in 2014. The court's answer to that question was "no". Davies J reasoned that the taxpayer had failed to discharge the onus of proving

that he had an ownership interest in the property in 2014;¹⁰

- if so, whether the taxpayer was entitled to the main residence exemption in Subdiv 118-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). The court’s answer to that question was “no”;¹¹ and
- if not, whether the amount of the capital gain on which the taxpayer was assessed was excessive. It was the taxpayer’s burden¹² of proof, and the court’s answer to that question was “no”, the assessment was not excessive.¹³

“However aside from that loan agreement, there is no evidence whatsoever to substantiate either the amount of interest, the land tax or any selling costs.”

Evidence before the court

The taxpayer (Mr Mingos) and his tax agent (Mr Munro) gave evidence in the proceedings. The oral testimony evidence of both witnesses was unsatisfactory in terms of substance and was self-serving.¹⁴ The court made this assessment in contrast to the objective circumstances of the tax dispute and the contemporaneous records that were before the court.

Relevantly, the taxpayer asserted in his affidavit and deposed to the difficulties he had in raising the funds necessary to comply with the orders and to the arrangement for the Lemnian Investment Trust to borrow the funds.

The taxpayer also deposed that to enable the Lemnian Investment Trust to borrow from the mortgagee (the Bank of Queensland), the said property was needed as security, and so he arranged to have the residence transferred to Lemnian Investment Trust.

The taxpayer deposed that he never intended to give “the benefit of” the property to the Lemnian Investment Trust and only transferred the property to the Lemnian Investment Trust because the Bank of Queensland required it that way in order to proceed with the loan.

With respect to the reliability of the taxpayer’s evidence (Mr Mingos’ evidence), the court opined the following:

“24. In view of the emails, I reject the taxpayer’s evidence that the property was transferred to Lemnian as a requirement of the Bank. His evidence is not supported by the *contemporaneous email correspondence* and no other documentary evidence was adduced which demonstrates that it was a requirement of the Bank that the property be transferred to Lemnian.

...

27. Mr Mingos’ evidence was far from satisfactory. His evidence was vague, lacking in specifics and highly generalised and his subjective view about what he said he understood was contradicted by the objective circumstances that, as a director of Lemnian, he signed the transfer of land form placing title to the property in the name of the

company. He also signed, as fairly presenting the Trust’s financial position, the Trust accounts for each of the 2011 and 2012 income years in which the property was recorded as an asset of the Trust and the Trust accounts for the 2014 income year in which the sale proceeds were recorded as a receivable of the Trust.” (emphasis added)

With respect to the reliability of the tax agent’s oral testimony (the tax agent was named Mr Munro), the person who prepared the relevant accounts, the court opined the following:

“40. Faced with that email, Mr Munro then gave the self-serving evidence that:

MR MUNRO: On reflection, I meant Lemnian Investment Proprietary Limited.

COUNSEL: No, you didn’t. You just made the distinction between the trust and the company?

MR MUNRO: I’m saying to you that in my email there it’s an error. It’s not what I intended to say and it’s not consistent with the manner in which we’ve — we’ve — we’ve treated it in the books.

41. I reject as untruthful his evidence that what he said in the email to the Bank was in error. Against that evidence is the clear email instructing the Bank that the property title was to be in the name of the Trust, which I accept on its face was accurate and shows Mr Munro’s evidence to be demonstrably wrong in this respect. Later in his cross-examination Mr Munro gave evidence that he ‘never recorded anything as showing that [the] property belonged to the [Trust]’ as an asset of the Trust in the financial statements. I reject that evidence also as untruthful as the property plainly was accounted for in the financial statements as an asset of the Trust.

42. For the reasons given above, I have not accepted the evidence of these witnesses where their testimony was contradicted by contemporaneous documents which I consider to be more reliable. Given the contradictory documentary evidence, I was left with the clear impression that there was a great deal of reconstruction in their evidence, rather than evidence based upon clear recollection.”

The court in the *Mingos* case rejected the evidence of these witnesses where their testimony was contradicted by contemporaneous documents.

For completeness, it is noted that the present status of the *Mingos* case is that the taxpayer has lodged an appeal to the Full Federal Court.

In *SDRQ and FCT*,¹⁵ the AAT allowed the taxpayer company to claim a capital loss on the sale of shares in one related company (Company B¹⁶), but disallowed the capital loss on the sale of shares in another related company (Company A¹⁷), having regard to the market values of the related companies’ shares at the time of acquisition and disposal.

The AAT reduced administrative penalties in the sum of \$656,806.30 to the sum of \$448,948.75.

The tribunal reasoned:

“178. The Commissioner also submits, to which I accept, the Applicant *neglected to maintain contemporaneous records* required to substantiate the alleged cost base of the Company A shares and the alleged capital proceeds on the disposal of the Company A shares including the alleged ‘formalised’ agreements, financial information, and/or management accounts as at the valuation date.

179. There is no contemporaneous evidence of any valuation calculations carried out by Mr P or any other person either in 1989 or at any time up to and including when the capital losses were claimed in 2003, 2005 and, relevantly for this proceeding, in 2011.

180. There is no contemporaneous evidence of the use of valuation inputs or assumptions that are asserted to have been used in the calculation of the valuation of the Company A shares in 1989.

Moreover, importantly, I have found that no particular methodology was employed by Mr P (or Mr R) in fixing the purchase price for the Company A shares in January 1989.” (emphasis added)

Conclusion

Notwithstanding the many crossroads and challenges in the event of a tax dispute, there is value in conducting an assessment of the reliability of the documentary evidence in support of the taxpayer’s position prior to advancing a matter to litigation.

The recent cases of *Mingos v FCT* and *SDRQ and FCT* serve as a timely reminder of the importance of having access to contemporaneous records to support factual propositions in tax positions being adopted.

William Calokerinos, CTA

Barrister

Wentworth Chambers

References

- 1 Statutory notices include the following: s 353-10 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA) (request for documents); s 353-15, Sch 1 TAA (ATO to enter premises and demand business records); and s 353-25, Sch 1 TAA (ATO power to seek information from outside Australia).
- 2 PS LA 2012/5; s 284-75(1), Sch 1 TAA.
- 3 [1992] HCA 35 at [11].
- 4 [1989] HCA 9.
- 5 *Lemongrove Services Pty Ltd v Rilroll Pty Ltd* [2019] NSWCA 174 (*Lemongrove Services*).
- 6 *Lemongrove Services* at [33].
- 7 *Lemongrove Services* at [45] and [46].
- 8 *Mingos v FCT* [2019] FCA 834 (*Mingos*).
- 9 Subdiv 118-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
- 10 *Mingos* at [43].
- 11 *Mingos* at [65].
- 12 S 14ZZO TAA.
- 13 *Mingos* at [70].
- 14 *Mingos* at [25].
- 15 *SDRQ and FCT* [2019] AATA 2003 (*SDRQ*).
- 16 *SDRQ* at [197].
- 17 *SDRQ* at [198].