Form over substance – the taxpayers' indefatigable battle

A TAX PAYER V COMMISSIONER OF TAXATION [2006] AATA 980

INTRODUCTION

There are many situations in which taxpayers may not judge or characterise payments received by them in the same way as the Commissioner. The decision by the Administrative Appeals Tribunal ("Tribunal") in *A Tax Payer v Commissioner of Taxation*[1] ("Tax Payer") is another recent example of where a taxpayer has objected against the Commissioner's decision to characterise a payment so to include it in the taxpayer's assessable income. Although the decision in the *Tax Payer* case does not state any new principle of law, it is an important case for its emphasis on, and consideration of, the fundamental question of form versus substance.

In this case the Tribunal considered whether payments made to the taxpayer as eligible termination payments ("ETP") in relation to the taxpayer's employment both in Australia and in the United Kingdom ("UK") were correctly characterised in relation to her employment in each country, and therefore whether the payment arguably relating to her period of foreign employment could be characterised as an exempt non-resident foreign termination payment ("exempt ETP"). The Tribunal held that the taxpayer failed to substantiate that the payments were calculated in reference to her periods of employment in each country and the entire amount should be characterised as an ETP, therefore forming part of the taxpayer's assessable income.

FACTUAL BACKGROUND

The taxpayer joined a UK company "W" ("UK Company") as a UK resident pursuant to an employment contract dated 6 August 1990. Under this contract, the taxpayer was to be employed in the UK but could be required to work in other locations as directed by the UK Company.

From 1 October 1997 the UK Company seconded the taxpayer to Australian company "O" ("Australian Company") for a three-year period subject to change by the UK Company. The secondment was agreed upon between both the UK and Australian companies so that the taxpayer continued to be employed by the UK Company pursuant to the original employment contract. The taxpayer applied for and was granted Australian residency soon after commencing her secondment with the Australian Company in 1997.

On 1 April 2001 the taxpayer became an employee of the Australian Company pursuant to letters dated 1 January 2001 and 31 January 2001. These letters included new terms and conditions of her employment in moving to "local terms". Among these terms and conditions were that the taxpayer:

- was entitled to continuity of employment from 6 August 1990 (when she originally commenced employment with the UK Company) for the purposes of termination benefits; and
- termination of the taxpayer's employment by the Australian Company or the taxpayer could occur on six months' notice or a termination payment in lieu of such notice.

The taxpayer continued as an employee of the Australian Company until she resigned on 29 November 2002. Upon termination the taxpayer was paid $348,340.38 by the Australian Company (pursuant to a Deed of Settlement). The taxpayer requested that the Australian Company pay this amount to her in two payments ($145,141.83 and $203,198.56), each into a different bank account.

The taxpayer included the amount of $145,141.83 in her tax return as an ETP, but did not include the amount of $203,198.56 as she considered this to be an exempt ETP.

The Commissioner issued the taxpayer with an amended assessment for the 2003 income year to include the $203,198.56 ("Amount") in the taxpayer's assessable income. The taxpayer objected to the Commissioner's amended assessment, which he disallowed on 31 May 2005. The taxpayer then sought a review of this objection by the Tribunal which is the subject of this case.

RELEVANT LEGISLATION

Section 27A of the *Income Tax Assessment Act 1936* ("ITAA 1936") defines "eligible termination payment" and "exempt non-resident foreign termination payment" as:

> "Exempt non resident for eign termination payment" in relation to a taxpayer, means:
>
> (a) a payment made in respect of the taxpayer to which the following subparagraphs apply:
>
> (i) the payment is made otherwise than from a superannuation fund (as defined by subsection 6(1)) in consequence of the termination of the taxpayer's employment;
>
> (ii) the payment would, apart from paras (ka) and (ma) of the definition of "eligible termination payment", be an eligible termination payment;

> (iii) the employment was service in a foreign country as a holder of an office or in the capacity of an employee; and
>
> (iv) the payment related solely to a period of the employment during which the taxpayer was not a resident of Australia.

The definition of "eligible termination payment" is extensive. Subsections (ka) and (ma) referred to above state that "eligible termination payment" does not include:

> (ka) an exempt resident foreign termination payment or an exempt non-resident foreign termination payment;
>
> (ma) a payment from a fund that is an eligible resident non-complying superannuation fund, or an eligible non-resident non-complying superannuation fund, when the payment is made.

ISSUES BEFORE THE TRIBUNAL

The central issue before the Tribunal was whether the taxpayer was able to satisfy the requirements contained in section 27A(1)(a)(iii) and (iv) ITAA 1936. In the context of the taxpayer's circumstances, this involved consideration of the following questions:

1. Was the Amount related to the taxpayer's service with the UK Company in the UK?
2. Could the whole of the termination payment be divided into two to reflect periods of employment in the UK and Australia, respectively?
3. If there was one termination payment, could the Amount be exempt?
4. On either of the taxpayer being seconded to the Australian Company in 1997, or, on accepting new arrangements with the Australian Company in 2001, was there termination of employment?
5. Did the Taxpayer hold an "office" in the UK concurrently with her position with the Australian Company so that her employment with the UK Company continued until the termination of her office?

These questions were dealt with separately by the Tribunal.

Was the Amount related to the Taxpayer's service with the UK Company in the UK?

To satisfy section 27A(1)(a)(iv) ITAA 1936, the taxpayer had to satisfy the Tribunal that part of the termination payment related to her service with the UK Company in the UK. Therefore, it was crucial to the taxpayer that the termination payment was split by the Australian Company, as the taxpayer submitted that each amount constituted approximately one month's salary for each year of service, based on, seven years' service in the UK from 1990 to 1997, and, five years in Australia from 1997 to 2002, respectively.

The taxpayer's submission was not supported by her Deed of Settlement as it did not refer to either this particular calculation of the two payments or these two distinct periods of employment. Moreover, the payments made to the taxpayer did not equate to one month's salary for each year of service and the aggregate sum was approximately eleven months' salary for twelve years' service.

Neither was the taxpayer's submission supported by other documents before the Tribunal. An ETP payment summary prepared by the Australian Company stated the aggregate sum of $348,340.38 related to an eligible service period beginning 1 September 1990. There was also a document before the Tribunal that referred to the payment in lieu of notice of eleven months' salary in accordance with the letter of offer dated 1 January 2001. As was the case with the Deed of Settlement, there was no reference to the UK and Australian periods of service.

Email correspondence between the taxpayer and the Australian Company and within the Australian Company was not supportive of the taxpayer's submission. An internal email of the Australian Company dated 5 November 2002 noted that "12 months (including the time leading up to 30 November 2002) [was to be] treated as an ETP", that the taxpayer was requesting the payment be split in two and the feasibility of doing this. A further email on 18 November 2002 brought the date of termination forward to 29 October 2002 and stated that the eleven month payment would be divided in two and paid into separate bank accounts.

Could the termination payment be divided into two to reflect periods of employment in the UK and Australia, respectively?

The Tribunal considered the Commissioner's written reasons for disallowing the taxpayer's objection to his amended assessment. In these reasons the Commissioner mentioned that there could not be separate service periods for the purpose of calculating an eligible service period, as one could only aggregate the periods pursuant to section 27A(1)(a) which states that:

> "where the relevant eligible termination payment is an eligible termination payment by virtue of para (a) or (aa) of the definition of eligible termination payment – the period, or the aggregate of the periods, of the employment to which the relevant eligible termination payment relates;"

The Tribunal also considered the explanatory memorandum[2] with respect to section 27A to ascertain the purposes of the provisions particularly contained in section 27A(1)(a). However, while recognising that an employee may serve in several companies within a group, the explanatory memorandum did not consider the event of a taxpayer serving part of the eligible service period overseas and therefore did not provide further assistance to the Tribunal.

If there was one termination payment, could the Amount be exempt?

The taxpayer submitted that there were two separate and distinct payments reflecting her employment in both the UK and Australia. However, the Commissioner submitted that there was one payment which was split into two at the taxpayer's request.

While section 26(d) ITAA 1936, the predecessor of section 27A(1)(a), required payment to be in a specified "lump sum", there is no such requirement in section 27A(1)(a) as explained in the explanatory memorandum. This is supported by the definitions of both ETP and exempt ETP in the ITAA 1936, as neither definition prohibits the division of a lump sum for the purposes of section 27A, and also the case of *Federal Commissioner of Taxation v Comber*[3] where it was held that where payment is in a lump sum it could be constituted of several components.

On either of the Taxpayer being seconded to the Australian Company in 1997, or, on accepting new arrangements with the Australian Company within the group in 2001, was there termination of employment?

The Tribunal considered two competing views on when termination occurs to determine whether the taxpayer's employment was terminated either in 1997 or 2001. One view was that "employment may not necessarily be terminated if the employee continues to serve, though he serves under a contract of service whose terms differ from the earlier contract"[4]. As a result, where a person transfers to a company within the same group (as was the case here) and the person discontinues working under the original employment contract, termination of employment does not occur.

However, Taxation Ruling 93/140 provides a second view that where a company makes a payment and the company ceases carrying on a business and transfers the business to an associated entity, the payment will be an ETP if it is made "in consequence of the termination of employment of the former employee"[5]. This argument affirms Taxation Ruling IT 2152 which considers that "where a company or other employer ceases carrying on a business which has been transferred to another associated entity, it will be accepted that the employees of the company have been terminated".

After examining these views, the Tribunal concluded that there was no termination of the taxpayer's employment upon secondment in 1997 or on accepting new arrangements within the group in 2001. Furthermore, the UK Company did not cease in business when the taxpayer was seconded to the Australian Company in 1997 or when she commenced employment under new conditions with the Australian Company in 2001. Termination of the taxpayer's employment only occurred upon resignation on 29 November 2002.

Did the Taxpayer hold an "office" in the UK concurrently with her position with the Australian Company?

The taxpayer submitted that while she was on secondment she continued to either be employed or hold an office in the UK which continued until the Deed of Settlement was executed, therein terminating both her employment with the Australian Company and her UK office. If this was the case, the taxpayer argued that her employment with the Australian and UK companies ended simultaneously and that the termination payment related wholly to her employment with the UK Company.

While the Tribunal accepted that the taxpayer did have some claim to an "office" upon her initial secondment, this did not further her claim. Particularly as records of the Australian Company in relation to the termination payment were such that the payment was calculated as payment in lieu of notice in accordance with her employment terms set out in the letter of offer dated 1 January 2001.

The Tribunal noted that the taxpayer's biggest problem was that there was not a satisfactory nexus between the potential concurrent holding of a UK office and the payment. In relation to this issue, the Tribunal considered that the payments must be made as a consequence of the termination of the taxpayer's employment. As a result it was necessary for the Tribunal to consider whether the payment was made in consequence of the termination of the taxpayer's employment with the Australian Company or partially in consequence of the termination of the taxpayer's employment or office with the UK Company. For the payment to be made in consequence of any or all of these events, a causal connection between the termination and payment needed to be established[6].

DECISION

The Tribunal held that the taxpayer was unable to satisfy the requirements contained in section 27A(1)(a)(iii) and (iv) ITAA 1936. Specifically the Tribunal held the following, in relation to the questions considered:

1. (a) At no stage did the Australian Company understand the reason for dividing the termination payment, apart from the taxpayer's request to do so, as evidenced by the "reasonable benefit limits" report and other documents generated for tax purposes for the relevant income year which show $348,340.38 as a post June 1983 component of an ETP.

   (b) Although the two components of the termination payment paid to the taxpayer reflected the taxpayer's service in the UK and Australia, respectively, there was no other evidence or witness statement to support the taxpayer's submission regarding the method of calculation. Meanwhile there was evidence to suggest that the Australian Company based the termination payment on eleven months in lieu of notice in accordance with the letter of offer dated 1 January 2001.

   (c) The fact that the Australian Company rather than the UK Company made the payment was not fatal to the taxpayer's case as this was not a requirement of section 27A(1).

2. The eligible service period was not pertinent to determining whether a payment was an ETP or an exempt ETP but was only important in calculating tax payable. In these circumstances, the Tribunal had to direct its attention as to whether the amount could still qualify as an exempt ETP if there was a single termination payment.

3. It was not fundamental whether there was one payment or two. Rather it was important to consider "whether the amount claimed was for service in a foreign country and paid solely in connection with a period when the taxpayer was not a resident of Australia".

4. The Tribunal held that the only time the taxpayer's employment was terminated was on 29 November 2002. The termination payment reflected the entire period of service as a goodwill gesture pursuant to the letter dated 1 January 2001.

5. The Tribunal held that the taxpayer had not established a causal connection between the termination of the UK office and the payment. There was evidence before the Tribunal that showed that although the holding of an office in the UK was contemplated by the taxpayer's original contract of August 1990, the continuation of that office was not contemplated within the January 2001 contract. As the taxpayer was found not to be holding the UK office contemporaneously with her employment with the Australian Company the taxpayer could not therefore establish a connection between the termination payment in November 2002 and the termination of her UK office.

COMMENT AND CONCLUSION

This case, while not remarkable for any new legal proposition, serves as a timely reminder that despite taxpayers structuring transactions in a myriad of ways to reflect their perception of why a particular payment was made, substance will rule over form.

Although the Tribunal expressed its sympathy for the plight of the taxpayer in her expectation that the Australian Company should recognise her period of employment overseas, this expectation could not alter the correct characterisation of the payments made to her.

The Tax Payer case considered whether components of a termination payment could be referenced to two periods of the taxpayer's employment — one in Australia and one in the UK. The taxpayer argued that one component was an exempt ETP because it related to her period of employment with the UK Company while in the UK and directed her employer to split the termination payment into two reflecting her approximate length of service in the UK and Australia, respectively.

However, the Tribunal held that the entire termination payment was an ETP. There was a raft of evidence against the taxpayer and she was unable to discharge the required burden of proof. This included substantial written evidence that the Australian Company had consistently based calculations of the termination payment upon payment in lieu of notice in accordance with the letter of offer dated 1 January 2001. There had never been any reference to the taxpayer's UK service, which was buttressed by the fact that her employment conditions had moved to local Australian terms. Moreover the Australian Company had reported the termination payment to the tax office as an ETP. The taxpayer's case was not assisted by her being unable to produce written evidence or witnesses capable of supporting her fundamental contention and challenging the evidence against her.

To reiterate, substance will continue to rule over form. A spade will continue to be a spade unless alternative characterisations are supported by the circumstances and evidence. Taxpayers' expectations will not be indulged.

AMBRY LEGAL

Reference notes

1 *[2006] AATA 980.*

2 *No 3 of 1984.*

3 *(1986) 10 FCR. 88*

4 *Professor Parsons in Income Taxation in Australia (1986), referring to Henly v Murray [1950] 1 ALL ER.*

5 *Taxation Determination 93/140.*

6 *In consideration of the finding in Le Grand v Commissioner of Taxation [2002] FCA 1258.*