

SATISFYING THE TAXPAYER'S BURDEN OF PROOF IN CHALLENGING A DEFAULT ASSESSMENT — THE MODERN LABOURS OF SISYPHUS?

ROBIN WOELLNER* AND JULIE ZETLER**

ABSTRACT

It is well established that pursuant to *Taxation Administration Act* 1953 (Cth) ss 14ZZK(b)(i) and 14ZZO(b)(i), a taxpayer seeking to challenge an ATO income tax assessment before the AAT or Federal Court respectively bears the burden of proving that the ATO's assessment is excessive and also of proving 'what the assessment should have been'.

While this task may be approached in various ways, depending on the circumstances, it is clear that it requires the taxpayer to do more than merely show that the ATO made an error in the assessment process. The taxpayer must establish positively the alteration which needs to be made to render the assessment correct and show that this correct amount is less than the amount assessed.

Under the 'normal' assessment pursuant to under s 166 *ITAA* 36, where the taxpayer has lodged a return and the assessment is based upon that return, the ATO will generally proceed by determining the taxpayer's assessable income and subtracting allowable deduction and other amounts in order to determine the taxpayer's taxable income.

However, where the taxpayer has not lodged a satisfactory return, the ATO may make a 'default' assessment under s 167 *ITAA* 36. This section provides that if 'any person makes default in furnishing a return; or ... the Commissioner is not satisfied with the return furnished ... [then] the Commissioner may make an assessment of the amount upon which in his or her judgement income tax ought to be levied, and that amount shall be the taxable income of that person for the purpose of section 166'.

As 167 default assessment therefore does not involve calculation of the taxpayer's assessable income and allowable deductions, but rather an estimation of the taxpayer's 'taxable income' based on asset betterment, T account, industry benchmarks or other bases which will almost inevitably not be precisely correct in any particular case.

Nevertheless, the taxpayer's task is still to demonstrate that the assessment is excessive, and to satisfy this burden of proof, the case-law makes it clear that the taxpayer must avoid the 'fatal flaw' of merely demonstrating that the ATO may have made an error in the assessment process, and must instead establish positively what their taxable income was, and demonstrate that this amount was less than the amount assessed by the ATO.

Given the clarity and simplicity of the principles involved, it is puzzling that taxpayers continue to attempt merely to challenge elements of the ATO's calculations — a 'fatal flaw' which condemns them to almost certain failure.

The lessons from the past are crystal clear, and a recent series of decisions in *Gashi, Rigoli and Mulherin* demonstrate that taxpayers and their advisers ignore these lessons at their peril. As has been said, those who do not learn from history are doomed to repeat it.

* Adjunct Professor, JCU and UNSW.

** Senior Lecturer, Macquarie University.

I INTRODUCTION

Where a taxpayer seeks to challenge a default assessment in the AAT or Federal Court, ss 14ZZK(b)(i) and 14ZZO(b)(i) of the *Taxation Administration Act* 1953 (Cth) effectively reverse the burden of proof¹ and impose on the taxpayer the burden of proving that the Commissioner's assessment is excessive, and what the assessment should have been.² The rationale for this reversal of the burden of proof is generally said to be that 'the facts in relation to [the taxpayer's] income are peculiarly within the knowledge of the taxpayer'.³

It is well established that in order to satisfy this burden, it is not sufficient for a taxpayer merely to show that the ATO has made a mistake in the process of its assessment — the taxpayer must establish definitively what their taxable income was, and show that this is less than the amount assessed by the ATO.

These are not conceptually complex or ambiguous provisions; their requirements are clear and are supported by equally clear guidelines in court decisions. Yet, despite their clarity, taxpayers in a series of recent cases appear to have ignored or disregarded these clear guidelines, and embarked on the very approach that the courts have identified as doomed to failure.

Given the direct and indirect monetary and other costs of Federal Court litigation, this is puzzling, to say the least.

This article discusses the process of making a default assessment, and explores three recent decisions to identify the common error made by the taxpayers in those cases, and the steps the courts identified which would have avoided the 'fatal flaw'.

II BACKGROUND

Where the taxpayer has lodged an income tax return for the relevant period, the ATO will generally make a 'normal' assessment under s 166 *ITAA* 36, based on the information in the return (and other available information) and will proceed (in essence) by determining the taxpayer's assessable income and subtracting allowable deductions and other amounts in order to derive the taxpayer's taxable income and tax payable. This means that the assessment and supporting documents will contain details of assessable income and allowable deductions which the taxpayer can focus on in structuring their objection and subsequent challenge.

However, the position is quite different where the ATO makes a default assessment — for example because the taxpayer fails to lodge a return, the ATO is not satisfied with a return lodged, or the ATO believes that a person who has not lodged a return has derived taxable income. In this case, s 167 of the *ITAA* 1936 provides that 'the Commissioner may make an assessment of the amount upon which in his or her judgement income tax ought to be levied, [and] that amount shall be the taxable income of that person for the purpose of section 166' (emphasis added).

While similar principles apply to 'ordinary' assessments, the different procedure under s 167 and the more 'opaque' nature of a default assessment,⁴ make a significant difference to the taxpayer's task of satisfying the burden of proof.⁵

1 *Briggs v DFCT (WA)*; *Ex parte Briggs* 87 ATC 4278, 4282–3 (Sheppard J). In *McCormack v FC of T* Stephen J characterised the provisions as creating a rebuttable presumption of law that an assessment is not excessive: 79 ATC 4111, 4128; cf *Vadasz v FC of T*, 2006 ATC 2384, 2392 (RW Dunne); M Italia, 'Taxpayers in Australia Bear the Burden of Persuasion and Burden of Production', *International Review of Business Research Papers* (2011) 7(1), 231; K Wheelwright, 'Taxpayers' Rights in Australia' (1997) 7 *Revenue Law Journal* 226, 235–6, 237; R Warnock, 'Guilty Until Proven Innocent' (1992) 62 *Australian Accountant* 26.

2 The effective reversal of the burden of proof under these sections has been justified on the basis that the taxpayer is usually in the best position to know and prove what their true tax position is: *Gauci v FC of T* 75 ATC 4253, 4261 (Mason J); *Ex parte Briggs*, above n1, 4293 (Sheppard J).

3 And 'there is every reason to assume that the legislature did not intend to confer upon a potential taxpayer the valuable privilege of disqualifying himself in that capacity by the simple and relatively unskilled method of losing either his memory or his books': *Trautwein v FC of T* (1936) 56 CLR 63, 87–8 (Latham CJ); cf *Ex parte Briggs*, above n1, 4293 (Sheppard J).

4 *George v FC of T* (1952) 86 CLR 183; *McAndrew v FC of T* (1956) 98 CLR 263. Section 167 can be used to make original or amended assessments: *McAndrew*, above, PS LA 2007/24, [38].

5 See among many, *Ex Parte Briggs*, above n 1, 4290–1 (Sheppard J).

To provide a background to discussion of the taxpayer's task in meeting the burden of proof under s 167, it is useful to look at the circumstances where and the process by which the ATO makes a default assessment under s 167.

A Making a default assessment

The ATO policy in relation to default assessments is spelt out in PS LA 2007/24⁶ and the ATO's Default Assessment Guide.⁷

As noted, the process involved in making a default assessment is quite different from that of a 'normal' assessment under s 166. Under s 167, the ATO makes 'a direct judgement as to the amount of taxable income without first ascertaining assessable income less allowable deductions'.⁸

In making this estimate, the ATO may rely on 'any basis that is reasonable and takes into account [the taxpayer's] particular circumstances'.⁹ Normally, the ATO will begin by seeking information either formally or informally¹⁰ from the taxpayer.¹¹ If sufficient information is not available from the taxpayer,¹² information may be sought from third-party sources 'in order to provide a reasonable basis for determining taxable income'.¹³ The ATO will then make an assessment based on the information available.¹⁴

Techniques which the ATO employs as the basis for a default assessment include the use of externally obtained information,¹⁵ indirect audit methodologies (such as the 'T account'¹⁶ or 'asset betterment'¹⁷ methods), statistical information from sources such as corporate databases or the ABS,¹⁸ or extrapolation from prior years' returns.¹⁹

In recent times, the ATO has also used small industry benchmarks in appropriate cases,²⁰ with significant deviations from the relevant industry's benchmarks²¹ being used by the ATO both as a factor in selecting a business for audit, and subsequently in generating a default

6 Practice Statement Law Administration, PS LA 2007/24 'Making default assessments: section 167 of the *Income Tax Assessment Act 1936* and other similar provisions'.

7 Ibid [4]; IGOT, Review into the Australian Taxation Office's use of benchmarking to target the cash economy — publicly released 4 October 2012, [5.36]; [5.40]; Table 16.

8 Ibid [15]. The default assessment must observe the usual requirements for any valid assessment: *ibid* [37], [39], and [49]–[60].

9 Ibid [68]; IGOT, Benchmarking Review, above n 8, [5.33].

10 Ibid [24]–[25].

11 Ibid [20]–[22].

12 For example where a taxpayer claims that their records have been lost or destroyed and they cannot reconstruct their tax affairs.

13 Ibid [22].

14 Ibid [46].

15 Ibid, examples 4, 5 and 7, [102]–[103], [105].

16 Ibid [69]. Under the 'T account' method, the cash available to the taxpayer at the beginning of the period plus any cash received during the relevant period is compared with cash expended during the period plus cash on hand at the end of the period. If the two sides of the T account do not balance, the ATO will infer that the taxpayer may have undisclosed income.

17 Ibid [56]. Under the 'asset betterment' method, the taxpayer's net worth at the end of each relevant year is compared with their net worth at the beginning of that year, to generate an estimate of annual asset growth. Non-deductible expenditure is added to this estimate and liabilities and exemptions are subtracted. The result is then treated as the taxpayer's total taxable income.

18 Ibid [72]–[75]; Example 2 ([100]); Example 6 ([104]).

19 Ibid [68]; Example 3 ([101]); see also the ATO 'Default Assessment Guide', ATO website <www.ato.gov.au>.

20 The use of industry benchmarks in this way has been controversial: IGOT, Benchmarking Review, above n 9 [5.28]–[5.30], [5.35], and [5.37].

21 'Industry benchmarks' comprise 'performance benchmarks' (based on information that small businesses report to the ATO in returns and BAS et al) and 'input benchmarks' (based on information provided to the ATO by industry participants and trade associations): CPA Small Business and Taxation Services, 'Understanding and using small business benchmarks' <http://www.time4tax.com.au/ato_benchmarks_22.html>; ATO 'Small business benchmarks', ATO website <www.ato.gov.au>; D Groch 'The taxpayer's heavy burden', (2012–13) 47(6) *Taxation in Australia*, 358, 359.

assessment. The industry benchmarks reflect the ‘normal’ range within which businesses in over 100 industries²² usually operate.²³

While correct ‘on average’, industry benchmarks will almost inevitably be inaccurate in any specific case²⁴ — as with the other methods of estimation.

In order to give the taxpayer an opportunity to put forward an alternative basis of calculation or to rebut the assumptions on which the ATO assessment is based, the ATO will generally issue a ‘default assessment warning letter’ advising the taxpayer or their agent in advance of the ATO’s intention to issue a default assessment, the basis upon which it is proposed to levy tax, and the date by which any overdue return needs to be lodged to avoid the issue of a default assessment.²⁵

However, a default assessment may be issued without prior notice where, for example, the ATO perceives a risk that the taxpayer if warned may flee the jurisdiction, dissipate their assets, or move funds outside Australia.²⁶

B Penalties and prosecution

The ATO will automatically apply an administrative penalty of 75 per cent of the tax-related liability when it issues a default assessment, and this penalty may be increased by 20 per cent, for example for taxpayers who have a history of non-compliance²⁷ (giving a total of 90 per cent).

Penalties are therefore potentially severe, and one might expect that a taxpayer would take great care to maximise their chances of avoiding them. Surprisingly, as will be seen, this is not always the case.

To add to the taxpayer’s problems, the issue of a s 167 default assessment does not alter the fact that the taxpayer has failed to lodge a required return, and they may still be prosecuted for this failure.²⁸

III MAKING A S 167 DEFAULT ASSESSMENT: ‘A GUESS TO SOME EXTENT’

Given the nature of a s 167 default assessment, the courts have long recognised that such assessments are unlikely to be precisely correct. Indeed, in *Trautwein v FC of T*,²⁹ Latham CJ pointed out that:

In the absence of some record in the minds or books of the taxpayer, it would often be quite impossible to make a correct assessment. The assessment would necessarily be a guess to some extent, and almost certainly inaccurate in fact.³⁰

22 The ATO groups the industries under the categories of Building and construction trade services; Education, training, recreation and support services; Food services; Health care and personal services; Manufacturing; Professional, scientific and technical services; Retail trade; Transport, postal and warehousing; and Other services: CPA website, above n 21; ATO website, above n 21.

23 For example, cost of items such as goods sold, labour, rent and GST-free sales compared to turnover, and motor vehicle expenses to turnover.

24 Groch, above n 21, 360.

25 PS LA 2007/24, above n 6 [17]; ATO Default Assessment Guide, above n 19.

26 For example, where a non-resident proposes to sell their only Australian asset) or an urgent need arises for other purposes: PS LA 2007/24, above n 6, [18]–[19].

27 ATO ‘Default Assessment Guide’, above n 19; *Gashi v FC of T* [2013] FCAFC 30; 2013 ATC ¶20-377 - application for special leave to appeal refused by the High Court on 16 August 2013: [2013] HCA Trans 181.

28 PS LA 2007/24, above n 6 [79]–[80].

29 (1936) 56 CLR 63, 87 (Latham CJ) — quoted in part with approval in (among others) *Gashi*, above n 27, [55] (Bennett, Edmonds and Gordon JJ); see also *Ex Parte Briggs*, above n 1, 4293 (Sheppard J).

30 *Trautwein*, above n 3, 87 (Latham CJ); quoted in *Ex Parte Briggs*, above n 1, by Sheppard J at 4293, who observed that a valid s 167 assessment ‘may go close to guesswork’. Similarly, in *FC of T v Dalco* [1990] HCA 3 [6]; 168 CLR 614, 616; 90 ALR 341; 20 ATR 1370; 90 ATC 4088, 4090 Brennan J observed that the amount determined under s 167 ‘may not in truth be the taxpayer’s taxable income for a particular year and it may not be so regarded by the Commissioner ... but for the purposes of s 166, that amount is the taxpayer’s taxable income for the year ... unless it is shown on appeal ... [to be] wrong’.

As a result, the courts have been prepared to give the ATO considerable leeway in making a s 167 assessment, particularly where³¹ the taxpayer has made it difficult for the ATO to assess them accurately.³² In such circumstances, the taxpayer can hardly complain if the ATO estimate is inaccurate, provided the ATO does 'the best [it] can in the circumstances'.³³

However, while the courts have been prepared to give the ATO considerable latitude in making default assessments under s 167, it is clear that such an assessment must be based on a genuine attempt to determine the taxpayer's taxable income. That is, the assessment must be based on some reasonable or rational grounds³⁴ and cannot be simply a guess or estimate made on 'no intelligible basis',³⁵ or by 'plucking figures from the air' at random: *Re DCT (WA)*; *Ex Parte Briggs*.³⁶

Even so, a default assessment is a powerful weapon, and it

may have a 'flushing out' effect in that it may yield an incorrect result of the taxpayer's actual taxable income [which] will place the burden on the taxpayer to show that the assessment is excessive (footnotes omitted).³⁷

A Satisfying the burden of proof — the taxpayer as a modern-day Sisyphus?³⁸

The burden of proof imposed on the taxpayer by ss 14ZZK or 14ZZO may be discharged in various ways, depending on the circumstances, and it is for the taxpayer to decide how it will approach this task in any particular circumstances.³⁹

While the courts have given clear guidelines on what is required, in practice ss 14ZZO(a) and 14ZZK(a) impose a heavy burden on taxpayers seeking to challenge a default assessment.⁴⁰

In particular, the courts have regularly pointed out that the fact that taxpayer may be able to show that the ATO made a mistake in the assessment process does not of itself prove that the assessment is excessive or satisfy the taxpayer's burden of proof. Indeed, unless the parties agree to confine the review to specified matters,⁴¹ demonstrating errors in the ATO's method of calculation or characterisation⁴² may simply create a 'vacuum' in which the ATO's assessment is known to be wrong, but there is no evidence of what the taxpayer's correct taxable income is. Thus, in *PNGR v Commissioner of Taxation* 2013 AATA 942, McCabe SM pointed out that where a taxpayer fails to establish what the assessment should have been (ie what their true taxable income was), then even if the tribunal accepted that the amended assessments were excessive, it would be left 'uncertain as to the correct amounts that should be assessed', so that the applicants would fail to discharge the burden of proof. Indeed, if a taxpayer could succeed

31 *Ex Parte Briggs*, above n 1, 4294 (Sheppard J).

32 In that case, by refusing to lodge returns in defiance of court orders, and failing to co-operate in an interview held under s 264 *ITAA 1936*. Sheppard J described the taxpayer's conduct as 'a deliberate course of defying the tax laws and the tax authorities of this country': 87 ATC, 4285. The difficulties the ATO may face in such circumstances are outlined in *Ex Parte Briggs*, above n 1, 4283–8.

33 *Ex Parte Briggs*, above n 1, 4294 (Sheppard J).

34 PS LA 2007/24, above n 6, [55]; ie it must not be colourable or made for an improper purpose: S Barkoczy, 'The Nature of an Income Tax Assessment', *Journal of Australian Taxation* (Jan/Feb 1999), 36, 43–4 cites *Re Pezzano, ex parte DFC of T* 89 ATC 4259 (Beaumont J), *Briggs*, above n 1, 4295 (Sheppard J), and *Scallan v FC of T* 89 ATC 4129, 4141, where Wilcox J observed that 'The fact that a person making a judgement as to given facts recognises the possibility, even the strong possibility, of error does not mean that the judgement loses its quality as such. If the judgement represents the best assessment which the decision-maker can make, on the materials and available, it remains a judgement, however vulnerable it may be to attack when further facts emerge.'

35 *Trautwein*, above n 3; PS LA 2007/24, [55], [64].

36 *Ibid* 87–8 (Latham CJ); *Ex Parte Briggs*, above n 1, 4294 (Sheppard J).

37 Barkoczy, above n 34. In *Ex Parte Briggs*, above n 1, Sheppard J, 4295.

38 According to Greek mythology, for crimes against the Gods, Sisyphus was condemned to eternally roll a huge stone up a hill, only to have it roll back down as it neared the top. See Merriam-Webster, Sisyphus 2014 <<http://www.merriam-webster.com/dictionary/sisyphus>>.

39 *FC of T v Dalco* 168 CLR 614, 616; [1990] HCA 3, [14]; 90 ATC 4088, 4093 (Brennan J); *Gashi*, above n 27, [63] (Bennett, Edmonds and Gordon JJ).

40 See Woellner, Barkoczy, Murphy, Evans and Pinto *Australian Taxation Law* (24th edn), CCH Aust Ltd, 1752–3.

41 As occurred in *Moignard and Commissioner of Taxation* [2014] AATA 342; cf *Mulherin v FC of T* 2013 ATC ¶20-423 — considered below.

42 *George v FC of T* (1952) 86 CLR 183; cf *Dalco*, above n 39; *Gashi*, above n 27; *FC of T v Rigoli* [2013] FCA 784; 2013 ATC ¶20-407, [10] (Pagone J), upheld on appeal [2014] FCAFC 29; 2014 ATC 20-446 (Edmonds, Jessup and McKerracher JJ); *Wheelwright*, above n 1, 234–5; *Groch*, above n 21, 358–9.

simply because there was no evidence positively identifying the correct tax position, that would mean that the burden of proving the existence of that element lay on the Commissioner', which would improperly invert the statutory burden of proof.⁴³

Accordingly, as Latham CJ indicated in *Trautwein*, the taxpayer must show not only that the assessment is incorrect, but also what correction needs to be made to make it correct, or more nearly correct.⁴⁴

The taxpayer's task is made more difficult because the courts and tribunals have interpreted ss 14ZZK (b)(i) and 14ZZO(b)(i) to mean that (among other things):

- there is no obligation on the ATO to do anything to 'defend' its assessment,⁴⁵ or to lead any evidence or positively prove that the assessments were correctly made.⁴⁶ Even if the ATO attempts to prove a positive case but fails, the taxpayer will still not succeed unless they satisfy the burden of proof;⁴⁷
- the Commissioner is entitled to rely upon any deficiency in the taxpayer's proof of the excessiveness of the amount assessed in seeking to uphold the assessment;⁴⁸
- the burden will not be discharged where the tribunal is not satisfied as to the facts of the case;⁴⁹ and
- there is no presumption that the taxpayer's financial records are correct or that the events they purport to record actually occurred.⁵⁰

B The practical difficulty in challenging a default assessment — the labours of Sisyphus

The broad nature of the ATO's s 167 power and the 'embedded assumptions' (above) which operate in favour of the ATO in a dispute over a default assessment, create 'real and significant obstacles' for a taxpayer endeavouring to discharge the statutory burden of proof under s 14ZZK(b)(i) or 14ZZO(b)(i).⁵¹

Thus, in *McCormack v Commissioner of Taxation*, Gibbs J noted that such sections impose on the taxpayer the obligation of proving the facts necessary to make out their case.⁵² This requires a taxpayer to positively establish their actual taxable income and thus show that the amount on which they have been assessed under s 167 exceeds their actual substantive liability.⁵³

43 *McCormack v FC of T* 79 ATC 4111, 4128 (Stephen J); cf *Gashi*, above n 27; [66] (Bennett, Edmonds and Gordon JJ).

44 *Trautwein*, above n 3, 87–88, (Latham CJ); cf Wheelwright, above n 1, 234. Indeed, this is spelled out expressly in the wording of ss 14ZZK and 14ZZO — see above.

45 *Vadasz v FC of T* 2006 ATC 2384; *Pyke v FC of T* 2007 ATC 2564; cf *George v FC of T* (1952) 86 CLR 183, 189–90).

46 *FC of T v Dalco* (1990) 168 CLR 614 at 623; [1990] HCA 3, [14]; 90 ATC 4088 at 4093 (Brennan J) — citing *Gauci v FC of T* (1975) 135 CLR 81 at 89 (Mason J), and in turn cited by the Full Federal Court in *Gashi*, above n 27, [61] (Bennett, Edmonds and Gordon JJ); *Ex Parte Briggs* above n1, 87 ATC at 4282–3; Wheelwright, above n 1, 234–5; Groch above n 21, 359.

47 Wheelwright, above n 1, 235

48 *Gashi*, above n 27, [61], citing *Dalco*, above n 46, CLR 624; HCA [15]; ATC 4093 (Brennan J); Wheelwright, above n 1, 235.

49 *The Trustees of the Bontoc Superannuation Fund v FC of T* 205 ATC 2317, 2318–9; *Case 13/2006* 2006 ATC 182, 186.

50 *Saffron v FC of T* 94 ATC 4049, 4050; *Cooper v FC of T* 2010 ATC ¶10-130.

51 Groch, above n 21, 359.

52 *McCormack v Commissioner of Taxation* (1979) 143 CLR 284, 301 (Gibbs J) — in that case, the taxpayer was required to prove affirmatively that the relevant property was not acquired for the purpose of profit-making by sale; cf *Dalco*, above n 46, CLR 621-623; HCA [16] (Brennan J), [17] (Toohey J); ATC 4091-4; *Addoug v Commissioner of Taxation* [2010] AATA 79 [6] (MD Allen SM); *Gashi*, above n 27 [61].

53 *Dalco* above n 46, CLR 623-625; HCA [12] (Brennan J); [17], [20], (Toohey J); ATC 4092; *Trautwein* above n 3, 88 — cited in *Gashi*, above n 27 [63]; *FC of T v Rigoli*, above n 42; Groch above n 21, 358.

To do this, the taxpayer must produce evidence which on the balance of probabilities⁵⁴ proves all the factual elements essential to the correct operation of the law.⁵⁵ It has been said that this means that the taxpayer must 'explain away all other possible sources of income ... leave no uncertainty as to their affairs'⁵⁶ and 'exclude by their proof all sources of income except those which they admit'.⁵⁷ If the taxpayer is not able to establish positively all the elements necessary to the correct application of the law, the taxpayer will 'almost inevitably' fail.⁵⁸

The task of Sisyphus was hopeless — no matter how many times he strove to push the stone to the top of the hill, it would always roll back to the bottom. By comparison, a taxpayer seeking to satisfy the statutory burden of proof in relation to a default assessment is not in as hopeless a position as Sisyphus, the odds are certainly stacked heavily in the ATO's favour.

However, the courts have provided useful guidelines to help taxpayers in their task. For example in *Ma*, Burchett J observed that:

if a taxpayer denies any undisclosed income, provides acceptable evidence of how he spends his time, and demonstrates a reasonable explanation for any appearance of the possession of assets, he will generally discharge his burden of proof unless some positive reason is shown why he is to be disbelieved ...⁵⁹

Nevertheless, as noted, in trying to discharge the onus in relation to a default assessment, the taxpayer faces particular difficulties, because a default assessment may contain no 'discrete' figures of putative income or deductions for the taxpayer to focus on. Instead there may be merely a net taxable amount, reflecting the auditor's judgement and an asset betterment calculation or other method of estimation.

In such cases, if taxpayers are to successfully challenge a default assessment, while they and their advisers may usefully attack errors in the ATO's process or calculations, they must always bear in mind that attacking the ATO case is unlikely to achieve success by itself. The ultimate task is always to prove on the balance of probabilities that the taxpayer's taxable income was less than the figure estimated by the ATO.

A long line of cases illustrate very clearly that failing to focus on the key task of proving the amount of the taxpayer's actual taxable income (the 'fatal flaw') inevitably results in the taxpayer failing to discharge the burden of proof. For example, in *Baini v FC of T*⁶⁰ the ATO used industry benchmarks to create a default assessment served on a taxi operator. The taxpayer argued that his taxis were old and inefficient, so that the industry benchmark allowed for expenses was too low in his particular case. However, the taxpayer failed to produce positive evidence of vehicle mileages, servicing records, fuel expenses and the like, and the AAT accordingly held that the taxpayer had failed to satisfy the burden of showing that the assessment was excessive.⁶¹

As noted above, a taxpayer's position will be easier if the ATO is prepared to agree to limit the dispute in a case to a defined set of issues, so that demonstrating that the ATO has made an error in determining one or more of those agreed issues will necessarily lead — in those limited circumstances — to the conclusion that the assessment is excessive.

Thus, in *Moignard and Commissioner of Taxation*⁶² the relevant issue was confined to the question of whether the ATO was correct to include a sum of \$480,476 in the taxpayer's assessable income for a particular year of income. RW Dunne (SM) decided that the taxpayer had discharged the s 14ZZK(b)(i) burden of proving that the amended assessment was excessive because there was evidence that the sum was not assessable income of the taxpayer personally

⁵⁴ *Nixon v FC of T* 79 ATC 4377, 4381 (Hunt J).

⁵⁵ Groch, above n 21.

⁵⁶ Ibid 358.

⁵⁷ Ibid 359, citing *George*, above n 45. This may require that the taxpayer provide positive proof e.g. of the origin and non-income nature of disputed amounts deposited into the taxpayer's account: ibid 360 — or that disputed amounts actually were loans and not of an income nature.

⁵⁸ Ibid 358.

⁵⁹ *Ma v FC of T* (1992) 37 FCR 225, 230 (Burchett J); cf *George v FC of T*, above n 45.

⁶⁰ 2012 ATC ¶10-259.

⁶¹ Above n 60, [159]–[164] (SA Forgie DP).

⁶² [2014] AATA 342.

under s 97 of the 1936 *TAA* for that year, but was instead properly assessable to the applicant as trustee of the Wine Logistics Trust.⁶³

However, in the absence of such an agreement, the taxpayer must go beyond merely pointing to errors in the ATO assessment process, and must establish the actual amount of their taxable income for the relevant period.

Unfortunately, recent cases suggest that some taxpayers have still not absorbed that lesson.

IV ‘THOSE WHO CANNOT REMEMBER HISTORY ARE CONDEMNED TO REPEAT IT’⁶⁴ — THE ONGOING IMPACT OF THE ‘FATAL FLAW’

An observer might be forgiven for thinking that, given the numerous warnings that the courts and tribunals have issued about the need to focus on proving the taxpayer’s actual taxable income, taxpayers and their advisers would be alert to this problem and would ensure that they addressed the key issue directly and fully.

This is not a case of complex or convoluted provisions whose meaning is obscure or contested — the principles are clear and unambiguous, and have been repeated many times.

Unfortunately, the decisions in *Gashi*, *Rigoli* and *Mulherin* suggest that the lessons of the past have not always been fully absorbed, and that the ‘fatal flaw’ continues to undermine efforts by taxpayers to discharge the burden of proof in relation to a default assessment.

A *Gashi v FC of T*

In *Gashi v FC of T*,⁶⁵ so far as relevant, the husband and wife taxpayers had failed to lodge various income tax returns. The Commissioner audited the taxpayers, and subsequently issued default assessments (calculated using the ‘asset betterment’ method) under s 167. In each case, the Commissioner also imposed administrative penalties of 75 per cent with a 20 per cent uplift factor for several years under s 284–220 (1) (a) *TAA*.

Both taxpayers challenged the default assessments. Mr Gashi sought to discharge the burden of proof by leading evidence as to his sources of employment income, part-time work as a toolmaker salesman, and an inheritance from his mother’s estate in Kosovo, as well as explaining certain overseas transfers made in the names of other persons.

Mrs Gashi argued that throughout the relevant periods she had not been involved in her husband’s business dealings, and that her taxable income consisted only of social welfare receipts, rent and interest as well as income from two properties and a Luxembourg bank account containing an inheritance from her grandmother.

On appeal, the Full Federal Court (Bennett, Edmonds and Gordon JJ) reiterated the basic principles applying to the burden of proof under s 14ZZO(b)(i) and held that, so far as the asset betterment default assessments were concerned:

- 1 The Commissioner was not required to prove the nature of the income received by the taxpayer.⁶⁶ It is ‘no part of the duty of the Commissioner to establish affirmatively what judgement [he] formed [under s 167], much less the grounds of it, and even less still the truth of the facts affording the grounds’: *George v Federal Commissioner of Taxation* (1952) 86 CLR 183 at 204.⁶⁷

63 [2014] AATA 342, [89]–[90] (Dunne SM). Similarly, in *Mulherin v FC of T* (below) the Full Federal Court suggested that if the taxpayer could have agreed with the Commissioner to confine the issue of the amounts on which the assessments depended to the income of the (conduit) Foundation in each of the income years, the taxpayer might have been able to discharge the burden by proving the actual income of the Foundation in each of the contested years: 2013 ATC ¶20-423, [45] (Edmonds, Griffith and Pagone JJ).

64 George Santayana, (1905) *Reason in Common Sense* (volume 1 of *The Life of Reason*), 284.

65 *Gashi v FC of T* [2013] FCAFC 30 (14 March 2013); 2013 ATC ¶20-377 — special leave to appeal to the High Court was refused on 16 August 2013: [2013] HCA Trans 181.

66 *Ibid* [61], [63], [67].

67 *Ibid* [55].

The only question was whether Mr Gashi had discharged the burden under s 14ZZO(b)(i) of proving that the assessments in issue were excessive.

- 2 The s 167 power of assessment is 'necessarily different' from that under s 166.⁶⁸ Under s 167, the 'normal' process of calculating taxable income as assessable income minus deductions is not possible (in whole or part) because the taxpayer has either failed to lodge a return, or the Commissioner is not satisfied with the return lodged, and instead tax is imposed on the amount which in the Commissioner's judgement 'income tax ought to be levied'.⁶⁹
- 3 The asset betterment method of is a legitimate basis for determining the s 167 taxable amount for the purposes of a default assessment⁷⁰ — notwithstanding that the resulting assessment will necessarily be a 'guess to some extent' and 'almost certainly inaccurate in fact'.⁷¹
- 4 The ultimate question in such cases is whether the amount of each assessment was excessive, with the burden being on the taxpayer to prove this. Accordingly:

A taxpayer who seeks to establish that a s 167 assessment based on the asset betterment method of calculation is excessive must positively prove his or her 'actual taxable income' and, in doing so, show that the amount of money for which tax is levied by the assessment exceeds the actual substantive liability of the taxpayer: *Dalco* at 623–5 and *Trautwein* at 88. The taxpayer must show that [any] unexplained accumulated wealth was from non-income sources ...⁷²

[That is, a taxpayer challenging a s167 assessment] must account for any unexplained increase in assets, explain the source/s of those assets, and then identify whether those sources are taxable.⁷³

Put another way, if the disclosed 'actual' taxable income does not explain the increase in assets, then the taxpayer is unlikely to have discharged the burden of establishing the assessment is excessive. And, of course, that unexplained increase in assets cannot be viewed in isolation — it must also take into account the expenditure during that period ...

Consistent with that view, even if a taxpayer was able to prove that an item in the asset betterment statement was wrong or should not have been included, but did not adequately explain the source or sources for the otherwise unexplained increase in wealth, the taxpayer would not discharge the burden under s 14ZZO of the *TAA*.⁷⁴

- 5 Accordingly, Mr Gashi's grounds were 'misconceived': he had committed the fatal flaw of basing his case purely on an (ultimately unsuccessful) attempt to prove that certain items listed in the Asset Betterment Statement were wrongly calculated or should not have been included. However, as the Court pointed out,⁷⁵ even if Mr Gashi had been successful in proving his submissions, this would not have discharged the burden of proof, because to successfully challenge the s 167 assessment:

Mr Gashi was required to demonstrate the unexplained accumulated wealth in each of the relevant years was from non-income sources. Mr Gashi did not show the source or sources of funds from which he acquired the increase in assets in each of the relevant years. In fact, he did not attempt to do so... [The Full Court noted that the trial judge had commented that] A striking thing about Mr Gashi's evidence is that it was not calculated to disclose the level of his income in any of the years in question, nor even to disclose particular transactions from which the generation of income should be inferred ...⁷⁶

Mr Gashi therefore failed to discharge the burden under s 14ZZO of the *TAA* ...⁷⁷

⁶⁸ *Ibid* [53] — indeed, the s166 assessment process has 'no resemblance or analogy to' that under s167: *Ibid* [56].

⁶⁹ *Ibid* [53]. — see also Latham CJ in *Trautwein*, above n 3, 87, 99–100, 105.

⁷⁰ *Ibid* [56].

⁷¹ Applying *Trautwein*, above n 3, 87.

⁷² *Gashi*, above n 65, [63].

⁷³ *Ibid* [65].

⁷⁴ *Ibid* [65]–[66].

⁷⁵ *Ibid* [67].

⁷⁶ Full Court, 2013 ATC at [28] — Jessup J at first instance had concluded that he had 'no alternative' but to find that Mr Gashi had fallen 'well short' of discharging the burden of proof: 2012 ATC ¶20-325, [40].

⁷⁷ *Gashi* above n 65, [67].

6 The Full Court also concluded that Mrs Gashi had failed to discharge the burden of proof.⁷⁸ The evidence put forward on her behalf consisted of oral evidence given by Mrs Gashi and a report prepared by a chartered accountant based on a number of assumptions (including, significantly, ‘*that her sources of income are known (being rental, interest and government payments)*’), which challenged elements of the ATO asset betterment statement.

Unsurprisingly, the Court held that this evidence was insufficient to discharge the burden of proof because the accountant’s report did not identify and prove Mrs Gashi’s actual sources of income. Instead, the report simply *assumed*, based on the instructions given by the taxpayers to the accountant, that Mrs Gashi’s sources of income were known and consisted (only) of rent, interest and government payments.

In addition, the accountant did not provide an explanation of the source or sources for the unexplained increase in Mrs Gashi’s assets over the relevant years, nor did the report identify whether those sources were taxable.

The Full Court’s comments on these points are instructive:

[76] ... the question posed by [the accountant in his report] was whether Mrs Gashi’s disclosed level of income was sufficient to fund the increase in assets from year to year ... For the purposes of s 14ZZO of the *TAA* in the context of an assessment issued under s 167 ... that question was irrelevant. The relevant question was: what ... were the sources, for the yearly increase in her net assets, and were those sources taxable? ... [The accountant] made a finding that it was ‘unsafe to assume that the assets owned by [Mrs] Gashi were paid for by her husband. That finding, again unexplained, simply begs the question — if Mrs Gashi’s assets were not paid for by her husband, what was the source of funding and was that funding taxable?’

[77] Indeed, Mrs Gashi did not seek to address the unexplained increase in her wealth in each of the relevant years. She gave no evidence of what activity (income producing or otherwise) was being carried on by her or, if carried on not by her, how she funded the unexplained yearly increase in her assets having made allowance for her annual expenditure and other disclosed sources of income.⁷⁹

Significantly, the Court pointed out that Mrs Gashi was not entitled to ‘pick and choose’ which part or parts of her increased wealth set out in the asset betterment statement she would seek to explain. For example, Mrs Gashi did not attempt to explain the large deposits into an account she held jointly with her husband or the source of funding for the significant assets in her own name; however, she did produce evidence about the source of the deposit into the Luxembourg bank account.⁸⁰ The Court pointed out that if Mrs Gashi wished to dispute the asset betterment calculations, s 14ZZO required that she positively establish her case in relation to the *whole* of the unexplained increase in her wealth in each of the relevant years. The fact that she chose not to do so meant that her attempt to discharge the burden of proof was bound to fail.⁸¹

The case is a classic example of the fatal flaw. Both taxpayers had committed the same basic error of attempting to debate some elements of the ATO assessment without focusing on the key issue of proving definitively that the assessment was excessive — thus answering the crucial question of what the taxpayer’s actual taxable income was, and whether that was less than the amount assessed.

An observer might have thought that a taxpayer and their advisers subsequently seeking to challenge a default assessment would have taken very careful note of the principles and clear guidelines provided by the Full Federal Court in *Gashi*, and would have ensured strict compliance with them. Surprisingly then, the same error was repeated shortly afterwards in *Rigoli*.

78 Ibid [75]–[77].

79 Ibid [75]–[78] (Bennett, Edmonds and Gordon JJ).

80 Ibid. The latter evidence had been rejected by the trial judge.

81 Ibid [77]–[79] (Bennett, Edmonds and Gordon JJ).

B *FC of T v Rigoli*

In *FC of T v Rigoli*,⁸² the Commissioner issued default assessments under s 167 to 'Little Joe' Rigoli following audits of the taxpayer's affairs. The ATO based its assessments not on asset betterment calculations, but on a 'complex analysis which had been undertaken [by the ATO] in an attempt to estimate receipts, payments and allowable depreciation for each of the years in dispute' — with much of this information 'based upon professional judgements and estimates rather than upon financial data since Mr Rigoli did not keep records'.⁸³

At the commencement of the AAT hearing, Rigoli had 'conceded' that he did not challenge the amounts identified by the Commissioner as income, but rather was claiming that he was entitled to additional deductions by way of depreciation on various items.

The AAT had accepted this 'concession' and proceeded to determine whether Mr Rigoli's claim for depreciation expenses should be allowed and if so, whether 'in those circumstances', Mr Rigoli had satisfied the burden of proof.⁸⁴

On appeal, Pagone J held that the AAT had approached the matter in the wrong way because it had misunderstood the nature of a s 167 assessment.⁸⁵ A default assessment is a 'fundamentally different' creature to a normal s 166 assessment, because the very nature of a s 167 assessment means that the subject matter or focus of a challenge to the assessment must be not on the individual elements of assessable income and deductions, but rather on 'the amount' upon which in the ATO's judgement, tax ought to be levied.⁸⁶

Pagone J noted that instead of focusing on this issue, Mr Rigoli had simply sought to show that the amount judged by the Commissioner to be the taxable income had failed to make appropriate allowances for depreciation — that is, the taxpayer was merely attempting to show that the ATO had made an error in determining the correct amount of deductions allowable to the taxpayer.

As Pagone J pointed out:

It is clear ... that the combined effect of s 167 and the legal burden of proof falling upon the taxpayer is that for a taxpayer to succeed in establishing the excessiveness of an assessment under s 167 (absent agreement between the Commissioner and taxpayer concerning the conduct of the proceedings) ... the taxpayer [must] establish not that the amount assessed by the Commissioner under s 167 ... was wrong but, rather, what the actual amount was. How that may be achieved will no doubt vary from case to case, but it cannot be done as the Tribunal proceeded, namely, by assuming that what was in contention in the proceeding before the Tribunal was only part of the Commissioner's assessment ...

On appeal, the Full Federal Court strongly endorsed the thrust of these comments, observing that the Rigolis' attempt to discharge the onus of proof by identifying some errors in the Commissioner's assessment

... is the very picking and choosing which the authorities make clear is impermissible. The taxpayer's choice is to pay tax according to the Commissioner's assessment under s 167 or to establish, as a matter of evidence, what was 'the amount upon which ... income tax ought to be levied'. An intermediate course, which involves elements of the Commissioner's calculations and facts which the taxpayer chooses to lead in evidence, is not an available option.⁸⁷

The case is another example of the simple and unambiguously clear proposition that the task for the taxpayer who is objecting to a s 167 assessment is not to prove that the ATO made a mistake, but rather to prove on the balance of probabilities the correct amount upon which tax should be levied.⁸⁸

⁸² *FC of T v Rigoli* 2013 ATC ¶20-407 (Pagone J), on appeal [2014] FCAFC 29; 2014 ATC 20-446 [25]-[26] (Edmonds, Jessup and McKerracher JJ).

⁸³ 2013 ATC 20-407, [5] (Pagone J).

⁸⁴ *Ibid* [6] (Pagone J).

⁸⁵ *Ibid* [11] (Pagone J).

⁸⁶ *Ibid* [8] (Pagone J) — referring at [9] to *FC T v Dalco*, above n 39.

⁸⁷ *Rigoli v FC of T* [2014] FCAFC 29; 2014 ATC 20-446, [25] (Full Court: Edmonds, Jessup and McKerracher JJ).

⁸⁸ 2013 FCA 784, [9]-[10] (Pagone J); [2014] FCAFC 29, [89] (Edmonds, Jessup and McKerracher JJ).

In the circumstances, Pagone J was untroubled to hold that the Rigolis had failed to discharge the burden of proof, and their appeals therefore failed.

Once again, a bemused observer might have expected that in light of the clear reiteration of the warnings and guidelines, subsequent taxpayers and their advisers would heed these warnings and focus on the relevant issue, to avoid wasting valuable time and money on a lost cause.

It was surprising, therefore, that when the issue arose again in *Mulherin v FC of T*, the taxpayer yet again made the same mistake — albeit in a different form — as their predecessors.

C *Mulherin v FC of T*

The decision in *Mulherin v FC of T*⁸⁹ followed the same well-trodden (but apparently not well understood) path as its two immediate predecessors.

In *Mulherin*, the taxpayer was born in Australia, but practised medicine in Hong Kong for many years before retiring and returning to Australia in the early 1990s. While in Hong Kong, the taxpayer had established a complex system of trusts and companies to manage his financial affairs. As part of these arrangements, the taxpayer set up the San Simeon Foundation, which was a resident trust estate of which the taxpayer was the sole primary beneficiary, with an account at the LGT Bank in Lichtenstein. In 2007 the taxpayer left Australia to live in Singapore.

The taxpayer did not lodge any Australian tax returns for the income years 2004–2007, but did lodge returns for the income years 1999–2003, disclosing a modest income but no amounts attributable to the investments with the LGT Bank or income from the Foundation. Subsequently, an employee stole electronic copies of records from the LGT Bank, and provided the ATO with compact discs containing financial and other information relating to Australian residents, including the taxpayer’s Foundation.⁹⁰ These records showed that the Foundation’s account balance had increased from US\$3.792 million to US\$5.974 million over the two year period 1999–2001 (an increase of around 51 per cent).

Using this information, the ATO applied the average annual increase rate in the Foundation’s funds (about 25 per cent) to assess Mulherin on ‘additional taxable income’ of around \$26 million over the period 1999–2007,⁹¹ plus administrative penalties at 75 per cent for intentional disregard, plus an uplift factor of 25 per cent,⁹² giving a total of some \$11.3 million in penalties.

The taxpayer argued that he was not presently entitled to the income of the Foundation, but did not appear to give evidence — his request to give evidence by video link from Singapore was rejected several times by the AAT.⁹³

In *Mulherin*, the taxpayer’s argument was somewhat different — the taxpayer argued that the AAT had made an error of law in concluding that Mulherin had not discharged the burden of proof by showing that the Foundation’s income was ‘probably’ less than the amount assessed, without proving a precise figure.

However, in light of prior authority, this was a ‘brave’ argument, which was peremptorily rejected.⁹⁴ The Full Court (Edmonds, Griffiths and Pagone JJ) underlined yet again, in relation to the requirements for challenging a default assessment, that it was not enough for the taxpayer merely to show error in the Commissioner’s assessment; instead

the taxpayer must positively prove his or her ‘actual taxable income’ and, in doing so, must show that the amount of money for which tax is levied by the assessment exceeds the actual

⁸⁹ *Mulherin v FC of T* 2013 ATC ¶20-423 (Edmonds, Griffiths and Pagone JJ).

⁹⁰ Cf *Denlay & Anor v FC of T* 2011 ATC ¶20-260.

⁹¹ On the basis that Mulherin was presently entitled to the income from the Foundation.

⁹² *Mulherin*, above n 91, [21]; cf s 284-220 TAA 1953 (Cth).

⁹³ *Ibid* [23]; cf [50]–[54].

⁹⁴ *Ibid* [41]–[42] (Edmonds, Griffiths and Pagone JJ), citing *Dalco*, above n 39 and *Gashi*, above n 65.

substantive liability of the taxpayer ... Unless he does so, the taxpayer has not discharged the burden of proving the assessment is excessive.⁹⁵

By failing to do so, the taxpayer had again failed to avoid the fatal flaw.

V CONCLUSION

The combined impact of the inherent nature of a default assessment and the burden of proof in tax litigation mean that the taxpayer — like Sisyphus — faces an uphill struggle to achieve success, and must focus carefully on the key requirements for a successful challenge.

However, unlike Sisyphus, a taxpayer does have a realistic chance to achieve success, provided they learn from the experiences of prior taxpayers and follow the guidelines mapped out by the courts in a series of cases.

The simple rule made unambiguously clear by a long line of decisions is that to successfully challenge a default assessment, the taxpayer must demonstrate definitively what their actual taxable income and liability is, and then show that this amount is less than the amount assessed by the ATO.

As noted at the outset, these are not conceptually difficult provisions. The rules are simple, starkly clear, and consistently applied by the courts; yet taxpayers and their advisers seem not to have absorbed the lessons of the past, and continue to pursue a line of attack long identified by the courts as doomed to failure.

The decisions in *Gashi*, *Rigoli* and *Mulherin* are merely the latest in a line of cases that illustrate the fate of taxpayers who commit the ‘fatal flaw’ of failing to focus on the essential issue in challenging a s 167 default assessment.

The puzzling question is why taxpayers and their advisers continue to ignore the clear lessons of the past — particularly given the significant amounts of tax and penalties at risk. It seems unlikely that professional advisers would be unaware of reported Federal Court decisions setting out stark and unambiguous warnings against the ‘fatal flaw’ approach, and providing equally clear guidelines on how to effectively challenge default assessments.

In that light, it is hard to see why a taxpayer or adviser would choose to incur the considerable expense of an AAT or Federal Court hearing while pursuing a line of argument that is doomed to failure from the outset.

Whatever the reason, the recent decisions considered above represent sad illustrations of the truism that those who cannot remember history are condemned to repeat it.⁹⁶

Hopefully, future taxpayers will not make the same error.

⁹⁵ Ibid [42] citing *Dalco*, above n 39, and *Gashi*, above n 65. The Court indicated that this principle applied regardless of whether or not the s 167 assessment was based on an asset betterment basis of calculation or some other method: *Mulherin*, above n 91 [44].

⁹⁶ George Santayana, above n 64.

