

Division 7A - Commissioner's Discretion, ADR and ATO Internal Facilitation

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The requirements of Division 7A of the Income Tax Assessment Act 1936 (**Division 7A** and **ITAA 36**¹ respectively) have been dealt with in other papers and by other presenters and a working knowledge of Division 7A is assumed. The focus of the paper is on dealing with situations where non-compliance with Division 7A has been discovered. Save as required by the issues considered in this paper, we do not, therefore, consider the operative provisions of Division 7A.

1. DIVISION 7A NON-COMPLIANCE

"This job has probably got the most screwing-up potential in the world." Larry Speakes (former White House Press Secretary under President Reagan)

Mr Speakes, might well, of course have been thinking of the tax adviser, practice as we do in an area of law fraught with complexity, controversy and unsettled issues. Division 7A is a primary example of the difficulties faced by tax advisers, and their client's, in the private business space.

Non-compliance with Division 7A may arise for one, or more, of a number of reasons including, a failure:

- of taxpayers to distinguish between their entities and themselves;
- to understand the complexities of Division 7A, including those arising due to changes in Australian Tax Office (**ATO**) policy² or a disjunct between the intent underpinning Division 7A and the legal scope of its provisions.

Non-compliance with Division 7A is generally discovered when:

- there has been a change of tax agent or accountant;
- new personnel join existing tax agent or accountant and are assigned to the client's matter. For example, to prepare the current year income tax return or as part of an end of year tax review;
- existing clients seek advice on other matters, for example, during a transaction or as part of a restructure of a family group of entities as part of a succession planning exercise;
- consequence of an ATO review, either as a result of self-detection or detection by the ATO;
- where multiple tax agents and accountants have been involved with different entities within a family group

Much has been written on the technical requirements of Division 7A, the facts and circumstances which, in practice, often give rise to such non-compliance allowing practitioners to be alert to the potential non-compliance risks. There is the subsequent question which all tax advisers ought to be considering: If we discover non-compliance with Division 7A, how do we deal with it! This second question, often, if not always, is when the panic sets in and, when the tax adviser needs to be pragmatic and formulate a plan to deal with the matter and its attendant risks.

2. DEALING WITH DIVISION 7A NON-COMPLIANCE

"Houston we have a problem!" James Lovell (with John Swigert, Jr. and Fred Haise Jr.: US's Apollo 13 moon flight team)

¹ Save where noted otherwise, all references in this paper are to the ITAA 36

² A recent example being the change in policy regarding unpaid present entitlements (UPEs)

Once a non-compliance with Division 7A has been discovered, practitioners should investigate to ensure that the non-compliance has not been repeated on other clients. The same considerations discussed below apply in the event that incidents of non-compliance are discovered on other client matters.

3. QUANTIFY THE EXPOSURE

Once non-compliance with Division 7A has been identified, a practitioner ought to quantify the exposure arising from that breach. This is important to assess the exposure to the client, and if applicable, any potential professional indemnity exposure to the practitioner themselves³:

- Consider the relevant amendment periods. In this regard it is important to keep in mind that amendment periods are extended to 4 years.⁴ Isolate non-compliance occurring outside amendment periods, for example, loan balances, payments and debt forgiveness due limitation periods (often referred to as statute barred loans) and focus on any on subsequent movements, payments or other breaches;
- In determining any potential exposure, the practitioner needs to be cognisant of the fact that the provisions of Division 7A have been dramatically amended over time and it is necessary to ensure that the applicable law at the applicable time is applied; and
- If, as is often the case, the non-compliance involves a trust, it is imperative that the trust deed and resolutions to determine the taxpayers who might be assessed and check their amendment periods.⁵

4. DIVISION 7A CORRECTIVE ACTION

"Mistakes are always forgivable, if one has the courage to admit them." Bruce Lee

Since the introduction of Division 7A the Commissioner has provided a limited number of administrative concessions whereby he affords taxpayers the opportunity to self-correct.

The ATO Practice Statement PS LA 2007/20 (**PS LA 2007/20**) set out an ATO administrative initiative to allow taxpayers to self-correct Division 7A errors or omissions and encouraged taxpayers and tax agents to review relevant income tax returns for the 2001-2002 to 2006-2007 income years. This initiative was very widely publicised by both the ATO and various professional bodies and it is, therefore, hoped that, in most cases, the appropriate corrective actions in respect of any Division 7A breaches in relation to those income years have been taken and we do not consider this any further in this paper.

Practice Statement PS LA 2010/4 (**PS LA 2010/4**) contains important administrative concessions that were available until 31 December 2011 where there had in the past been a misclassification of a UPE or a misapprehension of the existence of an ordinary loan. The practice statement provided for two self-corrective administrative options for taxpayers. Provided certain conditions were met, these options allowed taxpayers to:

- self-correct accounts where a UPE had been misclassified as a loan; or
- operate on the basis that the Commissioner would exercise his discretion under section 109RB ITAA36 (**S.109RB**) to disregard a deemed dividend.

As noted above, the PS LA 2010/4 administrative self-correction concession was only available prior to 31 December 2011. There are, therefore, at present, no opportunities or concessions available to taxpayers to self-correct non-compliance of Division 7A.

³ We consider this further below

⁴ ITAA 36, Regulation 20 item 2

⁵ We refer to *Yazbek v Commissioner of Taxation* [2013] FCA 39 where the court held that the Commissioner of Taxation (Commissioner) had a 4 year period to issue an amended assessment under s 170 ITAA 36 a 'beneficiary of a trust estate' during the 2005 income year

This, therefore, begs the question: So what is a taxpayer to do if Division 7A is breached?

5. COMMISSIONER'S DISCRETION

"Discretion is the better part of not getting exsanguinated." Jim Butcher, Blood Rites

Generally

There are several instances in the application of the *Income Tax Assessment Acts*⁶ (ITAA) where the tax status or liability of the taxpayer is dependent on the exercise of discretion by the Commissioner.⁷

The expression 'discretion' is almost never used in these instances. Instead, phrases such as "if the Commissioner is of the opinion",⁸ "to an extent that the Commissioner considers to be fair and reasonable",⁹ "[w]here the Commissioner is satisfied",¹⁰ etc. are employed. The courts have held that in these circumstances, it is the Commissioner who must form the opinion, be satisfied, or consider it reasonable, as it is he who has been entrusted by the legislature with the responsibility of evaluating the various matters concerned and forming an opinion or arriving at a decision.¹¹

Thus, for example, in *Kolotex Hosiery (Australia) Pty Ltd v Commissioner of Taxation* Barwick CJ said:¹²

"Quite clearly the Court cannot in any event substitute its view of any of the matters as to which the Act says the Commissioner is to be satisfied. It can of course decide that because of established facts or because of legal considerations the Commissioner could not have failed to have been satisfied. But if he is satisfied, it matters not in my opinion that he ought not to have been satisfied. The Court cannot overturn that satisfaction."

In conferring discretionary power on the Commissioner, the ITAAs generally lay down the relevant matters the Commissioner must take into consideration in exercising his discretion.¹³ From the taxpayer's standpoint, however, their usefulness is all too often negated by the inclusion of a phrase which empowers the Commissioner to take "any other relevant matter"¹⁴ into account in exercising his discretion.

What the relevant matters are would of course vary with the particular fact situation. Even more important however is the fact that a discretion may be exercised in favour of one person but against another on facts and circumstances essentially similar in both situations. Such an outcome would obviously be unfair and therefore unwarranted.

The *LexisNexis Encyclopaedic Australian Legal Dictionary* defines discretion as

"The power or authority of a decision-maker to choose between alternatives, or to choose no alternative."

⁶ ITAA 36 and the *Income Tax Assessment Act 1997* (ITAA 97)

⁷ For example former section 46A (1) and sections 99A (2), 103A (5) , 103A (5A) ITAA 36.

⁸ Section 99A (2) ITAA 36

⁹ Former sections 80DA (2) and (4)

¹⁰ S 80B (6) .

¹¹ Per Gavan Duffy CJ and Starke J in *Metropolitan Gas Co v Commissioner of Taxation* (1932) 47 CLR 621, 632; per Dixon J in *Avon Downs Ptp Ltd v Commissioner of Taxation* (1949) 78 CLR 353, 360; per Banwick CJ in *Giris Pty Ltd v Commissioner of Taxation* (1969) 119 CLR 365, 372 (*Giris*); per Isaacs J in *Moreau v Commissioner of Taxation* (1926) 39 CLR 65, 67; *Pure Spring Co Ltd v Minister of National Revenue* [1947] 1 DLR 501, 508 (*Pure Spring*).

¹² *Kolotex Hosiery (Australia) Pty Ltd v Commissioner of Taxation* (1975) 75 ATC 4028. Contra Gibbs and Stephen JJ, however, who expressed the view that the court could substitute its own opinion for that of the Commissioner. Such a view would appear to be against the trend of established authority *op cit* note 11

¹³ For example sections 99A (3), 103A (4E) and 109RB ITAA 36

¹⁴ For example section 109RB ITAA 36

The *LexisNexis Encyclopaedic Australian Legal Dictionary* goes on to note that:

“... discretion is usually confined by the statute which describes the ambit of decision-making power. Depending on the wording and nature of the legislation that confers a discretionary power, the repository of the discretion may or may not be under an obligation to consider whether to exercise it: *Western Australian Field and Game Association v Minister for Conservation* (1992) 8 WAR 64 ; 27 ALD 38 . A decision that is mandatory, once a decision-maker is satisfied that certain facts exist, is not a discretionary decision, notwithstanding that the decision-maker may be entitled to choose between alternative possible findings of fact: *Minister for Immigration and Multicultural Affairs v Eshetu* (1999) 197 CLR 611; 162 ALR 577; [1999] HCA 21”

The Explanatory Memoranda issued on the occasion of each amendment or addition to the ITAAs perhaps reflect the policy angle of each of the amendments or additions. But the Commissioner does not ordinarily give reasons for exercising his discretion in a particular way.

Barwick CJ in *Giris*¹⁵ and Lord Denning MR in the Court of Appeal in *Padfield v Minister of Agriculture, Fisheries and Food*¹⁶ have asserted that the person vested with discretionary power could be called upon to give reasons for his decision. The House of Lords, however, in *Padfield's* case held contrary to this.¹⁷ However, the House of Lords also pointed out in the same case that, if there was no reason given for the exercise of a discretion in a particular way, the court may infer that there existed no valid reason.

The provisions of Division 7A confer several relieving discretions on the Commissioner, which discretions allow him to either frank or disregard the deemed dividend or to permit corrective action, including in instances of marriage breakdown, undue hardship and for honest mistakes or inadvertent omissions.¹⁸ As with the discretions conferred on the Commissioner under other provisions of the ITAAs, in respect of the discretions conferred on the Commissioner by Division 7A, it is the Commissioner who must form the opinion, be satisfied, or consider it reasonable¹⁹ and it is imperative that in considering the Commissioner's discretions under Division 7A practitioners keep this in mind and treat it as a mantra in preparing any request for the Commissioner to exercise his discretion.

Undue Hardship (S109Q) and Extension of repayment period (S109RD)

In the case of undue hardship²⁰ or circumstances beyond the taxpayer's control,²¹ examples of the discretions exercisable are:

- where the minimum annual repayment in respect of an amalgamated loan²² has not been paid because of circumstances that are beyond the borrower's control, and the borrower would suffer undue hardship if the private company were taken to pay a dividend;²³
- to allow a further period within which a borrower may pay the minimum annual repayment in respect of an amalgamated loan where the borrower failed to make the required payment because of circumstances that are beyond the control of the borrower; and

¹⁵ See also *Commissioner of Taxation v Brian Hatch Timber Co (Sales) Pty Ltd* (1972) 128 CLR 28, per Menzies J at 52, and Owen J at 60 for similar views

¹⁶ *Padfield v Minister of Agriculture, Fisheries and Food* [1968] AC 997, 1006 (*Padfield*).

¹⁷ See also the Canadian case of *Pure Spring*

¹⁸ Section 109RC ITAA 36 (marriage breakdown); sections 109G(4), 109UA(3) and 109Q ITAA36 (undue hardship) and S.109RB (honest mistake or inadvertent omission). We do not consider marriage breakdown in this paper.

¹⁹ Generally, the Commissioner acts through authorised ATO officers, which ATO officers make decisions on the Commissioner's behalf

²⁰ Section 109Q ITAA 36

²¹ Section 109RD ITAA 36

²² Sections 109N and 109E(3) ITAA 36

²³ Section 109Q(1) ITAA 36

- where the Division 7A loan guarantee rules apply and a non-contingent liability arises to the guarantor as a result of the guarantee, and the target entity would suffer undue hardship if the private company were to be taken to pay a dividend.

In deciding whether he is satisfied that the undue hardship requirements have been satisfied, the Commissioner is required to consider:²⁴

- the borrowing entity's capacity to repay the loan at the end of the income year in which the amalgamated loan was made;
- any circumstances that have reduced the borrowing entity's capacity to repay the loan;
- whether the borrowing entity took all reasonable steps to make payments relating to the amalgamated loan during the current income year that are equal to the minimum annual repayment of the loan for the current income year; and
- whether the entity has made payments relating to the loan as soon as possible after the current income year, equalling the difference between:
 - the minimum annual repayment for the current income year; and
 - the amount of the payments relating to the loan made during the current income year.

*In Re Walsh*²⁵ the court held that for a hardship to be "undue", it must be shown that the particular burden to the applicant to have to observe or perform the requirement is out of proportion to the nature of the requirement itself, and the benefit that the applicant would derive from compliance with it.

The Explanatory Memorandum to *Tax Laws Amendment (2007 Measures No. 3) Act 2007 (TLAA 2007 and TLAA 2007 EM)* makes clear that as the Commissioner can choose not to exercise the power under section 109Q and that taxpayers should prepare their income tax returns on the basis of recognition of any deemed dividend(s) until such time as the Commissioner does, in fact, exercise the power under section 109Q. A taxpayer is, therefore, not able to self-correct (or self-assess on the basis that the discretion will be exercised), and a taxpayer will need to request the Commissioner to exercise his discretion.

As noted above, the Commissioner has a discretion to treat a failure to make the minimum annual repayment of an amalgamated loan by the required time as not giving rise to a deemed dividend if the minimum repayment is paid to the private company within a further time specified by him (**S109RD Discretion**).²⁶

The S109RD Discretion is exercisable by the Commissioner in respect of assessments for the 2006-2007 income year and later income years and is available where:

- there is an amalgamated loan and the borrower has either not made any repayment in respect of the loan for an income year, or has paid an amount that is less than the minimum repayment required (**Shortfall**);²⁷ and
- the Shortfall arose because the borrower was unable to pay the private company the minimum annual repayment because of circumstances beyond the borrower's control.²⁸

If the circumstances above are satisfied then, the Commissioner is empowered with discretion to decide in writing that a deemed dividend arises pursuant to Division 7A because of the

²⁴ Section 109Q(2) ITAA 36

²⁵ *In Re Walsh* [1944] VLR 147

²⁶ Section 109RD ITAA36

²⁷ That is, there is a shortfall of either the amount of the minimum yearly repayment required, or the balance of the minimum repayment not paid

²⁸ Section 109RD(1) ITAA 36

Shortfall, provided that the borrower pays the private company the amount of the Shortfall within a specified time.²⁹ Where the Commissioner exercises the discretion to allow the amount of the Shortfall to be paid within a specified time, the Shortfall will only be taken into account in the calculation of the minimum annual repayment required when it is actually paid.

In exercising the S109RD Discretion, the Commissioner must have regard to the nature of the circumstances mentioned in 2. above, and any other matters that he considers relevant.³⁰ The exercise of the Commissioner's S109RD Discretion must relate to only one amount that would otherwise be taken to be a dividend.³¹

A precondition for the availability of the S109RD Discretion is that the inability to pay the private company the minimum annual repayment arose because of *circumstances beyond the borrower's control*.

In *Rohrmoser v Registrar of Trademarks*,³² and in considering a discretion afforded to the Registrar of Trademarks to extend the time for doing an act or taking a step where the act was not done or the step was not taken by reason of "circumstances beyond the control of the person concerned", Jenkinson J said:

"In the context in which it is found, the expression 'circumstances beyond the control of the person concerned' does in my opinion designate – and designates only – *occurrences which neither the person concerned nor any person acting on his behalf to do the act or take the step could prevent*. The operations of nature and the activities of strangers may result in such occurrences. So, too, may the acts and omissions of certain independent contractors engaged by the person concerned or by his agent as, for example, the carrier of mail or the office cleaner, either of whom causes the loss or destruction of a document to be filed. But *the acts or omissions of the agent who, on behalf of the person concerned, is to do the act or take the step are not occurrences of the description specified in s 131(1) (a), in my opinion. Nor, in my opinion, are the acts or omissions of that agent's servants*. The section is, I think, correctly described as a force majeure provision."
(emphasis added)

The TLA 2007 EM gives the following examples of circumstances that may be outside the control of the borrower of a private company loan:

- the borrower has been in an accident and hospitalised, and cannot make the minimum annual repayments;
- the borrower has been hospitalised because of an illness, and cannot make the minimum annual repayments;
- the borrower is prevented from making the minimum annual repayments because their assets have been frozen by a court; or
- the borrower may have another loan from a third party (for example a bank) and, through a subordination of the private company loan, the borrower is prevented from making any payments on the private company loan.

It is respectfully submitted that the S109RD Discretion is limited in its application and to the extent that any non-compliance with Division 7A relates to a hardship of, or an event beyond the control, of the taxpayer's tax adviser rather than the taxpayer, the S109RD Discretion would not apply.

6. S109RB: THE COMMISSIONER'S GENERAL DIVISION 7A DISCRETION

S109RB confers on the Commissioner a general discretion in situations where the provisions of Division 7A have been activated as a result of an *honest mistake or inadvertent omission*

²⁹ Sections 109RD(2) and (4) ITAA 36

³⁰ Section 109RD(3) ITAA 36

³¹ Section 109RD(5) ITAA 36

³² *Rohrmoser v Registrar of Trademarks* [1987] FCA 22.

made by the “recipient” of the deemed dividend or the private company or by any other entity whose conduct contributed to that outcome (**S109RB Discretion**). When exercising the S109RB Discretion, the Commissioner may decide either that a deemed dividend pursuant to Division 7A (**Division 7A Deemed Dividend**) is to be taken as not having been paid, or that a Division 7A Deemed Dividend may be franked.³³

Whilst the S109RB Discretion was introduced in 2007,³⁴ it was (broadly) able to be exercised by the Commissioner retrospectively in relation to the 2001-2002 and later income years.

The Commissioner has discretion to make a decision if the relevant conditions are met. The Commissioner could initiate such action independently of the taxpayer, for example, in the course of an audit or other compliance activity. However, in practice it is unlikely that the Commissioner will unilaterally seek to exercise his S109RB Discretion and as the discretion offers significant relief from the application of Division 7A it is considered that the taxpayer should actively request the Commissioner to exercise the discretion if they believe they qualify for relief.

The Commissioner has issued a ruling, *Taxation Ruling TR 2010/8 (TR 2010/8)*, in which he considers the requirements which in his view must be met before the S109RB Discretion can be exercised. The Commissioner has also released an administrative practice statement, *Practice Statement PS LA 2011/29 (PS LA 2011/29)*, which is intended to provide guidance to ATO officers on when the condition of an honest mistake or an inadvertent omission will be met and the matters to which, in the Commissioner’s view he must have regard in exercising the S109RB Discretion. We consider both TR 2010/8 and PS LA 2011/29 in further detail below.

7. EXERCISE OF THE S109RB DISCRETION

The Commissioner can exercise S109RB Discretion if:

1. Division 7A would otherwise operate, with the result that either:
 - a private company would be taken to pay a particular dividend to a particular entity (referred to as “**the recipient**”); or
 - because of the Division 7A trust provisions,³⁵ a particular amount would be included, as if it were a dividend, in the assessable income of the recipient; and
2. that result arises because of an *honest mistake or inadvertent omission* by any of:
 - the recipient;
 - the private company; or
 - any other entity whose conduct contributed to that result.³⁶

The TLA 2007 EM, gives as an example of “any other entity” an interposed company or trust that makes a payment or loan to a shareholder or an associate of a shareholder of the private company (**associate**). TR 2010/8 gives examples of “any other entities” for the purposes of the S109RB Discretion as including a shareholder or an associate who is not the recipient, an officer or an employee of any relevant entity, a tax agent, an accountant or a legal adviser.

³³ Provided the recipient is a shareholder of the private company and the Division 7A trust provisions are not applicable

³⁴ By the TLA 2007

³⁵ Subdivision EA ITAA 36

³⁶ Section 109RB(1) ITAA 36

When making (or refusing to make) a decision under the S109RB Discretion, the Commissioner must take into account:³⁷

- the circumstances that led to the particular mistake or omission;
- the extent to which any of the entities whose mistake or omission may be relevant have taken action to try to correct the mistake or omission and, if so, how quickly that action was taken;
- whether Division 7A has operated previously in relation to any of those entities and, if so, the circumstances in which this occurred; and
- any other matters that the Commissioner considers relevant.

In PS LA 2011/29 the Commissioner sets out his views regarding each of the above factors.

The circumstances that led to the mistake or omission

This requirement directs the Commissioner to look broadly at the context in which the mistake or omission arose. This would include looking at matters beyond the conduct of the person who made the relevant mistake or omission and to look at the conduct of all of those who were involved. The Commissioner is of the view that this includes the following factors:

- Was there a failure to take reasonable care? Where the entity is careless because its attitude towards Division 7A is one of indifference and without care this may be a factor that could weigh against the exercise of the S109RB Discretion. For example, in circumstances where it would have been reasonable for the recipient or the private company to have obtained professional tax advice but the recipient or private company abstained from obtaining that advice, this might be a factor weighing against the exercise of the S109RB Discretion. It would be relevant to inquire into the reasons for not obtaining professional advice, the complexity of the transaction and the knowledge of the taxpayer or, in the case of a corporate taxpayer, the relevant individuals;
- Whether there has been a longstanding uncertainty in the interpretation of relevant Division 7A provisions. Where the interpretative issues are not contentious, that would weigh against the exercise of the S109RB Discretion;
- Whether it was reasonable to expect that the mistake should have been detected based on available information, systems and sophistication of entities;
- Evidence that the taxpayer has attempted to comply with Division 7A but had still committed the breach would be a factor that would weigh in favour of the exercise of the S109RB Discretion;
- The level of case law and ATO binding precedential materials on the application of the relevant Division 7A issue. Where guidance materials are available for the intended audience prior to the breach this would weigh against the exercise of the S109RB discretion; and
- The extent of disclosure and non-disclosure of relevant transactions in the financial statements of the relevant entities. Deliberate concealment or misdescription of transactions that are relevant to Division 7A would weigh against the exercise of the S109RB discretion.

The extent to which action to try to correct the mistake or omission has been taken and, if so, how quickly that action was taken

Although, no action by a taxpayer can alter the application of Division 7A once it has operated to treat a Division 7A Deemed Dividend to have been paid, the legislature expects corrective

³⁷ Section 109RB(3) ITAA36.

action to have been taken and, where it was taken quickly to correct the honest mistake or inadvertent omission, it will be a relevant factor in favour of exercising the S109RB Discretion.

“Corrective action”

The term “corrective action” is not a defined term for the purposes of Division 7A. Broadly, corrective action should put the parties in the position that they would have been had the provisions of Division 7A been complied with.

In PS LA 2007/20 the Commissioner published his views as to what he considers to be sufficient corrective action in the context of the applications of Division 7A and in TR 2010/8 he reaffirms that, in the absence of special circumstances, the presumption will be that the methods prescribed by PS LA 2007/20 are reasonable and appropriate.

PS LA 2007/20 defines corrective action broadly as taking the steps to fully rectify the non-compliance with Division 7A. This could mean, for example, putting in place loan documentation that complies with section 109N or, in the case of non-payment of the minimum annual repayments of principal and interest required by section 109E, a payment or payments equal to the total minimum annual repayments that were required from the commencement of the loan.

The following table summarises what corrective action meant in the case of a payment or loan made or a debt forgiven by a private company, or a failure to make a minimum annual repayment to a private company.³⁸

It the Div 7A deemed dividend arose because of a the following corrective action was required to be taken by 30 June 2008:
Payment by a private company	<ul style="list-style-type: none"> • Convert the payment to a loan • Enter into a Division 7A complying written loan agreement. • Make a payment or payments* to the company to reflect what would had to have been paid by way of minimum annual repayments.
Loan by a private company	<ul style="list-style-type: none"> • Enter into Division 7A complying written loan agreement. • Make a payment or payments* to the company to reflect what would had to have been paid by way of minimum annual repayments.
Failure to make the minimum yearly repayment in relation to an amalgamated loan	<ul style="list-style-type: none"> • Make a payment or payments* to the company to reflect what would had to have been paid by way of minimum annual repayments.
Forgiveness of a debt by a private company	<ul style="list-style-type: none"> • Treat the amount of the debt forgiven as the principal of a loan.

³⁸ Gaal, *The Division 7A Handbook Ed 7*, The Tax Institute

	<ul style="list-style-type: none"> • Enter into a Division 7A complying written loan agreement. <p>Make a payment or payments* to the company to reflect what would had to have been paid by way of minimum annual repayments.</p>
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* the payment (or payments) will have two components: a capital component and an interest component (see below).

The required corrective action was similar if an amount is treated as if it were a dividend because of a payment, loan or debt forgiveness by a trust.

Corrective action might, therefore; include:

- Paying a franked dividend to offset prior year loans and/ or repayments;
- Entering into a section 109N compliant loan agreement and making the necessary “catch-up” repayments;
- Converting UPEs to section 109N compliant loans (i.e. entering into a section 109N compliant loan);
- Adjusting descriptions in financial accounts to reflect the nature of the amounts in question, and where relevant quarantining UPEs pre-December 2009,³⁹ and
- Treating the amount of debt forgiven as the principal on a loan that complies with the requirements of section 109N; in forgiving any debt forgiveness, cognisance should be had to the relevant amendment periods and the effects of any forgiveness under Division 7A and the commercial debt forgiveness rules contained in Division 245 ITAA 97.

Taxpayers should, therefore, explain in their application for the exercise of the S109RB Discretion when the error occurred, when the error was identified, and when the corrective action, if applicable, was taken.

The Commissioner does not generally accept that a willingness to take corrective action as being sufficient for the favourable exercise of the S109RB Discretion.

The Commissioner expects taxpayers to implement corrective action unilaterally unless it can be shown that, by doing so, they would incur undue cost or inconvenience. For example, undue cost or inconvenience may arise if the parties propose to “fund” corrective action by paying a dividend to the affected shareholder or associate; which might lead to an oppressive tax outcome if the discretion is not exercised favourably.

A taxpayer who believes that corrective action is not warranted, or that corrective action should be conditional on a favourable exercise of the S109RB Discretion, should address these concerns in their application to the Commissioner for the exercise his discretion. Where this is done and the taxpayer’s concerns are based on reasonable grounds, the Commissioner considers that the failure to implement corrective action would not be regarded as a factor weighing against the exercise of the S109RB Discretion.

Whether Division 7A has operated previously in relation to any of the entities and, if so, the circumstances in which this occurred

This factor focuses on prior non-compliance with Division 7A. It should be distinguished from applications for the exercise of the S109RB Discretion involving more than one income year.

³⁹ Being cognisant of the provisions of Subdivision EA and any such quarantined UPEs

In particular, where Division 7A has previously applied to the taxpayer or related entities, this would be a factor weighing against the exercise of the S109RB Discretion. This would be of particular relevance to practitioners where the Division 7A breach has arisen on a number of client matters and care will need to be taken in addressing any such wide spread non-compliance.

Any other matters that the Commissioner considers relevant

As noted at the outset of this paper and the discussion on the Commissioner's discretions under the ITAAs, the "any other matters" requirement is very wide-ranging. However, it is submitted that when considering the matters that are relevant, regard must be had to the purpose of Division 7A.

In this regard, the purpose of Division 7A was put so succinctly in the Explanatory Memorandum that introduced it as follows:

- "9.1 Part 1 of Schedule 9 of the Bill will insert new Division 7A, of the Income Tax Assessment Act 1936 (the Act) to ensure that all advances, loans, and other credits (unless they come within specified exclusions) by private companies to shareholders (and their associates), are treated as assessable dividends to the extent that there are realised or unrealised profits in the company.
- 9.2 The purpose of the amendments is to ensure that private companies will no longer be able to make tax-free distributions of profits to shareholders (and their associates) in the form of payments or loans."

One of the "other matters" that may be relevant is in situations where, after the breach has been identified, the taxpayer or tax agent decide to turn a blind eye to it. In these circumstances, the Commissioner considers that he is entitled to weigh this against exercising the S109RB Discretion: The longer the period of inaction without a satisfactory explanation, the greater the weight that will be given to the inaction.

8. HOW ATO ADMINISTERS S109RB DISCRETION

In PS LA 2011/29 the Commissioner describes the exercise of the S109RB Discretion as a two-step process of:

- establishing that the Commissioner is empowered to exercise the S109RB Discretion because a Division 7A Deemed Dividend arose, on the balance of probabilities, as a result of an *honest mistake or inadvertent omission*, and
- if so, in deciding whether the S109RB Discretion should be exercised, have regard to the matters outlined in section 109RB(3)⁴⁰ and in deciding what conditions, if any, should be imposed.

An honest mistake or inadvertent omission

"By ignorance we mistake, and by mistakes we learn" Proverb

A threshold condition for the exercise of the S109RB Discretion is that the Commissioner must be satisfied that the provisions of Division 7A apply because of an honest mistake or inadvertent omission by the recipient, the private company or by another entity that contributed to the application of Division 7A.

Whether or not there is an honest mistake or an inadvertent omission is an objective question to be determined by reference to the circumstances giving rise to the failure to satisfy Division 7A.⁴¹

⁴⁰ These factors are considered in paragraph 7 (pages 8 and 9) above

⁴¹ TLAA 2007 EM

The TLAA 2007 EM states:

“Whether or not there is an honest mistake or inadvertent omission is an objective question to be determined by reference to all the circumstances surrounding the failure to satisfy the requirements of Division 7A. In practice, the taxpayer will need to demonstrate to the Commissioner that the failure was the result of an honest mistake or inadvertent omission.”

Drawing a conclusion about the objective intentions or purposes of a person or persons from a set of facts can be problematic.

The TLAA 2007 EM states that:⁴²

“[t]here is a very wide range of possible mistakes or omissions that would result in Division 7A deeming there to be a dividend paid to a taxpayer.”

So what is an “honest mistake” or an “inadvertent omission”? TR 2010/8 sets out the Commissioner’s view on the meaning of “honest mistake” and “inadvertent omission”:

“Ordinary meaning applies

62. The terms ‘honest mistake’ and ‘inadvertent omission’ are not specifically defined for the purposes of section 109RB or for tax law purposes more generally. Accordingly, each term takes on its ordinary meaning as appropriate to the context in which it is used.

Honest mistake

63. *The Macquarie Dictionary, 2005, 4th Edition, The Macquarie Library Pty Ltd, NSW* (Macquarie Dictionary), defines **honest** as:

1. honourable in principles, intentions, and actions; upright: an honest person.
2. showing uprightness and fairness: honest methods.
3. acquired fairly: honest money.
4. open; sincere: an honest face.
5. genuine or unadulterated: honest commodities.
6. truthful; creditable; candid.

64. *The Australian Oxford Dictionary, 2004, 2nd Edition, Oxford University Press, Melbourne* (Australian Oxford Dictionary), defines **honest** as:

1. fair and just in character or behaviour, not cheating or stealing;
2. free of deceit and untruthfulness, sincere.

65. *The New Shorter Oxford English Dictionary, 1993, Clarendon Press, Oxford* (New Shorter Oxford English Dictionary), defines **honest** as:

- 3a Of an action, one's feelings etc: showing sincerity of character or intention; fair, straightforward; free from fraud;
4. Of a person: marked by uprightness or probity; fair and righteous in speech and act; fundamentally sincere or truthful; not lying, cheating, or stealing.

68. The Macquarie Dictionary defines **mistake** as:

1. an error in action, opinion or judgment.
2. a misconception or misapprehension.

69. *The Butterworths Australian Legal Dictionary, 1997, Butterworths, Sydney* (Butterworths Australian Legal Dictionary), defines **mistake** as:

Either a belief in the existence of a thing which does not exist, or ignorance of a relevant thing, or both.

70. The Australian Oxford Dictionary defines **mistake** as:

1. an incorrect idea or opinion; a thing incorrectly done or thought;

⁴² At para 1.36

2. an error of judgment.

71. The New Shorter Oxford English Dictionary defines **mistake** as:

A misconception about the meaning of something; a thing incorrectly done or thought; an error of judgment"

The Commissioner is of the view that the

"...distinction made in criminal matters between mistakes of fact and mistakes of law are not relevant for the purposes of subsection 109RB(1)"

In TR 2010/8, it is pointed out that the relevant facts and circumstances must meet the description of honest mistake, and it is not a requirement that the mistake also meet the description of being reasonable. The reasonableness of the mistake may, however, be pertinent to the question of whether the belief in the existence of a thing was actually held by the entity.⁴³ Further the Commissioner is of the view that the

"...entity's honesty must be in relation to the operation of Division 7A Lack of honesty in relation to a matter that does not relate to Division 7A is not relevant for the purposes of subsection 109RB(1)."

However, the Commissioner also considers that proving that a mistake is not dishonest does not necessarily, and of itself, provide sufficient evidence that the "honest(y)" requirement has been satisfied. The Commissioner considers that carelessness would not necessarily amount to dishonesty;⁴⁴ however, he considers that

"deliberate indifference or wilful blindness would not satisfy the requirement of honest and would not constitute an honest mistake"

TR 2010/8 defines an inadvertent omission as follows:

"Inadvertent omission

77. The terms **omission** and **omit** are defined by the Macquarie Dictionary as:

Omission , noun 1. the act of omitting. 2. the state of being omitted. 3. something omitted.

Omit , verb (t) (omitted, omitting) 1. to leave out: to omit passages of a text. 2. to forbear or fail to do, make, use, send, etc.: to omit a greeting.

78. *Black's Law Dictionary* , 2004, 8th Edition, Thomson West, USA, describes omission as follows:

omission , n 1. A failure to do something; esp., a neglect of duty [the complaint alleged that the driver had committed various negligent acts and omissions].2. The act of leaving something out [the contractor's omission of the sales price rendered the contract void]. 3. The state of having been left out or not done [his omission from the roster caused no harm]. 4. Something that is left out, left undone, or otherwise neglected [the many omissions from the list were unintentional].

79. *Stroud's Judicial Dictionary of Words and Phrases* , 2006, 7th Edition, Sweet & Maxwell, London, describes omission as:

omission . An 'omission' to perform a duty involves the idea that the person to act is aware that performance is required or needful.

80. *The Oxford Companion to Law* , 1980, Clarendon Press, Oxford, states that **omission** is:

A failure to an act, or the not-doing of it. An omission may be deliberate, or be inadvertent, as by forgetfulness. In general, an omission is legally significant only if there was a legal duty to

⁴³ *R v. Morgan* [1976] AC 182; [1975] 2 All ER 347; *R v. Saragozza* [1984] VR 187

⁴⁴ In quoting *Royal Brunei Airlines Sdn Bhd v. Tan Kok Ming* [1995] 2 AC 378; [1995] 3 All ER 97

act and not to omit, so that the omission is a breach of legal duty to have acted.

81. *The Australian Oxford Dictionary* defines **omission** as:
 1. the act or an instance of omitting or being omitted;
 2. something that has been omitted or overlooked.

82. *The New Shorter Oxford English Dictionary* defines **omission** as:
 1. The action or an act of neglecting or failing to perform something, esp. a duty.
 2. The action of omitting or failing to include something or someone, the fact of being omitted.

83. *Butterworths Australian Legal Dictionary* relevantly defines **inadvertence** as:
 1. failure to observe or pay attention; ... 2. In a restricted sense, ignorance of the law'

84. *The Australian Oxford Dictionary* defines **inadvertent** as:
 1. (of an action) unintentional;
 - 2a. not properly attentive b. negligent.

85. *The New Shorter Oxford English Dictionary* defines **inadvertent** as:
 1. Of a person: not properly attentive or observant;
 2. Of an action: unintentional."

The Commissioner considers that

"Inadvertence implies a degree of pre-existing knowledge. Inadvertence is often described as being a failure to observe, or failure to pay attention. Whether an omission will be regarded as inadvertent is a question of fact and degree in each case"

It has been said that inadvertence means negligence or carelessness where the circumstances show an absence of bad faith,⁴⁵ and that ignorance of the law may fall within the word "inadvertence".⁴⁶ In TR 2010/8, it is pointed out that, although ignorance of the law may constitute inadvertence, this will not always be the case and whilst a mistake or omission might be the result of ignorance it would need to be established that the relevant entity's ignorance led to the honest mistake or inadvertent omission that resulted in the operation of Division 7A.

Importantly, "ignorance" of the law, in the sense of a wilful indifference, has been held to be evasion. This might have material implications for the quantum of any potential Division 7A non-compliance. In *SRBBB and Commissioner of Taxation*⁴⁷ the AATA rejected the argument that reliance on the advice of an accountant was sufficient to establish that there was no evasion. In reaching his decision the Deputy President, Hon. R N J Purvis QC states:

"67. As was said by Dickson J in *Denver Chemical Manufacturing Co v Commissioner of Taxation (NSW)* [1949] HCA 25; (1949) 79 CLR 296 at 313.

'I think it is unwise to attempt to define the word "evasion". The context of section 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 reasonable 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'.

⁴⁵ *Re County Council Elections; Ex parte Lenanton; Ex parte Pierce* (1889) 53 JP 263.

⁴⁶ *Nichol v Fearby; Nichol v Robinson* [1923] 1 KB 480.

⁴⁷ *SRBBB and Commissioner of Taxation* [2001] AATA 529; (2001) 47 ATR 1191; 2001 ATC 2194

68. In *Barribb v Commissioner of Taxation (NSW)* (1941) 2 AITR 161 at 164, Tiernan J said:

'The Applicant 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'.

This is apposite for the S109RB Discretion as often non-compliance with the provisions of Division 7A arise where it has been overlooked by a previous tax adviser and is brought to the attention of a new tax adviser.

For example in ATO Private Ruling Number 90082 the taxpayer had engaged the services of the same accountant for over 20 years during which time the accountant had treated certain payments as loans (for Division 7A purposes). The taxpayers were not aware that the payments had been treated as loans, nor of any obligation for the loans to be repaid. The accountant became seriously ill and, "due to their health condition, did not appreciate that treating the moneys as loans would give rise to a dividend pursuant to Division 7A". Accordingly, no loan agreements were entered into and no minimum repayments were made.

The taxpayers later changed to a new accountant, who identified the breach of Division 7A. The new accountant arranged for appropriate corrective action to be taken and a private ruling request was lodged seeking relief under the S109RB Discretion.

The Division 7A Case Panel held that the Division 7A issue arose out of ignorance, rather than from an honest mistake or inadvertent error; in particular, the former accountant was "ignorant" because, given the length of their appointment and the fact that Division 7A was introduced back in 1997, they should have acquired some knowledge of Division 7A and how it operated. The taxpayers were also at fault because they clearly used the moneys for private purposes and, irrespective of whether the accountant had been authorised to treat payments as loans, Division 7A would have been an issue anyway as Division 7A catches both payments and loans. Access to the discretion was therefore denied.

In comparison, in Private Ruling Number 79738 an ATO audit was completed in relation to the company for a particular income year. At the end of that income year, the balance sheet of the company indicated an asset in the company's books of a certain amount, being a debit loan account to the shareholder. The tax agent at the time of the audit produced two loan agreements that related to the loan amount. However, the agreements did not meet the requirements of section 109N.

The shareholder requested the Commissioner to exercise the S109RB Discretion with an undertaking:

- To enter into a current dated loan agreement that complies with section 109N from when the loan arose;
- That the shareholder will make catch up payments to the company to ensure that the minimum prescribed payments are brought up to date;
- The total minimum prescribed payments above the amount repaid by the shareholder will be paid to the shareholder by way of the company declaring a fully franked dividend and offsetting the amount against the amount due under the loan. The dividend will be included in the shareholder's assessable income. The interest component will be included in the company's assessable income, and the shareholder will not be claiming a deduction or the interest payable under the loan.

The Commissioner exercised his discretion under S109RB, on the basis that the mistake or omission happened because of the failure of the tax agent to execute agreements that comply with the requirements of Division 7A. The Commissioner considered that it was relevant that the loan was recognised in the company's books, being a debit loan account to the shareholder. The fact that loan agreements were in place between the company and the shareholder, even though they were deficient, substantiated the claim of honest mistake/inadvertent omission.

Common and recurring mistakes or omissions

The Commissioner considers that the fact that a mistake or omission:⁴⁸

- has commonly occurred does not necessarily establish that an honest mistake or inadvertent omission occurred in the taxpayer's circumstances. However, in the absence of direct evidence, the fact that an error is common may support the conclusion it was an honest mistake or inadvertent omission;
- recurs does not automatically qualify or disqualify a taxpayer from satisfying the requirements of S109RB. Each mistake or omission must be examined separately to determine whether it is in fact an honest mistake or inadvertent omission. A mistake or an omission may recur for different reasons and it is necessary to enquire into those reasons to determine whether each occurrence is, or continues to be, an honest mistake or inadvertent omission. However, once a person becomes aware of a past mistake or omission, the circumstances will not support a finding of any new honest mistake or inadvertent omission on those particular circumstances.

9. PRACTICAL ASPECTS OF THE S109RB DISCRETION

The Commissioner may make a decision that is subject to any of the following types of conditions:

- a condition that the recipient (or another entity) make specified payments to the private company (or another entity) within a specified time; and
- a condition that a specified requirement of Division 7A be met within a specified time.⁴⁹

This allows the Commissioner to require that the mistake or omission that gave rise to the failure to satisfy the provisions of Division 7A be corrected within a specified period of time. For example, the Commissioner might impose:⁵⁰

- the requirement that loan documentation be put in place that satisfies section 109N; and/or
- if the minimum annual repayments have not been made by the due date, that such amounts be paid by a later specified date.

Voluntary disclosure

"Success Comes Through Rapidly Fixing our Mistakes Rather than Getting Things Right the First Time" Tim Harford, author of Adapt: Why Success Always Starts With Failure

Since 1 July 2008, a taxpayer must apply to the Commissioner in order for his discretion to be exercised. This includes his discretion under S109Q, S109RD and S109RB. Whilst there is no prescribed form for applying for an application of the Commissioner's discretion,⁵¹ an application to the Commissioner might, potentially, constitute a voluntary disclosure. This is of particular relevance in situations where the Commissioner determines not to exercise his discretion in the taxpayer's favour.

Section 284-225 TAA 53 (**S284-225**) reduces the amount of the administrative penalty imposed under Subdivision 284-B or 284-C TAA 53 where an entity voluntarily tells the

⁴⁸ TR 2010/8

⁴⁹ Section 109RB(4) ITAA 36

⁵⁰ The TLAA 2007 EM

⁵¹ Section 388-50 Tax Administration Act 1953 (TAA 53); Practice Statement PS LA 2005/19

Commissioner about a shortfall amount, scheme shortfall amount or, from 4 June 2010, a false and misleading statement.

The base penalty amount is reduced by:⁵²

- 20% where the voluntary disclosure occurs after the Commissioner notifies the entity of an examination of its tax affairs is to be conducted and the disclosure will save the Commissioner significant time or resources in the examination;
- 80% where the voluntary disclosure occurs before the earlier of the Commissioner's notification of an examination or a public statement by the Commissioner seeking voluntary disclosures about a scheme that applies to the entity.⁵³

Given it is often pursuant to an ATO review that taxpayers and their tax advisers become aware of potential Division 7A non-compliance, of particular relevance to the topic at hand, the Commissioner can treat a voluntary disclosure made after the Commissioner has notified the entity of an examination as having been made before notification of the examination.⁵⁴

The Commissioner's sets out his interpretation of the application of S284-225 in *Miscellaneous Taxation Ruling MT 2012/3 (MT 2012/3)*.

The expression "voluntarily tell" is not defined in the legislation and takes its ordinary meaning.

The *Australian Oxford Dictionary* defines the word "voluntary" as

"done, acting or able to act of one's own free will; not constrained or compulsory, intentional",

and "tell" is defined to mean

"to make known; express in words; divulge".

According to MT 2012/3,⁵⁵ its meaning should be read in the context it appears.

A voluntary disclosure must, therefore, involve disclosure(s) of information not otherwise known to the Commissioner. It involves more than merely agreeing with what the Commissioner has already identified. For this reason, a disclosure might not be regarded as being made voluntarily where the entity would have been highly unlikely to have made the disclosure unless they were aware that the Commissioner was about to uncover the shortfall amount or scheme shortfall amount.

In *Practice Statements PS LA 2012/4* and *PS LA 2012/5* the Commissioner publishes his views on the approved form in which a voluntary disclosure need be made. The practice statements list the information required for the entity to make that disclosure. The Commissioner considers that the form requires the entity to identify the statement and explain the false or misleading nature of the statement. The precise form and structure are irrelevant as long as the information is given by the taxpayer in the manner required or allowed by the approved form. Where there is a shortfall amount, the taxpayer must provide the Commissioner with sufficient information to enable the Commissioner to accurately determine that shortfall amount. However, the taxpayer is not required to work out the shortfall amount itself.

Importantly, for applications to the Commissioner to exercise his discretion, a disclosure which substantially (but not fully) complies with the strict requirements of the approved form such that the Commissioner can, for example, work out any shortfall amount, the disclosure is treated as one meeting the requirements of the approved form. However, if the taxpayer

⁵² Section 284-225 TAA 53

⁵³ Where the shortfall is less than \$1,000 the penalty is reduced to nil

⁵⁴ Section 284-225(5) TAA 53

⁵⁵ Paragraph 90

supplied incomplete information in an attempt to obstruct or hinder the Commissioner from identifying the correct information, particularly where the degree of incompleteness is significant, the taxpayer's original disclosure would not be regarded as constituting voluntary disclosure.

10. AAT DECISION ON THE S109RB DISCRETION

In *Case 8/2012*,⁵⁶ the taxpayer was a shareholder and director of a private company, BuildCo that carried on a building business. In the income years ended 30 June 2005, 2006 and 2007, BuildCo made substantial payments to help the taxpayer with the expenses of renovating his house. The payments were not treated as loans in BuildCo's accounts in the 2005 income year but were so in the 2006 and 2007 income years.

Sometime after lodgment of BuildCo's 2005 income year company tax return, the taxpayer signed an undated loan agreement prepared by his accountant that recorded the loan from BuildCo, including the requirement to pay interest at the benchmark rate. The agreement did not specify the term of the loan which meant that it did not comply with section 109N. In August 2006, the taxpayer paid \$150,000 to BuildCo in part repayment of what he thought was the loan made in the 2005 income year. In the 2008 income year, after the ATO had commenced an audit, the taxpayer made several repayments to BuildCo, intending to fully repay all amounts owed. However, the repayments were partially offset by further borrowings from BuildCo.

The Commissioner treated the payments in each of the 2005, 2006 and 2007 income years as Division 7A deemed dividends.

In appealing the Commissioner's assessments the taxpayer directed the tribunal to S109RB. The taxpayer submitted that it was open to the Tribunal to exercise the S109RB Discretion because the Division 7A deemed dividend resulted from an "honest mistake or inadvertent omission". That mistake or omission, in the taxpayer's submission, was the failure to properly document the loans. Interestingly, the parties agreed that the S109RB Discretion is impliedly limited by the scope and purpose of the ITAAs.

In finding for the taxpayer, Deputy President SE Frost held that:

"... an overall assessment of the factors to which I have had regard under s 109RB(3) supports the exercise of the discretion in s 109RB for both the 2006 and the 2007 income years. I therefore exercise the discretion in accordance with s 109RB(2)(a) so as to disregard the deeming of the dividends in those years. There is no reason why any conditions should be imposed under s 109RB(4)."

The Commissioner's view is that *Case 8/2012* was decided on its facts.⁵⁷

In *Swift*,⁵⁸ the court considered that the AAT is required to examine the evidence and make the "correct or preferable decision". In *Swift*, French J (as he then was) said that the tribunal was:

"... bound to consider the relevant facts proved on the evidence before it and to decide on the basis of those facts what was the correct or preferable decision: ... In that process it was neither entitled nor required to place weight upon the fact that the Commissioner had exercised his discretion in a particular way ..."

The tribunal may exercise all the powers and discretions conferred on the Commissioner⁵⁹ and, as noted, reach the correct or preferable decision. For the AAT to merely conclude that a

⁵⁶ Building Company Owner v Commissioner of Taxation, *Case 8/2012*, [2012] AATA 755 (*Case 8/2012*)

⁵⁷ ATO Decision Impact Statement: Building Company Owner and Commissioner of Taxation

⁵⁸ *Federal Commissioner of Taxation v Swift* (1989) 18 ALD 679

⁵⁹ Section 43(1) the Administrative Appeals Tribunal Act 1975

decision was open to the Commissioner would be insufficient, and would provide grounds for intervention by a court on appeal.⁶⁰

On a review by the AAT of, or an appeal to the Federal Court against, an objection decision, the taxpayer is generally limited to the grounds stated in the objection.⁶¹ However, the discretion to allow the grounds of objection to be amended is very wide. For example, the AAT or court may allow a taxpayer to amend an objection to rely on entirely new grounds, even if they require consideration of matters not considered by the Commissioner in the original assessment process.⁶² The discretion may also be exercised to allow a taxpayer to rely on a fresh ground to dispute a matter already put in issue by the objection, or to include additional claims not already in dispute.⁶³ However, a taxpayer would not be allowed to amend the grounds of objection to challenge the validity of the assessment itself.⁶⁴

On the published facts in *Case 8/2012*, it would seem that the S109RB Discretion was not raised by the taxpayer as part of its objection and, and whilst not expressly noted in the judgement, the Deputy President, in fact, exercised the discretion of the AAT to allow the taxpayer to amend the grounds of objection to include an application for the exercise of the S109RB Discretion.

11. CHALLENGING THE COMMISSIONER'S EXERCISE OF DISCRETION

The availability of the objection, review and appeal procedures provided for by Pt IVC of the TAA 53 (**Pt IVC**) where a taxpayer is dissatisfied with the Commissioner's exercise of (or failure to exercise) a discretion, depends on the relevant provisions of the ITAAs (or regulations).⁶⁵

Division 7A contains no specific provisions allowing an objection under Pt IVC from an adverse exercise of the Commissioner's discretion. Consequently, a taxpayer might only object if the Commissioner's decision affects part of a taxpayer's assessment.⁶⁶

This results in the anomalous situation⁶⁷ that if a request for the Commissioner to exercise his discretion is made after the assessment for the relevant income year, the taxpayer may not have any objection rights,⁶⁸ whilst, a request for the exercise of the Commissioner's discretion made prior to the issue of the relevant assessment may give rise to objection rights.⁶⁹

The Commissioner's views on contesting an adverse decision of the S109RB Discretion are considered in PS LA 2011/29. PS LA 2011/29 states that if an objection to an assessment includes a ground relating to the operation of S109RB, then the Commissioner will consider that ground as part of deciding the objection. The Commissioner is of the view that consideration of the S109RB Discretion in an objection decision is properly the subject of review in any AAT review or Federal Court appeal under Pt IVC against that objection decision and notes that if any jurisdictional difficulty arises in the AAT or the Federal Court, the Commissioner will cooperate with the taxpayer to have the issue properly tested.

⁶⁰ See *Environment Protection Authority v Rashleigh* (2005) 159 ACTR 8.

⁶¹ Sections 14ZZK(a) and 14ZZO(a) TAA 53

⁶² *Lighthouse Philatelics PTY LTD v FC of T* 91 ATC 4942

⁶³ *Scott v FC of T* 2002 ATC 2077

⁶⁴ *Case 19/93* 93 ATC 232

⁶⁵ Section 14ZL TAA 53

⁶⁶ section 175A ITAA 36

⁶⁷ Gaal, *The Division 7A Handbook Ed 7*, The Tax Institute

⁶⁸ *Isaacs v FCT* [2006] FCAFC 105; *FCT v Administrative Appeals Tribunal* [2011] FCAFC 37.

⁶⁹ Arguably this was the case in *Case 8/2012*

The AAT is an administrative body which is vested with jurisdiction to review decisions of the Commissioner.⁷⁰ In practice this means that the AAT is required to stand in the shoes of the Commissioner and, as noted, reach the correct or preferable decision.

An appeal may be brought to the Federal Court on a question of law from the AAT. A federal Court can only interfere with the exercise of the Commissioner's discretion where it is vitiated by an error of law, for example, where the Commissioner has taken irrelevant considerations into account.⁷¹

In situations where review or appeal available under Pt IVC, it may be open to the taxpayer to bring judicial review proceedings in relation to the Commissioner's decision under the ADJR Act.

The decision in *FC of T v Administrative Appeals Tribunal & Ors*⁷² is instructive. In that case, the Commissioner appealed a decision of the AAT in relation to the Commissioner's discretion to disregard or reallocate excess non-concessional superannuation contributions to a different income year in limited special circumstances. The appeal related to whether the AAT had jurisdiction to review objection decision. At first instance the AAT held that it did not have jurisdiction to review the Commissioner's refusal to make a determination.⁷³ As it was only the assessment that could be the subject of the AAT's review when it reviewed the Commissioner's objection decision, it could not review the Commissioner's decision not to make a determination. In dismissing the Commissioner's appeal, the Full Court of Appeal held:

"The AAT was correct to conclude that it did not have jurisdiction to review the decision of the Commissioner to refuse to make a determination under s 292-465 of the 1997 Act ..."

In reaching the majority decision Keane CJ & Gordon J (Downes J dissenting) their Honours held:

32. The Commissioner submitted that even though no provision of Div 292 provided that the refusal of a determination under s 292-465 might be objected to under Pt IVC of the TAA, the refusal to make the determination was "sufficiently connected" or "integral" to the process of assessment of a taxpayer's liability to ECT that it was reviewable under Pt IVC of the TAA. In other words, the Commissioner contended that because the decision to refuse to make a determination in s 292-465 was "sufficiently connected" or "integral" to the process of assessment of a taxpayer's liability to ECT, it was open to the taxpayer to contend that the assessment was excessive because the Commissioner should have made a different decision under s 292-465.
33. The Commissioner's submission should not be accepted. The submission has no footing in the text of Div 292 of the 1997 Act. It requires a departure from the scheme established by Pt IVC without explicit legislative instruction in that regard. It assumes, wrongly, and contrary to the express words of s 14ZL of the TAA, that because the Commissioner has made a decision which is not a taxation decision at around the same time as making a taxation decision, the first decision can be brought under Pt IVC of the TAA. The assumption is wrong because it assumes that the Commissioner by his action may expand the categories of taxation decision which a taxpayer may object against in the manner set out in Pt IVC. And the submission is not supported by authority.
34. The criteria advanced by the Commissioner for deciding whether a decision made under the Act may be the subject of review under Pt IVC proceedings lack definite content. It is distinctly undesirable that entry across the threshold of a process of review should depend upon so open-textured an evaluation. It is by no means clear what decisions are, and what decisions are not, *connected* to or *integral* to the process of assessment. The Court must be slow to accept such uncertain criteria where to do so may lead to satellite litigation about whether a particular decision by the Commissioner falls within or outside the system of review provided by Pt IVC. Section 14ZL(1) was evidently intended to avoid just this kind of problem. In other words, it does not promote the certainty provided by s 14ZL(1) of the TAA to ask of a decision by the Commissioner whether it is "*integral*" to or *sufficiently "connected"* to the process of assessment in order to decide

⁷⁰ Section 43(1) TAA 53

⁷¹ Section 44(7) of the *Administrative Appeal Tribunal Act 1975*. *Avon Downs Pty Ltd v FCT* (1949) 78 CLR 353; *MacCormick v FC of T* (1945) 8 ATD 11; *Secretary, Department of Families, Housing, Community Services and Indigenous Affairs v Mouratidis* [2012] FCAFC 29

⁷² *FC of T v Administrative Appeals Tribunal & Ors* [2011] FCAFC 37 (*FCT v AAT*)

⁷³ Under section 292-465 ITAA 97

whether the decision or determination by the Commissioner may be the subject of review under Part IVC of the TAA.”

The Commissioner’s published views on the decision in *FCT v AAT* and the effects of that decision are:⁷⁴

“... that taxpayers will not be able to use the process in Part IVC of the TAA 1953 to seek review of certain assessments made under Division 292 of the ITAA 1997.

Specifically, an ECT assessment will not be reviewable under Part IVC of the TAA 1953 to the extent that:

- the basis for review is a determination, or refusal to make a determination under s 292-465 of the ITAA 1997 (for convenience, 'a s 292-465 decision'); and
- the taxpayer applied for the determination before 17 November 2010.

In such cases, the s 292-465 decision ('affected decision') is not part of the process of assessment.

Conversely, the Court’s ruling is not considered to affect the ability of a taxpayer to obtain review under Part IVC of the TAA 1953 of an ECT assessment ...”

In general terms, section 292-465 ITAA 97 (**S292-465**) permitted the Commissioner, on application by a taxpayer and if satisfied of certain matters, to make a determination that for the purposes of Division 292 ITAA 97, all or part of a person’s contributions were to be disregarded or allocated instead to another financial year specified in the determination. Analogous to the Commissioner’s discretions under Division 7A, and the S109RB Discretion in particular, prior to 17 November 2010, and the amending legislation, S292-465 did not expressly provided a determination under S292-465 may be included in a notice of assessment. The amending legislation also expressly allows a taxpayer to object against a S292-465 determination and ensures that the making of a determination under S292-465 is a decision forming part of the process of making an assessment for the purposes of the ITAA 97 and the *Administrative Decisions (Judicial Review) Act 1977 (ADJR Act)*.

12. NEW EMPHASIS ON ALTERNATIVE DISPUTE RESOLUTION AND ATO INTERNAL FACILITATION

In his address at the Tax Institute’s 28th Annual Convention in Perth on 14 March 2013, the newly appointed Commissioner, Chris Jordan prioritised the increasing use of dispute resolution processes to resolve taxpayer disputes in a timely manner. The Commissioner stated that:

“...[an] area of business I believe can be improved is the speed of resolving issues taxpayers have with us and even hopefully reducing the number of disputes...”

Our experts will in future be more visible and accessible - not 'faceless decision makers'...”

The Commissioner went on to say that:

“Resolving disputes is a significant investment for the ATO and for taxpayers: it can be costly, time and resource consuming, and a potential risk to our relationships and reputation if not well handled.”

On 1 August 2013, the ATO released *Practice Statement PS LA 2013/3 (PS LA 2013/3)* providing instructions to ATO personnel on what policies and guidelines must be followed when attempting to resolve or limit disputes by alternative dispute resolution (**ADR**). PS LA 2013/3 defines ADR is an umbrella term for processes, other than judicial or tribunal determination, in which an impartial person, assists those in a dispute to resolve or narrow the issues between them.

ATO obligations with respect to ADR

⁷⁴ ATO Decision Impact Statement: *FC of T v Administrative Appeals Tribunal & Ors*

PS LA 2013/3 further states that participation in the ADR by the ATO must be done fully and effectively. An obstructive or uncooperative attitude indicates a failure to participate in good faith. The ATO is to approach the ADR with 'good management' (i.e. in a way that is efficient, effective, economical and ethical and not inconsistent with the policies of the Commonwealth).

When to initiate ADR

While there is no optimal time for ADR, the ATO considers that the following are appropriate circumstances when ADR may be initiated:

- after the ATO issues a position paper during an audit;
- during a review at the objection stage before a final decision is made by an ATO officer; or
- during the litigation stage.

The ATO notes that attempting ADR too early may increase the overall cost to parties and cause unnecessary delay as parties may not be in an informed position to engage in discussions.

ATO expectations of taxpayers in ADR

Paragraph 27 of PS LA 2013/3 outlines the ATO's expectation of taxpayers in ADR:

The ATO expects taxpayers and their representatives to:

- be prepared, including ensuring that all relevant people are participating or directly accessible;
- participate fully, effectively and in good faith;
- be authorised to discuss and resolve the dispute;
- provide the ATO with all relevant documents prior to the ADR process; and
- be willing to negotiate and attempt to resolve all aspects of the dispute or clarify prior to the ADR process any limitation of the scope of the ADR process

ATO Internal Facilitation

In 2013 ATO initiated a pilot internal facilitation process. This process has now been extended to a range of disputes including less complex disputes arising from indirect tax, small business and individual audits and objections.

Facilitation is a process used by the ATO where an impartial ATO facilitator meets with the taxpayer/their tax agent and the ATO case officers to identify issues in dispute, develop options, consider alternatives, and attempt to reach an agreement to resolve disputes in a cost effective manner. The facilitator is given a broad mandate and importantly the facilitator is required to:

- act in an independent manner notwithstanding the facilitator's ATO employee status;
- to keep the taxpayer information disclosed during the facilitation confidential.

Division 7A Case Panel

All cases relating to the exercise of the S109RB Discretion were initially referred to, and deliberated before, the Division 7A Case Panel. We understand that this is no longer the case and that matters relating to non-compliance with Division 7A and applications for the

exercise of the Commissioner's discretion (including the S109RB Discretion) are being dealt with by the relevant case officer, with a review by members of the former Division 7A Case Panel in complex situations.

This together with the ATO's prioritising the use of ADR processes, such as its facilitation process, to resolve taxpayer disputes in a timely manner commend these processes for resolving Division 7A non-compliance and afford the taxpayer the opportunity to disclose any breaches which may have occurred and to put their request of the exercise of the Commissioner's discretion to the ATO in an informal and (relatively) relaxed environment and in a cost effective manner.

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