THE TAX INSTITUTE

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2015 PRIVATE BUSINESS TAX RETREAT

Division 7A

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1 Introduction

This paper addresses what to do when you take on a client that has pre-existing 'tax issues' – specifically a Division 7A problem.

In deciding how to deal with such an issue you need to:

- Identify the issue(s);
- Identify the taxpayer(s);
- Identify what year the issue relates to;
- Determine when an issue is out of time to be looked at;
- Consider what the ATO's administrative practices are, particularly in relation to trusts;
- What might enliven an open-ended assessment – particularly 'evasion' and what this might mean.

While the focus of the paper is on issues that are adverse to a taxpayer – Division 7A, there may be times where the 'issue' is that an item or transaction has been treated incorrectly in the past so that a taxpayer is due a refund. Much the same process applies in dealing with either adverse or beneficial issues (identification of the issue, the taxpayer, the year, whether you are within time to request an amendment, etc.).

The use of 'aggressive' structures and how to deal with them is also covered.

As a final point I have set out some comments on what to do if you are the cause of the pre-existing tax issue.

References in this paper are to the *Income Tax Assessment Act 1936* (Cth) (ITAA1936), *Income Tax Assessment Act 1997* (Cth) (ITAA1997), *A New Tax System (Goods & Services Tax) Act 1999* (Cth) (GST Act), the *Fringe Benefits Tax Assessment Act 1986* (Cth) (FBT Act) and the *Taxation Administration Act 1953* (Cth) (TAA1953).

A reference in this paper to the lodgement date is a reference to the earlier of the date of lodgement and the due date for lodgement of a return.[1]

[1] Section 109D(6), ITAA1936.

2 Issue(s) and taxpayer(s)

This paper is directed towards a situation where you have recognised that a client has a Division 7A issue that needs to be dealt with. It needs to be emphasised however that, given the complexity of taxation law, Division 7A may not be the only issue that may need to be dealt with.

For example, where Division 7A might apply, it could also be the case that there is an interest deductibility issue. This could occur where a private company borrows at interest to on-loan at no interest to a shareholder or associate of a shareholder.

It also sometimes occurs that profits are retained in a company and then loaned out to a shareholder or associate of a shareholder in a situation where the PSI rules should have otherwise attributed the whole of the income to the individual earning the PSI, so that the PSI rules apply instead of Division 7A.

As well it is not always clear who the taxpayer is that is affected by the issue identified. Usually this occurs in relation to trusts, where a change in the tax law income of the trust does not necessarily impact on the beneficiary that received a distribution that year, but may impact instead upon the trustee or another beneficiary. In relation to a trust where its taxable income is adjusted it is necessary to:

1. Review the deed to determine what the income of the trust is;
2. Review the distribution resolution or minute for the year in question and determine whether it dealt with the trust income in such a way that you can determine where an adjustment to the tax law income will flow.
3. Determine which beneficiary, or the trustee, will bear the tax impact of the adjustment and in what proportion.

A common mistake still occurs in relation to recognising the taxpayer impacted by a Division 7A problem where there is a direct loan or payment for benefit of a person. It has been said that Division 7A operating to deem a loan or payment to be a dividend has negative implications for the private company concerned, but this has not been the case since 1 July 2006 when the requirement debit to the franking account when a deemed dividend arose was removed. It has also been said that it is the shareholders that are taxed on Division 7A deemed dividends in all cases. This is not true. It is the recipient of the loan or the payment that is impacted by a Division 7A deemed dividend.

3 Identify the year

Tax returns are lodged for a year of income and usually an assessment is issued as a result of the lodgement.

Tax law provides limits on the period within which the Commissioner can amend an assessment.

If an issue has an impact on an assessment that is out of time for amendment, then the issue is, in effect, a non-issue. To determine that this is the case however it is necessary to identify the year to which the issue relates.

While it is usually easy to identify which year of income an issue relates to, it is not always obvious.

Division 7A is aimed at preventing a private company from making tax-free distributions to its shareholders or their associates by way of loans, payments and debt forgiveness, and can treat such transactions as deemed unfranked dividends.

If the issue was that someone had been loaned an amount by a private company, that a forgiveness had occurred in relation to a debt owed to a private company, or that a private company had made a payment to or for the benefit of the person, the starting point in identifying how to deal with the Division 7A issue is to consider in which year the Division 7A issue arose.

Division 7A operates on a year-by-year basis.

In relation to a loan by a company or a trust it is the amounts loaned in a particular year that can be treated as deemed dividends.

As an example the starting point in considering whether a 'debit loan' balance of $1 million at 30 June 2012 is an issue it is necessary to determine whether that loan came about in the 2012 financial year, or whether it has built up over a number of years. If it has built up over a number of years it is necessary to determine in which years it arose. Note that this point is complicated by the operation of section 109R (dealing with repayments)[2].

The year in which a deemed dividend arises is also important as it can impact on distributable surplus even if there is no amount shown as a deemed dividend in someone's return.

Where Division 7A operates on the forgiveness of an amount, it operates at a point in time when a loan is forgiven. Legal forgiveness is not necessary for the forgiveness of an amount to be treated as a trigger for a Division 7A deemed dividend. Under Division 7A it is only necessary that (section 109F(6)):

> An amount of debt an entity (the ***debtor***) owes a private company is also ***forgiven*** for the purposes of this Division if a reasonable person would conclude (having regard to all the circumstances) that the private company will not insist on the entity paying the amount or rely on the entity's obligation to pay the amount. (The amount is forgiven when a reasonable person would first reach that conclusion.)

[2] I covered this point in my paper 'Division 7A' at the 6th NSW Annual Tax Forum in 2013.

In relation to forgiveness there is also an ordering rule that provides that it is the earliest time that a debt could be taken to be forgiven that is the time at which the debt is forgiven.

In relation to payments the potential for a deemed dividend arises at the point when a payment is made.

4 Where to next?

Having identified the year in which the potential Division 7A issue arose and the taxpayer affected, it is necessary to then move forward in one of two ways:

- By considering the time limits for amendment of assessment; and
- By considering the quantum of the distributable surplus.

Whichever starting point you choose however, unless you determine that there is no issue as a result of the assessments being out of time or there being insufficient distributable surplus, the issue will need to be analysed other starting point.

In practice a cursory glance at the relevant year's financial account, to determine whether there is likely a distributable surplus, will often guide which starting point is chosen, that is, if there is clearly a distributable surplus (on the face of it) then start with the amendment periods; if instead if there seems to be no distributable surplus, start there.

5 Time limits

Many tax problems become 'out of time' if left for long enough.

The ATO's ability to raise or amend an assessment is generally governed by section 167 and 170[3].

There are time limits on the Commissioner amending an assessment in relation to income tax, FBT and GST. In relation to income tax the relevant provisions are found in section 170 of ITAA 1936.

An amended assessment is an assessment for these purposes, and note that an amendment can extend the time for further amendments to the assessment (subsection 170(3) of ITAA 1936). From 2004-05 subsection 170(1) also applies for nil assessments.[4]

Taxpayers are afforded the ability to extend the time periods for amendment, and the Commissioner is entitled to apply to the Courts for an extension of time if he does so within the limited time periods.[5]

The time limits in subsection 170(1) are set out separately for individuals, companies, and entities assessed as trustees. The provisions for an individual are:

Amendment of assessments	
Time of amendment	Qualification
The Commissioner may amend an assessment of an individual for a year of income within 2 years after the day on which the Commissioner gives notice of the assessment to the individual.	This item does not apply: (a) if the individual carries on a business at any time in that year unless the individual is a small business entity for that year; or (b) if the individual is a partner in a partnership that carries on a business at any time in that year unless the partnership is a small business entity for that year; or (c) to an individual in the capacity of a trustee of a trust estate at any time in that year (see item 3 for this case); or (d) if the individual is a beneficiary of a trust estate at any time in that year unless the trust is a small business entity for that year or the trustee of the trust (in that capacity) is a full self-assessment taxpayer for that year; or (e) if it is reasonable to conclude that any person entered into or carried out a scheme (either alone or with others) for the sole or dominant purpose of the individual obtaining a scheme benefit in relation to income tax from the scheme for that year; or

[3] Though see also sections 168 and 169 of ITAA1936.

[4] There are special provisions concerning 2003-04 and earlier years assessments where no tax was payable set out in section 171A of ITAA1936.

[5] See subsection 170(7) of ITAA 1936 and subsection 155-35(3) of the GST Act.

	(f) in any other circumstance prescribed by the regulations. This item is subject to items 5 and 6.

The provisions for companies and trusts are almost identical and are in item 2 and 3 of the table.

If the 2-year time limits in items 1 – 3 do not apply then the time limit becomes 4 years under item 4.

Item 5 provides that the Commissioner can amend at any time if he or she is of the opinion there has been fraud or evasion. Item 6 then provides for an unlimited period of amendment where it is necessary to give effect to a decision on review or appeal, and where it is necessary to give effect to an objection decision or a pending review or appeal.

In relation to items 1 – 3 the following observations need to be made:

1. It is not always easy to determine whether an entity is a small business entity, given the need to take into account the turnover of the entity, its affiliates, and entities connected with the entity.
2. Simply being a potential beneficiary of a trust is enough to give the Commissioner 4 years to amend - *Yazbek v Commissioner of Taxation* [2013] FCA 39.
3. While the words 'if it is reasonable to conclude that any person entered into or carried out a scheme (either alone or with others) for the sole or dominant purpose of the individual obtaining a scheme benefit in relation to income tax from the scheme for that year' appear to mirror Part IVA, it is not necessary for Part IVA to apply for an amendment to occur in these circumstances - *Kocharyan v Commissioner for Taxation* [2015] FCA 13.
4. The time period begins from the time that the Commissioner 'gives' the notice of assessment to a taxpayer, meaning that the time will begin from the time that the letter would have been delivered in the ordinary course of post (assuming that is the method of delivery)[6], and can be presumed to have been received on the fourth working day after having been posted[7].

Following the decision in *Yazbek* the Commissioner issued a decision impact statement[8] setting out that he would not change his compliance approach in relation to individuals and would only amend outside of the 2 year period for a person that is merely a beneficiary of a trust unless the individual's case is 'complex'. The ATO give three examples:

> in audits of high wealth individuals and family groups (whether or not the individual received a distribution from the trust in that income year), particularly where there is a close familial relationship between the beneficiary and the trust, the beneficiary is actively involved in the administration of the trust and / or the beneficiary is able to influence the distribution of income or capital from the trust; or
>
> where there is an adjustment to the taxable income of the individual emanating from compliance action in respect of the trust; or

[6] Section 29, *Acts Interpretation Act 1901* (Cth).
[7] Section 160, *Evidence Act 1995* (Cth).
[8] http://law.ato.gov.au/atolaw/view.htm?DocID=LIT/ICD/NSD1471of2012/00001

> in other circumstances involving complexity, including complex audits relating to claims for work-related expenses which cannot be concluded within two years.

The ATO do not seek to limit themselves to two years in the case of companies.

It is important, depending upon the issue, to also consider the implications of the regulations made for the purposes of Section 170 – Regulation 20 of the *Income Tax Regulations 1936* (Cth). Some of the more relevant of the 8 items set out in regulation 20 are:

- Where there is a non-arm's length dealing between associates the Commissioner has 4 years to amend.
- **Where Division 7A applies and the company is subject to a 4 year period of review the Commissioner has 4 years to include an amount in the assessable income of a shareholder or associate under Division 7A.**
- Where 'taxpayer has not identified income (ordinary or statutory) from one or more foreign transactions for the purposes of, or in the course of, an assessment' and the income is not from a resident investment vehicle the Commissioner has 4 years to amend an assessment.
- If Section 45B (demergers and capital benefits), 177E (dividend stripping), section 177EA (franking credit streaming), section 270 of Schedule F (income injection test), section 165-180 – 165-205 (schemes around COT), Division 175 (schemes to use losses) or Subdivision 207-F (not qualified person for franking credits, dividend strips, etc.) apply then the Commissioner has 4 years to amend an assessment.

In most cases once the year that the issue relates to has been identified, and section 170 has been reviewed it becomes clear when the issue will be out of time. If the issue is already out of time then nothing more can be done – unless you want to do something, as it is possible for a taxpayer to request that the Commissioner treat an objection as if it has been lodged within time. If the issue is not out of time (because there is no amendment period or because it has not yet expired) then it is necessary to consider what action to take.

6 No time limits

There are a number of instances where there will be no time limit on a taxpayer or the Commissioner dealing with a Division 7A issue.

The most obvious of these is where the Division 7A issue has not been the subject of an assessment, so that an original assessment can be raised.

6.1 Trustee assessments

Where it is the trustee of a trust that should be taxed on a Division 7A deemed dividend to the exclusion of a beneficiary, or on behalf of a beneficiary (usually a minor or non-resident) there may be no time limit for an assessment to be raised, if there is no original assessment.

In December 2004 Government released the Treasury 'Report on Aspects of Income Tax Self Assessment'[9]. A recommendation of that report was that there be a limited period of time for the ATO to amend an assessment showing a nil liability (recommendation 3.4).

In the *Tax Laws Amendment (Improvements to Self Assessment) Act (No. 2) 2005* the definition of assessment was amended to include (relevantly to discretionary trust trustees):

> (d) for any other taxpayer that is the trustee of a trust estate but excluding a taxpayer that is the trustee of a fund or unit trust referred to in paragraph (a), (b) or (c) of the definition of **eligible entity** in subsection 267(1) - the ascertainment of so much of the net income of the trust estate as is net income in respect of which the trustee is liable to pay tax (or that there is no net income in respect of which the trustee is so liable) and of the tax payable on that net income (or that no tax is payable)

In 2005 the reference to eligible entity was a reference to eligible ADFs, superannuation funds and PSTs.

Currently the definition of assessment includes:

> (d) for a taxpayer that is the trustee of a trust estate (other than a trustee to which paragraph (b) or (c) applies or the trustee of a complying superannuation fund, a non-complying superannuation fund, a complying approved deposit fund, a non-complying approved deposit fund or a pooled superannuation trust)--the ascertainment:
>
> (i) of so much of the net income of the trust estate as is net income in respect of which the trustee is liable to pay tax (or that there is no net income in respect of which the trustee is so liable); and
>
> (ii) of the tax payable on that net income (or that no tax is payable); and
>
> (iii) of the total of a taxpayer's tax offset refunds for a year of income (or that the taxpayer can get no such refunds for the year of income);

[9] http://selfassessment.treasury.gov.au/content/report.asp - retrieved 19 May 2015

The definition of an assessment would appear to include what occurs when the Commissioner determines that there is no tax payable by the trustee on the net income of a trust estate following lodgement of the return.

Despite there being an 'assessment' when the Commissioner determines there is no tax payable by a trustee, the provisions dealing with amendment of assessments rely on counting from the time that the Commissioner 'gives notice of the assessment…'. It is not the Commissioner's practice to issue assessments to trustees when returns are lodged, so that the time limits in subsection 170(1) of ITAA1936 cannot begin to run[10].

The ATO issued Practice Statement Law Administration *PS LA 2015/2* in February 2015 which guides ATO staff to limit the time within which they will issue an assessment to the trustee of a trust, to ensure that trustees are subject to, broadly, a similar period of review as other taxpayers. The ATO refer to such an assessment as an 'original' assessment, presumably because they have not chosen previously to issue an assessment, though technically it would seem that the original assessment occurs when the Commissioner determines the liability of the trustee, not when he gives an assessment to the trustee.

The net income of a trust is ordinarily assessed to the beneficiaries. A trustee may, however, be issued with an assessment and taxed in certain instances, for example in respect of a non-resident beneficiary or where no beneficiary is presently entitled to the trust's income.

The ATO considers that them having an unlimited time to review the assessment made when the return is lodged is inconsistent with the outcome contemplated by the *Report Aspects of Income Tax Self Assessment,* that all taxpayers returning a nil liability should have a limited period of review.

Accordingly, the ATO states that its practice will be to limit the review period for trustees to the following time periods:

- four years after the relevant trust tax return was lodged; or
- two years after lodgment of a return for the 2014 or a later income year, if the trust is a small business entity for that year and none of the qualifications in item 3 of the table in subsection 170(1) apply.

The ATO states that the exceptions, where the above time limits will not apply, are where:

- the trustee has not lodged a trust return for the relevant income year;
- the Commissioner is of the opinion that there has been fraud or evasion;
- an extended or unlimited amendment period would apply; or
- the time limit has been extended by agreement with the trustee.

The ATO states that the time limit may be extended by way of agreement with the trustee, if the ATO has started examining the affairs of a trust and it is not reasonably practicable for it to ascertain that the trustee is liable to tax within the above time limits because of actions taken or statements made, or unreasonable omissions, by the trustee or a related entity. In this case, the ATO advises that the matter should be escalated to an SES officer who, in consultation with the trustee, should determine the period within which an assessment is to be raised.

[10] PSLA 2015/2 paragraph 1

The following examples, of the application of the above time limits and exceptions, are included in the Practice Statement.

> Example 1 - time limit for raising an original trustee assessment
>
> The 2010 income tax return for the Oak Family Trust was lodged on 9 May 2011. The trust was not a small business entity for the 2010 income year. An audit of the trust reveals that some of the trust net income should be assessed to the trustee under section 99A. The time limit for review has not been extended by agreement with the trustee. An assessment should be issued to the trustee by 9 May 2015.
>
> Example 2 - multiple trustee assessments
>
> A trust return for the Cedar Family Trust was lodged on 9 May 2011. The trust was not a small business entity for that income year. An assessment is issued to the trustee under section 98 on 30 June 2011. As a result of audit activities, the Commissioner considers the trustee should instead be assessed under section 99A. The time limit for review has not been extended by agreement with the trustee. The section 99A assessment must be made by 9 May 2015 and is an original, not an amended, assessment.
>
> Similarly, if the result of the audit was that the trustee was assessable under section 98 in respect of a different beneficiary, then that assessment should also be issued by 9 May 2015.
>
> Example 3 - time limits do not apply - unlimited amendment period
>
> A beneficiary has been assessed under section 97 on all of the net income of a trust for the 2008 year. As a result of some compliance action taken by the ATO, it was established that the beneficiary's entitlement to trust income arose out of a reimbursement agreement. Consequently the net income is assessable to the trustee under section 100A. Under subsection 170(10) the ATO has an unlimited time to assess a present entitlement arising from reimbursement agreement. Accordingly, there is no time limit for issuing an amended assessment in this instance, however the ATO states that its officers should endeavour to do so as soon as practicable.
>
> Example 4 - extension of time limits
>
> A trust's taxation affairs are being reviewed. However, due to the complexity of the arrangements, the ATO does not expect to complete the review before the end of the abovementioned time limits. The ATO obtains the trustee's agreement to extend the relevant time limit by a further six months. The ATO has until 14 November 2014 to issue a trustee assessment/s (if required), unless it negotiates further time.
>
> Example 5 - extended timeframes
>
> The 2009 return for the Pine Family Trust lodged on 9 May 2010 indicates that all of the net income is assessable to an individual beneficiary. That beneficiary's assessment is issued on 6 June 2010.
>
> On 1 June 2014, the beneficiary requests an amendment on the basis that the trustee's resolution appointing income was invalid. The default beneficiary (a minor) was instead presently entitled to all the income and the trustee should have been assessed under section 98 on all of the net income. The ATO officer should escalate the case to an SES officer who, having regard to all of the facts, will determine in consultation with the trustee a period within which an assessment is to issue.

It is disappointing that the Commissioner has decided to deal with the issue of limiting the time period for amending the assessment of a trustee in this way – by issuing administrative, and therefore non-binding guidance to his officers. The law could operate in the way it is intended to in relation to the

assessment the Commissioner makes when determining the liability of a trustee (as defined by the term 'assessment' in subsection 6(1) of ITAA1936) if he changed his internal processes so that a nil assessment was issued when a trust return was lodged. A taxpayer could then rely on the law, rather than the decisions of the Commissioner's officers, to determine whether an assessment issued to a trustee should be amended.

6.2 Statutory provisions

There are provisions of both the ITAA 1936 and the ITAA 1997 that, if they operate, give the Commissioner an unlimited period of time to amend an assessment. Those provisions are in section 170(10) and 170(10AA) of ITAA 1936. The provision of concern where Division 7A may apply is section 100A of ITAA 1936 – the 'reimbursement agreement' provision. In an arrangement involving a corporate beneficiary that has not been paid, section 100A could cause concern.

Section 100A can apply where there is a corporate beneficiary that is made presently entitled to distributable income of a trust in circumstances where both:

- someone else actually benefits from that income, and
- a purpose of a party to the agreement is obtaining a tax benefit.

Arrangements involving 'ordinary family or commercial dealings' are excluded from the definition of a reimbursement agreement. The ATO have said in a fact sheet released in 2014[11] that they will treat an arrangement where a UPE is put on Division 7A footing (either a sub-trust or a complying loan agreement) that they will ordinarily treat such an arrangement as an ordinary commercial dealing. For arrangements that do not comply with Division 7A however (the very mistakes that are the subject of this paper) it is unclear what the ATO will do in relation to section 100A.

Where section 100A applies the beneficiary that would otherwise be taken to be presently entitled to income is taken not to be so entitled, with the consequence that no-one is taken to be presently entitled to that share of trust income, so that instead the net income referrable to the income is assessable to the trustee at section 99A rates.

6.3 Fraud or evasion

In the case of income tax, GST and FBT the Commissioner is given an unlimited period of review where he is of the opinion that fraud or evasion has occurred.

The Commissioner's views on what constitutes fraud or evasion are contained in PS LA 2008/6.

6.3.1 Fraud

Of the two types of conduct that might give rise to an unlimited period of review fraud is the easiest to understand, and, potentially, to recognise. Though the term fraud is not defined for tax purposes it

[11] https://www.ato.gov.au/General/Trusts/In-detail/Technical-issues/Trust-taxation---reimbursement-agreement/

meaning for the purposes of former section 170(2)(a) of ITAA 1936 (where an assessment could be amended at any time if the Commissioner was of the opinion that there was fraud or evasion) was confirmed as being something in the nature of fraud at common law in *Kajewski & Ors v FC of T* [2003] FCA 258:

> Fraud within s 170(2)(a) involves something in the nature of fraud at common law, ie, the making of a statement to the Commissioner relevant to the taxpayer's liability to tax which the maker believes to be false or is recklessly careless whether it be true or false.

Common law fraud occurs where a false representation has been made knowingly, without believing it to be true, or recklessly, without care as to whether it is true or false.[12]

It appears clear that for fraud to have occurred the fraud needs to occur at the time that the representation is made, that is when the relevant return or statement was made.

6.3.2 Evasion

Evasion is more difficult to define than fraud, and in *Denver Chemical Manufacturing Co. v Commissioner of Taxation* 79 CLR 296 Dixon CJ said 'I think it unwise to attempt to define the word 'evasion''.

In *Regina v Meares Matter No Cca 60468/97* [1997] NSWSC 458 Gleeson CJ stated (emphasis added):

> Although on occasion, it suits people, for argumentative purposes, to blur the difference, or pretend that there is no difference, between tax avoidance and tax evasion, the difference between the two is simple and clear. Tax avoidance involves using, or attempting to use, lawful means to reduce tax obligations. Tax evasion involves using unlawful means to escape payment of tax. Tax avoidance is lawful and tax evasion is unlawful. Although some people may feel entitled to disregard that difference, no lawyer can treat it as unimportant or irrelevant. It is sometimes said that the difference may be difficult to recognise in practice. I would suggest that in most cases there is a simple practical test that can be applied. If the parties to a scheme believe that its possibility of success is entirely dependent upon the revenue authorities never finding out the true facts, it is likely to be a scheme of tax evasion, not tax avoidance.

In *Barripp v Commissioner of Taxation* (1941) 6 ATD 69 Mr Barripp did not return income from the sale of his property in 1927 because he said he had received advice from his accountant that the amount was not assessable until the mortgage on the properties on which the profit was made were paid off. An amended assessment including the profit was issued in 1938. It was the case that he had received funds in prior years from similar transactions and paid tax on them. Mr Barripp did not contend that he had not informed his accountants of the profit, he said he had but that the advice was that the profit did not need to be included. The Board of Appeal and the NSW Supreme Court did not believe that Mr Barripp had received the advice he said he had. In the High Court, McTiernan J stated:

> The facts proved come down to these. The taxpayer received the omitted income in that year. He knew that he received it in that year. He omitted it from his income. He knew or the knowledge ought to be imputed to him that it was omitted. He gave as an explanation that he believed that it was not taxable in that year. But the question whether

[12] *Derry v Peek* (1889) 14 App. Cas 337 at 373.

> the excuse offered could change the complexion of the facts proved is only an abstract one because the reality of the excuse was not established. The case therefore stands in this situation. The appellant intentionally omitted the income from the return and there is no credible explanation before the court why he did so. His conduct in my opinion answers to the description of an avoidance of taxation at any rate by evasion.

It is clear that, in finding that evasion occurred, it was the lack of excuse for why the amount was excluded from income when the relevant return was lodged that grounded the finding of evasion.

In *Denver Chemical Manufacturing Co. v. Commissioner of Taxation* 79 CLR 296 the Commissioner of Taxation had adopted a basis for assessing income tax to the company otherwise than on its profits. Tax was levied on a percentage of the sales of product in Australia by the company (which was incorporated in New York). This arrangement had been entered into in 1917. The manager of the Australian branch, as the result of a suggestion by a friend named Mr Wrigley, from 1923 only included sales made to persons in NSW in the company's returns. Nothing was communicated to the Tax Department concerning the change in reporting. In 1928 the Commissioner asked for profit and loss statements and balance sheets for the company. Despite obtaining these from the New York head office in 1929 the brank manager decided to withhold it from the Commissioner. In around 1941 the ATO began an audit and discovered the change in reporting. In 1941 the assessments for 1923 – 1934 were amended on the basis that there had been an evasion of tax.

In *Denver Chemicals,* Dixon CJ, after stating it was unwise to attempt to define evasion stated that (emphasis added):

> The context of s. 210 (2) shows that it means more than avoid and also more than a mere withholding of information or the mere furnishing of misleading information. It is probably safe to say that some **blameworthy act or omission on the part of the taxpayer or those for whom he is responsible is contemplated**. An intention to withhold information lest the commissioner should consider the taxpayer liable to a greater extent than the taxpayer is prepared to concede, is conduct which if the result is to avoid tax would justify finding evasion.

Having stated the above Dixon CJ noted that the Board of Appeal had concluded that Denver Chemicals intentionally omitted the income and that there was no credible explanation as to why, which fit the description of avoidance by evasion. His honour also noted that the majority of the Board expressed their conclusion by adopting the expressions used by McTiernan J in *Barrip* and he stated that this was a conclusion exhibiting no error of law.

His honour did not spell out what blameworthy acts amounted to evasion for him, though presumably this was the intentional omission of income without explanation.

The Commissioner, however, in summarising the *Denver Chemicals* case said that there was evasion as[13]:

> 64. Matters of a blameworthy nature before Dixon J included:
>
> · the Commissioner had provided advice to Denver on how to calculate its liability for tax and Denver's Mr Woodward chose to ignore this advice after receiving different advice from his neighbour

[13] PSLA 2008/6.

· no clarification of the new method of returning sales income in 1923 or later years was sought by Denver from the Commissioner, and

· Denver withheld profit and loss and balance sheet information from the Commissioner for the 1927 and 1928 financial years, which would have revealed sales income from outside NSW.

While the above points are consistent with the facts, they were not in fact set out as blameworthy acts by the High Court. Whether the 'no clarification of the new method' is in fact a blameworthy act of the kind referred to by the Chief Justice is in fact of paramount importance in considering what should be done in a case where a prior year issue is discovered or inherited.

In a case where someone becomes aware, after having lodged a return considering it to be correct, that it was in fact incorrect, the Commissioner's interpretation seems to suggest that choosing not to ask the Commissioner his view on what should be done would be grounds for a finding of evasion.

If the *Denver Chemicals* decision is read in context however, it is clear that it was the intentional omission of the income, without credible explanation, **at the time that the returns were lodged**, that was what led the Board, the Supreme Court, and ultimately the High Court to consider that a finding of evasion was not in error at law.

In *Australasian Jam Co Pty Ltd v Federal Commissioner of Taxation* [1953] HCA 52, another case on evasion referred to by the Commissioner in his practice statement, a company lodged returns on the basis that its closing stock could be valued at a standard cost established before or in 1914, even though this bore no relationship to real cost. On appeal in the High Court, Fullagar J did not consider what constitutes evasion, he merely examined whether the Commissioner had entertained the view that there was evasion, and whether that view was based on a misconception of law. It was found to be a view the Commissioner held, and one not based on a misconception. The Second Commissioner gave evidence on his views as to whether evasion occurred, which are recorded in the judgement as being summed up as:

> There has been, says the Commissioner, no deliberate attempt to deceive, and therefore the case is not one of fraud. On the other hand, it would be unreasonable to suppose, and it has not really been suggested, that those responsible for the company's income tax returns were ignorant of the requirements of s. 31. They continued to use in their accounts a figure which had once represented cost but which no longer represented cost. They returned, for income tax purposes, the accounts of the company as quite correctly and properly kept by it for its own purposes, but not adjusted so as to comply with s. 31. They would have supplied further true information, if they had been asked for it, but they hoped, says the Commissioner, that they would not be asked for it, and they allowed, if they did not actually invite, my assessors to make an assumption which they must have known was unfounded. I think, says the Commissioner, that there has been here more than a mere withholding of information which might or might not be relevant: I think that there has been an intentional withholding of information lest I should hold the company liable to tax to a greater extent than it was prepared to concede, and I regard this as "evasion".

Despite the above being quoted in the ATO practice statement as to what was 'held' by his honour, the judgement goes on:

> It is not for me to say whether the view outlined above is right or wrong. I am satisfied that the Commissioner did entertain such a view, and that such a view is not based on any misconception of law. And I am not able to say that it was an unreasonable view - still less that it was arrived at "capriciously or fancifully or upon irrelevant or inadmissible

> grounds". The result is that, in my opinion, all the amended assessments were authorized by the Act, and all the appeals fail.

As in *Denver Chemicals,* this was a case where at the time that returns were lodged the taxpayer was considered to have knowledge that the returns it was submitting were incorrect, and this was the basis for finding that there was evasion.

6.3.3 Is a failure to correct evasion?

Following the case law, failing to correct for an issue that has been discovered, if it is discovered after lodgement of the return, should not result in a finding that evasion has occurred. This is on the proviso that there is no evasion at the time the return was lodged, that is, that there is a credible explanation as to why the impact of an issue was omitted.

It will likely be necessary to determine as well that there was no evasion on the part of the agent concerned, as it is reasonable to consider that a taxpayer is responsible for the evasive conduct of their agent in the same way they are responsible for their fraudulent conduct.[14]

Delaying in responding to the Commissioner should he make enquiries could be a 'blameworthy act' in the *Denver Chemicals* sense according to the Commissioner's interpretation of the decision, but it is not clear that this should be the case.

It is not clear however, given the Commissioner's summary of *Denver Chemicals* in his Practice Statement whether he might assert (successfully or not) that failing to request an amendment or seek his guidance might amount to blameworthy conduct on which he could ground an opinion of evasion.

[14] *Kajewski & Ors v FC of T* [2003] FCA 258

7 Distributable surplus

The other way of determining the exposure to Division 7A deemed dividends is to consider the quantum of the distributable surplus in the year in which the potential deemed dividend arose.

The formula for distributable surplus is set out in section 109Y as:

Net assets +	Division 7A amounts	- Non-commercial loans	- Paid-up share value	- Repayments of non-commercial loans

The term 'Net assets' is then defined to mean:

> *net assets* means the amount (if any), at the end of the company's year of income, by which the company's assets (according to the company's accounting records) exceed the sum of:
>
> (a) the present legal obligations of the company to persons other than the company; and
>
> (b) the following provisions (according to the company's accounting records):
>
> (i) provisions for depreciation;
>
> (ii) provisions for annual leave and long service leave;
>
> (iii) provisions for amortisation of intellectual property and trademarks;
>
> (iv) other provisions prescribed under regulations made for the purposes of this subparagraph.
>
> If the Commissioner considers that the company's accounting records significantly undervalue or overvalue its assets or undervalue or overvalue its provisions, the Commissioner may substitute a value that the Commissioner considers is appropriate.

and

> *non-commercial loans* means the total of:
>
> (a) any amounts that:
>
> (i) the company is taken under former section 108 or section 109D or 109E, to have paid as dividends in earlier years of income; and
>
> (ii) are shown as assets in the company's accounting records at the end of year of income; and
>
> (b) any amounts that are included in the assessable income of shareholders, or associates of shareholders, of the company under section 109XB as if the amounts were dividends paid by the company in earlier years of income.

The legislation above has been reproduced for a number of reasons.

First, it is to be remembered that Division 7A is part of the self-assessment system. A taxpayer is required to identify the amount of a Division 7A deemed dividend (after determining the amount of the distributable surplus) and then to include such amount in their assessable income.

The starting point in this is the company's accounting records, and there is no requirement on a taxpayer to ensure assets are reported at market value.

The second point to referencing the above formula is to highlight where Division 7A amounts are added. These are current year payments and amounts forgiven. Since 1 July 2009 these have been added back in working out how much the amount of a distributable surplus is. Before this change it was possible to loan all of the distributable surplus to a person, forgive the debt, and have no deemed dividend (though there might have been other tax issues).

A third point is the adjustments that can be made to distributable surplus for provisions. In many small companies provisions for annual leave and long service leave, especially for the controllers of a company, are not include on the accounts. Unlike assets, which are not counted unless on the accounting books and records, the provisions for leave can be taken into account whether they are recorded or not.

Lastly and more importantly is the reference to non-commercial loans. These are amounts from prior years that have been deemed to be dividends, but are still shown as company assets. In company's with a long history of poor compliance with Division 7A they can be significant sums. They do need to be amounts where there was sufficient distributable surplus in the years in which the loans were made for the amounts to have been taken to have been 'paid' as dividends in the year in which the loans occurred (or the minimum annual repayment was not made under section 109E).

In tackling a Division 7A issue from a distributable surplus point of view it is necessary to map back the potential Division 7A deemed dividends and the distributable surplus as far back as possible to identify whether there are non-commercial loans that can reduce distributable surplus.

The position of unbooked assets and the Commissioner's ability to revalue assets and liabilities is considered below.

If there is no distributable surplus in a year in which a Division 7A issue arises then there is no amount of deemed dividend so that Division 7A becomes a non-issue.

Two remaining small points can be made in relation to distributable surplus. The Commissioner now accepts that the tax liability for an income year of a company reduces it distributable surplus even if the amount remains unpaid[15]. In addition GIC as it accrues is a present legal obligation for Division 7A purposes.[16]

7.1 Goodwill and distributable surplus

An amount often not shown in a company's accounting records is internally generated goodwill.

The Commissioner is given a discretion to insert a different value for the assets where 'the Commissioner considers that the company's accounting records significantly undervalue or overvalue its assets or undervalue or overvalue its provisions.

[15] TD2012/10.

[16] *Commissioner of Taxation v. H* [2010]FCAFC 128.

It should be noted that the Commissioner is not given an explicit opportunity to value assets that do not appear in the company's accounting records.

Nonetheless the ATO in TD 2009/5 express the view that they do have the power to include a value for unrecorded goodwill. The ATO set out that they consider that their power to adjust values does not generally allow them to include a value for assets that are not shown on the accounts where accounting standards do not require them to be shown (note that there is no reference in 109Y(2) to accounting standards needing to be applied) but that they will use the power they consider they have 'where it is plain that the company, its shareholders and directors have acted, in making loans or other payments, in a way that treats the real and higher value of assets as their true value, that is, regardless of their value shown in the accounting records, and that the mischief against which Division 7A is directed is present, the Commissioner may, and generally will, substitute their true value.'

The ATO guidance on when the shareholders and directors have acted as if there was a higher value of the assets than that shown in the accounts exists only in two examples, and what might be able to be gleaned from those examples. Unfortunately, both examples are extreme, and therefore what can be drawn from them is slim.

In both examples the ATO have assets (goodwill and then a building) that are recorded at less than their worth, but that worth is either 'assessed by the shareholders and disclosed to third parties' or 'disclosed to third parties'. The shareholders then borrow interest free from their companies and have no distributable surplus. The ATO conclude in both cases that without the ATO revaluing the assets the shareholder would receive a 'tax free informal distribution' by way of the interest free loan.

It could be suggested and argued that rather than accessing company profits, for the shareholders to obtain interest free loans the company must be receiving funding from an external source, so that it is not profits that are being accessed, but instead third party finance which is channeled through a company. There is no mischief in the ATO examples worth taxing in the writer's view.

In both examples interest deductions should be denied on the external debt funding, which is the only tax result that should flow from the arrangement.

Both examples are ones where there is no distributable surplus. In practice guidance is often sought from an adviser when the ATO will revalue goodwill or other assets when there is simply insufficient distributable surplus to result in the whole of a loan or MAR not made resulting in a deemed dividend. There is insufficient guidance on when such may occur.

8 In time and distributable surplus?

If you have analysed the Division 7A potential deemed dividend issue and determined that there is an amount that is still within time to be taxable, then there are effectively only two choices: to do something or to do nothing.

To choose to do something would be to make a disclosure to the Commissioner, with a voluntary disclosure resulting in less penalties (or potentially no penalties) being applied (the reduction is 80% under section 284-225[17] if you 'voluntarily tell' the Commissioner before an examination begins), and the potential for interest remission. This would then potentially, depending upon the facts, lead into an application for the Commissioner to exercise his section 109RB discretion.

To choose to do nothing would only be an appropriate decision where there has been a return lodged and an assessment raised which at some point will become out of time for amendment. To choose to do nothing would mean to keep in reserve the potential to make a voluntary disclosure in case of audit. To choose to do nothing would only be appropriate where there had been a return lodged, that was thought to be correct when lodged. To choose to do nothing could be considered to be morally wrong, but there is nothing in tax law putting an onus on a taxpayer to correct a document that was lodged with incorrect information on it, when the view was held that the information on the document was correct at the time the document was lodged.

It should be acknowledged that to choose not to correct an error if it is found after the lodgement of a return may be considered by the Commissioner to be a basis for him to form the opinion that there has been fraud or evasion.

[17] *Taxation Administration Act 1953*.

9 109RB

If the decision is made to approach the Commissioner then it would be hoped that the discretion available to him in section 109RB, to disregard a deemed dividend or to allow it to be franked, could be exercised in the taxpayer's favour.

To enliven the discretion there needs to have been an honest mistake or an inadvertent omission.

The Commissioner's view on what constitutes an honest mistake or an inadvertent omission and how the process works from the ATO side to determine whether he should exercise his discretion is set out in TR 2010/8 and PSLA 2011/29. The ruling sets out what is meant by honest mistake and inadvertent omission, while the practice statement provides guidance for tax officers in the two step process required by section 109RB, being to first consider whether there has been an honest mistake or inadvertent omission and then to consider the factors set out in section 109RB(3), being:

> (a) the circumstances that led to the mistake or omission mentioned in paragraph (1)(b);
>
> (b) the extent to which any of the entities mentioned in paragraph (1)(b) have taken action to try to correct the mistake or omission and if so, how quickly that action was taken;
>
> (c) whether this Division has operated previously in relation to any of the entities mentioned in paragraph (1)(b), and if so, the circumstances in which this occurred;
>
> (d) any other matters that the Commissioner considers relevant.

While some guidance may be gleaned from the ruling and the practice statement, and the practice statement does usefully contains a list of circumstances may result in the discretion being potentially applied (in paragraph 34), and factors in favour of or against the exercise of the discretion (in paragraphs 37 and 38) the best indication of when the Commissioner might exercise his discretion can be gleaned from the material published on the private binding rulings register. Outside of broad statistics offered from time to time by the ATO[18] about the decisions of the Division 7A panel there is little other material that can be used to provide practical guidance on what is decided in actual cases.

It is acknowledged that the ATO PBRs are not binding precedential material, and contain only summarised versions of the facts and decision-making criteria.

At present there are 7 ATO PBRs on exercise of the discretion[19], some of those are discussed below:

Ruling ID	Précis	Decision
79738 and 79739 (10 March	• There was an audit. • There was a debit loan. • There were non-complying loan agreements.	Discretion exercised

[18] Michael Cranston, TTI NSW 5th Annual Tax Forum, "Managing Risk in the SME Market", 18 May 2012, page 15 – 60% of cases had discretion exercised.
[19] At 29 May 2015.

2008)	• Corrective action was agreed to be undertaken involving complying loan agreements and payments of principal and interest. • No deduction would be claimed for the catch up interest. • There had not previously been non-compliance with Division 7A. • The existence of loan agreements supported there being an honest mistake/inadvertent omission.	
90078 and 90082 (17 June 2009 and 27 July 2009)	• Loans from company to partnership. • Taxpayer and spouse shareholders in company and partners in partnership. • Same accountant used for 20 years. • Accountant ill in 2001. • No intention or authority for payments to be treated as loans, but accounted for as such. • Due to health condition, accountant was unaware of Division 7A requirements. • In 2007 new accountant became aware of problem. • Corrective action was putting in place loan agreement and fully franked dividends declared to pay principal and interest. • No previous non-compliance with Division 7A. • Funds used privately. • While accountant ill in 2001, continued to act until 2006.	Discretion not exercised[20]
94010 (18 January 2010)	• Family trust directly and indirectly owned group companies. • Company X in group acted as finance company, depositing income earned by group entities, and lending money to them. • Most loans company to company, but for 2. • New chairman appointed, requested tax review by independent firm. • All funds used for income producing purposes and none used for personal purposes. • No loans to family members or associates for non-income producing purposes. • Division 7A issue caused change of accountant. • Corrective action is one set out in PLSA 2007/20.	Discretion exercised
1012432251659 and 1012432584000 (17 and 23 April	• Money loaned by company to family trust which is a shareholder. • Invested in separate bank accounts in family trust. • Money 'could be' called upon to meet company expenses. • No on-loaning to beneficiaries. • Trust held commercial property used in company business.	Discretion exercised

[20] This appears to be example 4 from the PSLA where the discretion was exercised. The difference is in the PSLA the new accountant was instructed immediately.

2013)	• No loan agreement and no interest but also no rent paid. • Only recently did agent become aware of Division 7A issue – thought only applied to loans to shareholders.[21] • Majority of loan repaid, not clear if interest paid. • Matter arose from voluntary disclosure and used for 'commercial purposes'.

It should be noted that none of the above cases resulted in the ATO allowing a deemed dividend to be franked.

[21] Presumably this means company to individuals, as trust is a shareholder.

10 Past 'aggressive' structures

When considering what might be considered by the ATO to be 'aggressive' structures used to prevent the straight operation of Division 7A a few come immediately to mind:

- Limited liability partnerships as trading entities or as corporate beneficiaries;
- Companies limited by guarantee as trading entities or as corporate beneficiaries;
- Public trading trusts as corporate beneficiaries; and
- Hybrid trusts using corporate beneficiaries or hybrid trusts as investment vehicles for corporates.

Limited liability partnerships were a viable alternative to a private company up until 1 July 2009, in that they were taxed at 30%, but not subject to Division 7A. From 1 July 2009 a limited liability partnership (corporate limited partnership) is treated as a private company for Division 7A purposes unless for the whole of the income year:

- The partnership has 50 or more members; and
- No entity has, directly or indirectly, and for the entities' own benefit an entitlement to 75% or greater share of the income or capital of the partnership.

While not caught by Division 7A prior to 1 July 2009, it would be possible for the Commissioner to use Part IVA to deny a tax benefit where the limited liability partnership was set up to provide a tax benefit to a taxpayer, which could include using it to avoid the operation of Division 7A. The time limits in relation to Part IVA being used as a basis for supporting an amended assessment have been considered earlier in this paper. For a limited liability partnership that is no longer intended to be 'used' the options include leaving the entity in place, winding it up, or de-limiting the partnership and then distributing the partner capital accounts as partner capital. Leaving the entity in place if the potential Part IVA risk is out of time is likely the most attractive option. Winding up the partnership may result in frankable distributions being paid (assuming that profits were not 'credited' when they were earned). De-limiting then distributing, where the alternative is that there would have been frankable distributions would need to be considered carefully in light of the potential for Part IVA to be applied.

Companies limited by guarantee are prevented from distributing to their members[22]. A way to bring to an end an arrangement involving a company limited by guarantee is to wind it up, and pass the benefit of the profits of the company to the members. It is however necessary to first convert it to a company limited by shares[23]. The conversion could result in a C2 gain for a member that is issued with shares if the market value of the shares is greater than the cost base of their member's interest. If the company's profits are paid out and the company comes to an end before the end of the year in which the conversion happens however (or if a liquidator once appointed determines there will be no return triggering CGT event G3) then there should be a capital loss equal to the gain.

Public trading trusts can pay profits to their unit holders so that such a structure could be wound up by paying profits to unit holders as frankable distributions.

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[22] Section 254SA, *Corporations Act 2001* (Cth)
[23] Section 162, *Corporations Act 2001* (Cth)

An arrangement that has been seen to ‘side step’ the operation of Division 7A is the use of hybrid trusts where either:

- A trust distributes to a corporate beneficiary, the corporate beneficiary subscribes for units, and then the UPE and the subscription obligation are offset so that there is no UPE amount that could become a Division 7A loan; or
- A private company subscribes for units in a unit trust that are said to be worth the amount paid for them so that there is no amount of ‘payment’ for Division 7A purposes.

In each case the trust is a hybrid trust so that the corporate beneficiary or corporate unit holder does not become entitled to capital gains.

Both arrangements do not appear to be designed to allow money to flow indirectly to benefit a natural person, but instead to allow corporate rates to be paid on income, while capital gains can be subject to the general discount, or to allow money to remain in a trust past the time that the ATO considers that the amounts should be treated as on sub-trust or as Division 7A loans.

There is some risk that section 100A of ITAA1936 may apply to the corporate beneficiary arrangement.

Beyond severing the connection between the private company and the trust by redeeming the units (with the potential for a capital gain or loss) and then putting the arrangement between the trust and the private company on Division 7A terms, there appears to be no simple way to deal with such arrangements.

11 Commissioner's determinations

There are instances in tax law where the Commissioner must make a determination before there is an amount that is assessable to a taxpayer, or before there is another tax consequence for a taxpayer.

For example, in Division 7A, if a loan is made through an interposed entity, the amount of the deemed dividend is the '… amount (if any) determined by the Commissioner …' (section 109W of ITAA 1936 as it operates with section 109T). Without the Commissioner having made a determination there is no amount that is a deemed dividend.

In section 45B of ITAA 1936, in its dealing with demerger benefits, the Commissioner may determine that section 45BA applies to the whole or part of a demerger benefit.

Under Part IVA of ITAA 1936 the Commissioner may make a determination to, inter alia, include an amount in assessable income, deny a deduction, disallow a capital loss or foreign tax offset.

From the way these and other provisions requiring the Commissioner to make a determination are couched, it is clear that they cannot apply without a determination by the Commissioner. In a self-assessment system, where no statutory obligation is imposed upon a taxpayer to ask the Commissioner what determination he may make, it is not clear why a taxpayer would ask the Commissioner to make a determination, save for the desire for certainty.

It is noted that there are other circumstances where advisers commonly make the determination that the legislation requires be made by the Commissioner without a second thought. For instance, in determining the tax residency of an individual subject to either the 'domicile test' or '183 day test' a person is only a non-resident if '… the Commissioner is satisfied that …' the person has a permanent or usual place of abode outside of Australia. Anecdotally advisers commonly 'self-assess' whether the Commissioner would be satisfied. While whether the Commissioner might be satisfied in a particular taxpayer's circumstances might be inferred from the Commissioner's rulings, without asking the Commissioner whether he is satisfied about the relevant place of abode, arguably, no determination on residency can be made.

Where the Division 7A issue that has been inherited is one that only has a tax consequence where the Commissioner makes a determination (for example an interposed entity issue, or a distributable surplus after a revaluation) it is possible to form the view that there is in fact no issue to deal with until the Commissioner examines the circumstances of a client's position, forms a view, and makes a determination that some tax consequence should flow from the position.

12 Penalties

If you do choose to approach the Commissioner under section 109RB for him to exercise his discretion, he may decline, and instead impose tax and penalties.

While the tax law imposes no positive obligations on a person to amend a return once it has been lodged to reflect the correct position (assuming that the position was thought to be correct at the time the return was lodged so that there is no fraud or evasion at that point) it does provide incentives for amending returns to reduce the potential exposure to penalties.[24]

Penalties can be imposed under tax law at levels based upon the culpability of the relevant person, being the taxpayer or their agent. Penalties apply at the level of:

- 25% for a failure to take reasonable care or where the tax shortfall is more than the greater of $10,000 and 1%[25] of the income tax payable by the taxpayer for the year;
- 50% where there is recklessness; and
- 75% where there is intentional disregard.

Where Part IVA is applied the penalty is 50% unless it is reasonably arguable that Part IVA does not apply in which case there is a 25% penalty.

Penalties can be increased by 20% in the instance where (subsection 284-220(1) of Schedule 1 to the TAA 1953):

- you prevent or obstruct the Commissioner from finding out about a shortfall amount, or about the false or misleading nature of a statement; or
- you become aware of the false or misleading nature of a statement after the statement is made (e.g. a return is lodged) and you do not tell the ATO about it within a reasonable time.

In addition the penalty is uplifted by 20% where the penalty is imposed across multiple years.

The potential for a penalty to be uplifted by 20% if you do not tell the Commissioner about an issue within a reasonable time is incentive for rectifying an issue by telling the Commissioner of it.[26]

12.1 Voluntary disclosures

If you 'voluntarily tell' the Commissioner in the 'approved form' about the shortfall amount or the false or misleading nature of a statement before being advised of an 'examination' of your tax affairs then the reduction is 80%[27] in the penalty that would otherwise apply.

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[24] An excellent paper on penalties is 'The Penalty Provisions and their Administration: Living Meaning or Dead Letter?' By Paul Sokolowski in March 2014.

[25] Note these thresholds are higher where a trust or partnership is concerned – see subsection 284-90(3) of Schedule 1 to the TAA 1953

[26] The Commissioner also has the power to remit penalties under subsection 298-20 of Schedule 1 to the TAA 1953

[27] The penalty will be nil where the shortfall is less than $1,000 – this does not apply to scheme shortfalls.

The ATO accept that as long as you provide sufficient information in a disclosure that your disclosure will be accepted as being in the approved form.[28]

The ATO consider[29] that as the term 'examination' is not defined it takes its ordinary meaning, and can encompass not only audits but any examination of an entity's affairs. Nonetheless, experience has shown that the ATO will commonly treat anything short of an audit as being a situation where you can be treated as making a disclosure prior to being notified of an examination. They state in PS LA 2012/5 that:

> 60. Because the phrase 'examination ... of your affairs' is so broad it may result in circumstances where it is harsh to not allow the higher reduction in penalty, for example where the Commissioner is merely identifying and/or assessing risks. In these cases, the Commissioner will generally exercise the discretion under subsection 284-225(5) (see paragraph 133 in Appendix 1 of this Ruling), the effect of which is to provide the entity with an 80% or full reduction in the penalty otherwise attracted.

Paragraph 133 then provides:

> 133. As a general rule, the Commissioner's discretion will be exercised in the following circumstances:
>
> (i) where the Commissioner is merely identifying and/or assessing risks, for example a risk review, notwithstanding that this is considered to be an examination;
>
> (ii) where the disclosure is not within the scope of the examination as notified to the entity (that is, it is outside the risk(s) or issue(s) covered by the examination);
>
> (iii) where the tax officer invites the entity to make a voluntary disclosure within a specified period or by a specified date, and the entity makes a full disclosure within that period or by that date;
>
> (iv) where, during the initial notification of the examination, the tax officer advises the entity that the examination will commence at a subsequent date (known as the formal date of commencement), and the entity makes a full disclosure on or before that date; or
>
> (v) where a company is undertaking its own review of its affairs (often called 'a prudential audit') at the time the Commissioner notifies the entity of the examination and it could reasonably be concluded that the entity was going to disclose the outcome of its review irrespective of the Commissioner's examination.

In relation to whether you 'voluntarily tell' the Commissioner states in MT 2012/1 that[30] [31]:

> 72. ... The word 'voluntary' is defined in the Australian Oxford Dictionary as 'done, acting, or able to act of one's own free will; not constrained or compulsory, intentional'. It is seen as an act done without persuasion or compulsion on the part of the Commissioner.
>
> 73. A disclosure will not be regarded as being made voluntarily where the entity merely 'came clean' when caught. In other words, where the facts or reasonable inferences indicate that the entity:

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[28] Paragraph 144 of PS LA 2012/5.
[29] Paragraph 47 of MT 2012/3.
[30] Judicial guidance on what was meant by 'voluntarily told' under the old penalty provision section 226E of ITAA 1936 (repealed) can be found in *British American Tobacco Australia Services Ltd v FC of T* [2009] FCA 1550.
[31] The Commissioner has a discretion in subsection 284-225(5) to treat a disclosure after being notified of an examination as having been made before notification.

· was aware of the shortfall amount, the scheme shortfall amount or the false or misleading nature of the statement; and

· would have been highly unlikely to have made the disclosure had it not become aware the Commissioner had uncovered, or was about to uncover, the shortfall amount, scheme shortfall amount or false or misleading nature of the statement (this includes where an entity intentionally disregards a taxation law).

74. However, mere suspicion that the entity would not have come forward will not be sufficient. In addition, the fact that the Commissioner has notified the entity that an examination will be conducted in relation to a particular issue, or that an issue has been identified as a high risk, will not, of itself, mean that a disclosure in relation to that issue is not made voluntarily.

If the disclosure is made after being notified of an examination of a taxpayers tax affairs, the penalty reduction is only 20%, and in addition to having to voluntarily tell the Commissioner of the shortfall or false or misleading nature of the statement in the approved form it is necessary for the disclosure to be reasonably estimated to save the Commissioner a significant amount of time or resources in the examination.

The disclosure needs to provide sufficient information for the Commissioner to adjust the tax related liability. The Commissioner accepts that in some instances it may not be possible to quantify every adjustment, and that a voluntary disclosure in these circumstances will be accepted if the taxpayer has done everything reasonably necessary to enable or assist the ATO in identifying the shortfall amount.[32]

Note that where you are concerned about an issue and make a voluntary disclosure, there is no need to admit liability (for instance where the issue results in an unclear tax position). The ATO note that[33]:

108. The entity need not admit liability in respect of the shortfall amount or scheme shortfall amount disclosed, or admit that the statement they made was incorrect. The entity is eligible for the reduced penalty rates whether or not the entity maintains an opinion contrary to that of the Commissioner or disputes:

· the adjustment made by the Commissioner to the entity's tax-related liability; or

· any action taken, or not taken, by the Commissioner as a result of finding that a statement was false or misleading in a material particular.

12.2 Safe harbour and importance of agent's conduct

If the Division 7A issue that has been inherited has resulted from the conduct or advice of the previous tax agent it may be of assistance to take advantage of the 'safe harbour' provisions applicable to statements made on or after 4 June 2010 (subsection 284-75(6) of Schedule 1 to the TAA 1953). That section provides:

You are not liable to an administrative penalty under subsection (1) or (4) if:

[32] Paragraph 105, MT 2012/3.
[33] MT 2012/3.

(a) you engage a *registered tax agent or BAS agent; and

(b) you give the registered tax agent or BAS agent all relevant taxation information; and

(c) the registered tax agent or BAS agent makes the statement; and

(d) the false or misleading nature of the statement did not result from:

(i) intentional disregard by the registered tax agent or BAS agent of a *taxation law (other than the *Excise Acts); or

(ii) recklessness by the agent as to the operation of a taxation law (other than the Excise Acts).

There are two hurdles to be overcome in relation to the above provision, one being that you need to have provided your tax agent (or BAS agent) with 'all relevant taxation information'. As well, where an issue has simply been missed (for instance an omitted sale of a rental property) there will usually have been incomplete information leading to the omission.

As well it must be the case that the false or misleading statement did not result from recklessness or intentional disregard by the agent. My personal experience is that the ATO can characterise behaviour leading to a shortfall as being reckless in the first instance where the quantum of the tax involved is large, or where the issue is complex so that the adviser 'should' have obtained further advice.

The safe harbour provisions may therefore offer an opportunity to deal with a Division 7A issue without the imposition of penalties if the requirements of the section can be met.

13 What to do

Division 7A issues that are discovered to be out of time are common, but other times will be encountered where the amendment period for an assessment has not yet expired.

The decision to be made in relation to a Division 7A issue that is within time and that results in a tax shortfall, or a Division 7A issue that results in no shortfall but that results from a false or misleading statement, is one to be made in consultation with the client, that will consist of balancing:

- A client's desire for certainty about their taxation position;
- A client's desire to often pay the least tax possible;
- The desire to mitigate any penalties that may apply if the Commissioner examines the issue; and
- The risk that the Commissioner may consider 'doing nothing' in relation to an issue to be evasion.

If the decision is made to make a disclosure to the ATO, depending upon the nature of the issue, it may be prudent to obtain legal advice. Any disclosure should also be made in such a way that privilege in legal advice is not waived unintentionally.

Some comfort may be found in applying for the Commissioner to exercise his discretion under section 109RB of ITAA 1936 if the requirements of the provision can be met (an inadvertent mistake or honest omission).

14 You gave the bad advice

In the case where the Division 7A issue has been caused by bad advice given by you or your firm as advisers, it likely goes without saying that you have a conflict of interest with your client.

Solicitors have a duty to avoid conflicts between their duty to act in the best interests of a client and their own interest – see for example Rule 12 of the NSW Solicitor's rules.

Tax agents have a requirement to have in place arrangements to deal with conflicts of interest, and TPB Information Sheet 19/2014 recognises that in some cases it will not be possible to ensure that objectivity is not impaired by a conflict of interest and it will be necessary to decline to act.

The accounting bodies APES 110 Code of Ethics for Professional Accountants has similar requirements to avoid and manage conflicts of interest.

In a situation where your client has obtained bad advice from you, let them know that there is a conflict, advise them to get independent advice, and do the best you can to see the issue resolved in their favour.