

TAX BULLETIN

AN UPDATE PUBLICATION
FOR OUR CLIENTS

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DIVISION 7A - THE ATO'S DISCRETION TO DISREGARD A DEEMED DIVIDEND OR ALLOW A DEEMED DIVIDEND TO BE FRANKED (PART 1)

Earlier this week the ATO issued a Ruling outlining when it will make a decision to exercise its discretion to relieve taxpayers from the application of Division 7A.

The release of the Ruling brings to focus the potential difficulties that may occur in seeking the ATO's discretion. As outlined below, these difficulties highlight the need for taxpayers to take appropriate steps to mitigate Division 7A risks in the first place - and thus place themselves in the best position to satisfy the requirements to apply for the discretion.

The Ruling covers the gateway tests to the discretion by examining the meaning of the terms 'honest mistake' or 'inadvertent omission'. This publication (Part 1) outlines the ATO's view on this threshold test as contained in the Ruling.

It is noted that even if the gateway threshold test is satisfied, the discretion will only be exercised by the ATO having regard to all of the factors that contributed to the honest mistake or inadvertent omission. The Ruling highlights that the evidence required to show: (i) that an 'honest mistake' or 'inadvertent omission' has occurred; and (ii) the contributing factors to that mistake/omission, will be the subject of a Practice Statement - which the ATO has indicated will be issued in draft form before Christmas. Our next publication (Part 2) will provide an outline of this draft Practice Statement.

What steps should a taxpayer take?

While the Practice Statement has yet to be released, it is expected that the ATO will set a very high threshold that will need to be satisfied before the discretion will be exercised in any particular case. It is therefore, difficult for a taxpayer to rely on the ability of the ATO to exercise its discretion.

This problem in accessing the discretion highlights the need for taxpayers to focus their attention on the appropriate steps to mitigate Division 7A risks in the first place (and thus, also place themselves in the best position to satisfy the requirements to apply for the discretion).

Accordingly, it is important that taxpayers have some form of internal governance procedures that are aimed at ensuring maximum compliance with Division 7A.

Furthermore, due to the complexity of the provisions, it is also more important than ever to ensure that:

- an appropriate review of the potential implications of Division 7A is undertaken by your tax agent or advisor on an annual basis (prior to the lodgement of the tax returns); and
- where a group includes one or more private companies, advice is sought where arrangements and transactions occur between related group entities.

Where a taxpayer can prove that reasonable efforts have been made to comply with Division 7A, we believe that it will provide a stronger case to evidence that the relevant Division 7A error has been caused by an honest mistake or inadvertent omission.



Summary of the Ruling

Division 7A aims to ensure that any loans or payments by private companies to shareholders and/or their associates are treated as non-franked dividends (i.e. assessable income) in their hands - unless they are repaid or placed on the terms required by the provisions. Debts owed by shareholders and/or their associates that are forgiven by the private company can also give rise to assessable income under Division 7A.

Division 7A contains a complex set of provisions that have long been regarded as a veritable 'minefield' for the unwary - i.e. due to their complexity and scope it is, quite simply, too easy to run foul of these rules. Where an error has occurred in applying Division 7A, taxpayers will invariably consider accessing the ATO's discretion.

While the ATO accepts that the ordinary meaning of an honest mistake or inadvertent omission may be quite broad (i.e. in order to access the discretion), the Ruling requires a taxpayer to: (i) evidence their actual state of mind at the time of making the relevant error; and (ii) demonstrate that there was (in fact) an honest mistake or inadvertent omission. Furthermore, the ATO requires the taxpayer to show a causal link between the Division 7A error and the honest mistake or inadvertent omission.

Without further guidance on the evidence required, taxpayers and practitioners will find it difficult to determine whether the threshold test is satisfied. The soon to be released Practice Statement is intended to provide guidance on this evidentiary question. Accordingly, the contents of this Practice Statement will be critical for taxpayers seeking access to the discretion.

Detail about the Ruling

Gateway to the discretion

The Ruling outlines the requirements to be satisfied before the ATO can exercise its discretion under section 109RB to either disregard a deemed dividend under Division 7A or to allow a deemed dividend to be franked with imputation credits.

The threshold requirement that has to be met before the discretion can be exercised is that there has been an honest mistake or an inadvertent omission - for example, by a Director of the private company or by the Tax Agent for the company.

What is an honest mistake or inadvertent omission?

The Ruling states that a mistake is an incorrect view, opinion or misunderstanding about: how Division 7A operates; facts that are relevant to the operation of Division 7A; or matters that affect the operation of Division 7A. To fall within section 109RB it is also necessary that any such mistake must be honestly made.

The ATO says that an omission is a failure to take action that is either relevant to or affects the operation of Division 7A. To come within section 109RB, such an omission must be inadvertent.

Whilst the ATO acknowledges in the Ruling that there are a wide range of mistakes and omissions that could potentially qualify for the exercise of the discretion under Division 7A, we note that the ability to actually access the discretion may well be limited.

Evidence required by the ATO

It is a question of fact whether an honest mistake or an inadvertent omission has occurred. Furthermore, the taxpayer must demonstrate that the honest mistake or inadvertent omission in fact caused the relevant Division 7A error (i.e. there is a requirement to prove that a causal relationship exists).

In order to demonstrate the above, the ATO will require evidence to: (i) show the person's actual state of mind or belief at the time; and (ii) establish the causal relationship. This, in itself, may be difficult.

The Ruling does not deal with the actual evidence required for a taxpayer to satisfy the ATO whether an honest mistake or inadvertent omission has occurred. This will be covered in a Practice Statement (which is expected to be released in draft form before Christmas).

That being said, the ATO make the following statements in relation to the evidence required for the threshold tests:

- A taxpayer cannot simply assert that a mistake or an omission has taken place - evidence must exist to be able to convince the ATO (on the balance of probabilities) that a mistake or an omission has occurred;
- A taxpayer cannot simply assert that a mistake was honest or an omission was inadvertent - evidence must exist to be able to prove to the ATO (on the balance of probabilities) that an honest mistake or an inadvertent omission has occurred; and
- A taxpayer cannot simply assert that Division 7A applied because of the mistake or omission - evidence must exist to be able to show the ATO (on the balance of probabilities) that the honest mistake or the inadvertent omission caused Division 7A to apply.

Key points made by the Ruling

In determining whether an honest mistake or inadvertent omission has occurred, the following key points are made in the Ruling:

- Actions or omissions made to circumvent Division 7A cannot satisfy the requirements of an honest mistake or an inadvertent omission;
- While the ATO accepts that a mistake or omission can be the result of ignorance of the operation of Division 7A, deliberate behaviour to remain ignorant of the requirements of Division 7A will be unlikely to satisfy the meaning of an honest mistake or an inadvertent omission;
- The mistake or omission about a particular matter cannot be made subsequent to the error. Accordingly, the discovery of an error at a future date does not necessarily mean that the error satisfies the threshold requirements;
- The fact that a mistake or omission about the operation of Division 7A has been commonly made by a number of taxpayers does not necessarily mean that an honest mistake or inadvertent omission has occurred in a particular taxpayer's case. (However, in the absence of evidence to the contrary, the ATO notes that the fact an error is common will help support this conclusion); and
- A mistake or omission that is recurring will qualify as an honest mistake or an inadvertent omission if it: (i) recurs for the same reason; and (ii) the original mistake or omission qualified as an honest mistake or an inadvertent omission.



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FURTHER INFORMATION

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