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PRACTITIONER ARTICLES

[1420] **When exactly is a related party debt statute barred?**

- by Matthew Burgess and Patrick Ellwood, Directors, View Legal

The case of *Re Breakwell and FCT[2015] AATA 628* (25 August 2015, reported at 2015 WTB 37 [1393]) highlighted a common trap in relation to the circumstances where a related party debt will be statute barred. The decision, which was upheld on appeal in *Breakwell v FCT* [2015] FCA 1471 (22 December 2015, reported at 2016 WTB 1 [27]) remains a timely reminder of the critical interplay between various legislative provisions that practitioners must be constantly aware of.

Breakwell

In *Breakwell*, the taxpayer argued that a $1.1 million debt owed by him to a family trust should not be included in the calculation of the trust's net assets under the maximum net asset value test for the small business CGT concessions under Div 152 of the ITAA 1997. The basis of the argument was that the debt had arisen prior to 1998 and was therefore outside the 6-year period provided for under the *Limitation of Actions Act 1936* (SA).

In this regard, as noted by White J in the Federal Court decision, the relevant section in South Australia is not a bar to proceedings, rather, it creates a defence which bars the granting of a remedy. Similar legislation applies in every State and Territory except in New South Wales, where a creditor's right to the debt is effectively extinguished after the expiry of the limitation period.

Specifically, the taxpayer claimed that because no repayments had been made and he had not acknowledged the existence of the debt in writing, the debt had become statute barred meaning the family trust could no longer enforce repayment of the debt.

In finding against the taxpayer, the Administrative Appeals Tribunal noted that the taxpayer had signed the balance sheets for the family trust for the 2003 to 2008 income tax years (in his capacity as trustee). It was held that the signature on the balance sheets was sufficient to constitute an acknowledgement by him (as the borrower) of the existence of the debt.

This meant the debt was not statute barred and was required to be included in the calculation of the trust's maximum net asset value.

The taxpayer was unsuccessful in appealing the decision to the Federal Court, as previously reported by Jack Stuk and Danielle Gorman (see 2016 WTB 7 [181]). In brief, White J also raised a number of alternative methods by which the loan could effectively be recovered, including:

- the taxpayer as trustee of the family trust would face a duty-interest conflict in raising the limitation of actions defence;
- the South Australian legislation (which differs from other States in this respect) allows for an extension of the limitation period; and
- through an action by the trustee to recover trust property, which was again due to differences in the South Australian legislation as it has no limitation period in this regard.

Why are the statute barred rules so important?

Determining whether a debt has become statute barred can be relevant in a number of areas, for example:

- From a commercial perspective, ensuring the lender has the ability to demand the repayment of the debt.
- As highlighted in *Breakwell*, for determining whether or not a debt should be included in the maximum net asset value test under Div 152 of the ITAA 1997.
- Under Div 7A of the ITAA 1936, which treats a debt that has become statute barred as being forgiven (and therefore potentially gives rise to a deemed dividend).
- For determining whether a bad debt deduction can be claimed (see for instance TR 92/18).
- Estate planning, particularly (for example) where there are debts owed by a trust to a will maker and certain beneficiaries are intended to control the trust, with others to benefit under the will.
- Asset protection, particularly if the "gift and loan back" strategy has been implemented (see for example our article reported at 2013 WTB [1821]).

The key issue – the start date

In this context, it is obviously important to determine the date on which a loan is deemed to begin.

Historically, there has been some support for the argument that the start date for limitation period purposes was the date that a demand was made for repayment of the debt or the last date a formal acknowledgement (including by way of part payment) was made.

This position was at least partially due to the fact that under the relevant limitation legislation, an acknowledgement must generally be made in writing by the debtor to the creditor, and be signed by the debtor.

The "acknowledgment" debate

Although the relevant legislation is slightly different in each State and Territory across Australia, the general test to determine if a debt has become statute barred is whether, within the relevant period (typically 6 years for unsecured debts and 12 years for secured debts) there has been either:

- a partial repayment by the borrower; or
- a written acknowledgement of the existence of the debt signed by the borrower and addressed to the lender.

Although these tests would seem fairly straight forward, there is some debate as to whether the written acknowledgement must be intended by the borrower to be an acknowledgement to the lender of the existence of the debt.

In *VL Finance Pty Ltd v Legudi* [2003] VSC 57 (13 March 2003) (in the context of the Victorian legislation), Justice Nettle (then sitting on the Victorian Supreme Court) held that any acknowledgement must be intended by the borrower to be an acknowledgement to the lender of the existence of the debt.

Therefore, the mere signing of financial statements by the borrower in their capacity as a trustee or director will not be sufficient to "refresh" the debt. Importantly, it was also held that the limitation period (at least for the purposes of Div 7A of the ITAA 1936) begins to run ***immediately on the date that an at-call loan is made; not from the time when the first call for repayment is made***.

By contrast, *Lonsdale Sand & Metal v FCT* [1998] FCA 155 (5 March 1998) (in relation to the South Australian legislation) and now *Breakwell* have both concluded that the mere signing of the financial statements by the borrower will be sufficient to "restart the clock" on the recovery period.

Conclusion

The differences between the outcomes in relation to acknowledgments in *VL Finance* on one hand and *Lonsdale* and *Breakwell* on the other are hard to reconcile.

While it could be argued that *VL Finance* provided a far more robust analysis of the issue and reached a more reasoned conclusion, ***practitioners should be cautious relying on the decision given the conflicting judgments***.

Nonetheless, some common themes can be identified from all 3 cases, including:

- An oral acknowledgement by the borrower by itself will be insufficient to "refresh" a debt, unless accompanied by some written acknowledgement.
- The inclusion of a debt on the borrower's signed financial statements should be insufficient to "refresh" the debt, unless it can be shown that those financial statements were subsequently provided to the lender with the intention of acknowledging the existence of the debt.
- Where the debts are owed between entities with common directors, the signing of the lender's financial statements by a director who is also a director of the borrower will likely be seen by the ATO to be sufficient to "refresh" the debt.

Ultimately, ***practitioners should be wary of advising clients that debts have been statute barred where the debts are between related parties***.

This issue is generally most relevant if a client wishes to rely on PS LA 2006/2 (GA), which provides administrative relief from Div 7A where loans which arose prior to the introduction of those provisions in 1997 become statute barred. In this factual situation, it is critical to review the financial statements for each relevant financial year. The analysis must focus on whether it could be argued that the debt has at any time been "refreshed" by virtue of the borrower signing the financial statements in their capacity as a trustee or director.

[*Thank you to Hayden Dunnett from the View Legal team for his work in researching aspects of this article*.]

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[1421] **So, an SMSF is a safe place to keep your assets – right? What about payroll tax?**

- by Michael Doran, Director and Andrew Orange, Webb Martin Consulting

Until recently, it has generally been assumed that self-managed super funds (SMSFs) are, as a practical matter, outside the ambit of payroll tax grouping. It largely followed that SMSF assets are beyond the reach of State Revenue Offices.

The recent Queensland-based litigation between Mr Scott, Ms Bird and a custodian trustee, Can Barz Pty Ltd, (as applicants) and Commissioner of State Revenue (as respondent) - *Scott and Bird & Ors v Comr of State Revenue* [2016] QSC 132, reported at 2016 WTB 26 [872] - has demonstrated the truth of the axiom that "one should never say never" but one should be alert to possibilities.

How the concern arises

Mr Scott and Ms Bird (Scott and Bird) were the only trustees of an SMSF. The litigation arose out of the Queensland Commissioner's view that, for payroll tax (PRT) purposes, Scott and Bird should be grouped with other entities, including various companies in which they were both the only directors. Grouping arose on the basis that, as trustees of the SMSF, they were carrying on a business. Like most jurisdictions, under the *Payroll Tax Act 1971* Qld (PRT Act) "carrying on of a trust" is deemed to be a business.

The companies had PRT debts and the Commissioner regarded Scott and Bird and the other group entities as