


PS LA 2011/29 - Exercising the discretion under section 109RB of Division 7A

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This Law Administration Practice Statement provides guidance on the process to be followed when considering exercise of the Commissioner's discretion under section 109RB.

This practice statement is an internal ATO document, and is an instruction to ATO staff.

Taxpayers can rely on this practice statement to provide them with protection from interest and penalties in the following way. If a statement turns out to be incorrect and taxpayers underpay their tax as a result, they will not have to pay a penalty. Nor will they have to pay interest on the underpayment provided they reasonably relied on this practice statement in good faith. However, even if they don't have to pay a penalty or interest, taxpayers will have to pay the correct amount of tax provided the time limits under the law allow it.

1. What is this practice statement about?

Section 109RB of Division 7A of the *Income Tax Assessment Act 1936*¹ provides relief for taxpayers who trigger a deemed dividend as a result of an honest mistake or inadvertent omission. Under section 109RB, the Commissioner has the discretion to either disregard a deemed dividend, or allow it to be franked.

2. Who is authorised to exercise the discretion on behalf of the Commissioner?

In all matters across the ATO, the following officers within the Private Groups and High Wealth Individuals (PGH) business line where it is in the proper course of their duties are authorised to exercise the discretion:

- Executive Level 2 (All)
- Executive Level 1 Team Leaders within Engagement & Assurance Services
- Executive Level 1 Authorising Officers of Technical Excellence Services, and
- Executive Level 1 Division 7A Risk Manager.

When considering the discretion, the decision maker must:

- consider each case on its merits, having regard to the object of section 109RB and Division 7A generally
- make the decision in good faith and without bias, and
- make the decision independently and not at the direction of another person.

3. When should I consider the discretion?

You should consider the discretion when it is requested by the taxpayer, the private company or an authorised representative or where you become aware of a breach of Division 7A during a review or audit.

A request by the taxpayer does not need to be in a particular form, but it should contain enough information and evidence to enable a decision to be made.

4. What is the basic prerequisite before the discretion can be exercised?

A breach of Division 7A must exist before the discretion can be considered.

This means Division 7A must apply to a transaction(s) with the result that:

- the private company is taken to have paid a deemed dividend to a shareholder or shareholder's associate which is included in their assessable income under section 44, or
- an amount is included in the assessable income of the shareholder or their associate as if it were a dividend by reason of Subdivision EA of Division 7A.²

Where there are multiple breaches of Division 7A, you must consider the facts and circumstances of each breach and make a separate decision in relation to each.

5. I have identified a breach – what's next?

The decision whether or not to exercise the discretion is a **two-step process**.

¹ All further legislative references are to the *Income Tax Assessment Act 1936* (ITAA 1936), unless otherwise stated.

² Subdivision EA of Division 7A deals with Deemed Dividends arising in relation to Unpaid Present Entitlements of a company.

Step 1: Did the breach of Division 7A arise because of an honest mistake or inadvertent omission?³

Only if the answer at step 1 is YES can you proceed to step 2.

Step 2: Do the facts and circumstances support the exercise of the discretion- to either disregard a deemed dividend, or allow it to be franked?

The guidelines relating to this process must not be applied in a rigid or inflexible way.

STEP 1

Did the breach arise because of an honest mistake or inadvertent omission?

First, establish whether or not the breach arose because of an honest mistake or inadvertent omission. The discretion can only be exercised where the breach arose due to an honest mistake or inadvertent omission. The thing that was mistaken or omitted must have caused the breach. If the breach would have occurred regardless of the mistake or omission, then it is not a breach that arises because of that mistake or omission.

The honest mistake or inadvertent omission may be made by the recipient, the private company, or any other entity whose conduct contributed to the breach.

You should first consider the conduct of the private company and the recipient to determine if there was an honest mistake or inadvertent omission.

6. What if there is insufficient evidence to establish the cause of the breach?

The onus is on the entity seeking the exercise of the discretion to provide sufficient evidence to demonstrate an honest mistake or inadvertent omission. However, you should make appropriate attempts to obtain sufficient evidence. You should discuss the evidence required with the taxpayer and give them a reasonable opportunity to provide more.

If there is not enough evidence to establish an inadvertent omission or honest mistake, the Commissioner cannot exercise the discretion. This should be communicated to the taxpayer when advising of this decision.

³ Taxation Ruling TR 2010/8 *Income tax: application of subsection 109RB(1) of the Income Tax Assessment Act 1936* contains detailed guidance on the meaning of honest mistake and inadvertent omission.

7. What types of mistakes and omissions may result in the breach?

An honest mistake or inadvertent omission may be a mistake of law, a mistake of fact or a mixed mistake of law and fact. Where a mistake of law occurs, you should have regard to the level of knowledge and expertise of the person who made the mistake.

What is a mistake or omission?

The following are examples of mistakes made in relation to Division 7A:

- an incorrect view or misunderstanding of what the laws is:
 - the meaning of a provision of Division 7A
 - the definition of 'associate' in section 318
 - the interaction of Division 7A with other areas of tax law, for example, Fringe Benefits Tax (FBT), or
 - the operation of contract law (which may effect whether a loan agreement is validly made).
- a mistake or omission in relation to a fact:
 - using a company cheque book or credit card believing that you are using a personal cheque book or credit card
 - mistakes in the recording of transactions, for example transposition errors, miscoding, or
 - errors made in calculating the minimum yearly repayment.
- a mistake or omission that involves both a misunderstanding about what the law is together with a mistake in relation to a fact, including:
 - errors made when drafting loan agreements, such as in the term/interest rate of the loan
 - loan agreements that are incorrectly executed
 - making a late repayment on a loan, or
 - failure to make minimum repayments.

8. What facts and circumstances do I take into account in determining whether a mistake was honest, or an omission inadvertent?

You must consider all of the following factors equally. A mistake or omission needs only to be honest or inadvertent.

Relevant facts and circumstances that support honest mistake or inadvertent omission

- the relevant transactions were commercial (that is, accurately and completely recorded, independently audited)
- the party can demonstrate a good Division 7A compliance history (that is, genuine past attempts to comply with Division 7A both in general and in respect of the specific matter)
- the taxpayer has reasonably relied on professional advice, or has adopted a position that is a common mistake or omission
- other contributing factors may include:
 - the complexity of the facts
 - novel or contentious issues of law, or
 - a lack of ATO advice or guidance covering the facts or the law.⁴

Ignorance of the law is not in itself sufficient evidence to establish *honest* mistake or *inadvertent* omission. The reason for that ignorance is equally important.

Relevant facts and circumstances which weigh against honest mistake or inadvertent omission?

- the relevant transactions were uncommercial (that is, the arrangement had a purpose of avoiding tax or involved fraud or evasion; the transaction was artificial, not accurately or completely recorded or was not subject to independent review)
- the entity's behaviour and knowledge do not support a conclusion of honest mistake or inadvertent omission (that is, the entity had the relevant knowledge of Division 7A; Division 7A had previously applied in similar circumstances to the entity or the relevant party has a poor compliance history)
- the entities involved consciously or unreasonably avoided obtaining advice in relation to the relevant application of Division 7A or unreasonably relied on or ignored professional advice

⁴ A precedential ATO view is the ATO's documented interpretation of the tax laws administered by the Commissioner in relation to a particular interpretive issue, see Law Administration Practice Statement PS LA 2003/3 *Precedential ATO view*. The types of documents which set out ATO views are listed at paragraph 3 of PS LA 2003/3 and in the Schedule of documents containing precedential ATO views.

- other contributing factors may include:
 - the breach and associated transactions are straight forward or involve a straightforward application of the law, and
 - the breach involved transactions that are identified in publicly available and relevant ATO advice, or ATO advice⁵ provided to the taxpayer.

What if the transaction was intended to avoid the application of Division 7A?

Actions or omissions made to circumvent Division 7A cannot satisfy the requirements of honest mistake or inadvertent omission. Evidence that there has been a deliberate indifference or wilful blindness would not satisfy the requirement of honesty and would not constitute an honest mistake.

What if the taxpayer has relied on professional advice?

You must carefully consider:

- the underlying facts
- the disclosures made to the advisor
- the nature of the advice actually given
- the relationship between the taxpayer and their advisor
- whether the advice was relied on, and
- whether reliance on that advice was reasonable.

Where a taxpayer obtains and reasonably relies on advice from a professional advisor, any mistake or omission resulting from that reliance is likely to be honest or inadvertent.

Where a relevant entity has intentionally ignored professional advice this would tend to weigh against a conclusion that any resulting mistake is honest or omission inadvertent. This is particularly so if, had the taxpayer followed the advice, the breach wouldn't have occurred.

Where an entity knew or ought to have known that the adviser was prepared to disregard Division 7A, reliance on that advice is not likely to be reasonable. This is so even if the taxpayer made a full disclosure to the advisor.

⁵ ATO advice includes ATO education activities, such as webcasts, bulk mail outs and fact sheets, Public Rulings, Private Rulings, Law Administration Practice Statements, Taxpayer Alerts and any other relevant advice published by the ATO.

What if the taxpayer has not obtained professional advice?

Consider why the taxpayer failed to obtain professional advice. Relevant considerations include the size, complexity and nature of the transaction and the taxpayer's knowledge of Division 7A.

If the taxpayer did not seek advice due to wilful blindness, this would not constitute an honest mistake. Conversely a taxpayer may not obtain specific advice due to a genuine belief that they understood the law. Even though it might be reasonable to obtain advice in the circumstances, it can still be established that there was an honest mistake or inadvertent omission.

What if the breach is the result of a lack of knowledge of Division 7A?

A breach of Division 7A may result from a simple misunderstanding to intentional ignorance.

You need to identify and assess the extent to which the lack of knowledge caused the breach. Some relevant factors may be:

- the extent of and reasons for the lack of knowledge
- how the lack of knowledge contributed to the breach
- the taxpayer's attitude towards Division 7A generally
- the extent to which an advisor was engaged and briefed, and
- prior tax knowledge and experience of anyone involved in the transaction.

It is generally expected that a registered tax agent would be aware of the core provisions of Division 7A.

You should also consider if objective evidence in the form of a ruling request, correspondence or compliance activity indicates an awareness and knowledge of Division 7A. You must then consider this evidence in light of all the relevant circumstances.

What if the breach of Division 7A was of a kind that commonly happens?

Honest mistake or inadvertent omission is not always concluded in the case of a common mistake or industry practice. The taxpayer still bears the onus of proving that theirs was an honest mistake or inadvertent omission.

9. What evidence do I need to consider?

You must have sufficient information and relevant evidence to determine:

- the particular provision that has been breached
- the breach arose because of an honest mistake or inadvertent omission
- who made the mistake or omission
- how, why and when the mistake or omission occurred
- how, when, and by whom the breach was identified
- the use or application of the funds that resulted in the breach
- corrective action taken or proposed, and
- any other information or evidence that will help you to make a decision.

The following is a list of relevant evidence, which is not exhaustive:

- statements by relevant parties
- accounting records such as:
 - ledger accounts recording transactions, and
 - journal entries and supporting documents.
- minutes of meetings
- correspondence
- loan agreements, trustee resolutions or director's minutes and resolutions
- Division 7A working papers
- tax return preparation and information
- invoices or other source documents
- advice, and
- evidence which goes to knowledge, awareness or intent.

How should I deal with undocumented assertions?

Given the record keeping obligations that apply to businesses, a finding of honest mistake or inadvertent omission should ordinarily be corroborated with documentary evidence. However, you should consider the size of the enterprise when considering the extent of the record keeping required.

What if there is incomplete or conflicting evidence?

Generally, contemporaneous evidence should hold greater weight than evidence generated and assertions made after the fact.

STEP 2

Should the Commissioner's discretion be exercised? If so, how?

Once you have established that a breach of Division 7A occurred because of an honest mistake or inadvertent omission you can proceed to Step 2. This step requires you to consider whether you should exercise the discretion and if so how, including whether to attach conditions to the decision.

There is no presumption to exercise the discretion until Step 2 has been fully undertaken.

10. What do I need to consider in making a decision whether to exercise the discretion?

You must consider all of following factors set out in subsection 109RB(3).

- (a) the circumstances that led to the mistake or omission - 109RB(3)(a)
- (b) the extent to which any of the entities have taken corrective action, and if so, how quickly - 109RB(3)(b)
- (c) whether Division 7A has applied previously in relation to any of the relevant entities - 109RB(3)(c), and
- (d) any other relevant matters - 109RB(3)(d).

Generally, these can be the same factors to establish an honest mistake or inadvertent omission.

11. What were the circumstances in which the mistake or omission was made?

Subsection 109RB(3)(a) requires you to consider the circumstances in which the relevant mistake or omission was made.

- Did the taxpayer take reasonable care?⁶
- Did the relevant entity act in accordance with professional advice?

⁶ For a discussion on what is considered a reasonable care, see Miscellaneous Taxation Ruling MT 2008/1 *Penalty relating to statements: meaning of reasonable care, recklessness and intentional disregard*.

- Were there any unforeseen personal circumstances (such as sudden illness) that affected the ability to comply with Division 7A?
- Was ATO guidance publicly available and widely publicised or provided directly to the taxpayer or their agent?
- Was the breach part of a broader behaviour that involved tax avoidance, fraud or evasion?
- Was the taxpayer's application of a provision of Division 7A contentious or do they have a reasonably arguable position?⁷
- Given the complexity of the business and business records what is the likelihood of self detection of the breach?
- What attempts did the taxpayer make to comply with Division 7A?
- Are the transactions commercial in nature?
- To what extent were the relevant transactions recorded in the financial statements?
- What was the Division 7A knowledge of other relevant parties to the transaction?

12. To what extent, and when, has appropriate corrective action been taken?

Taking timely and appropriate corrective action will weigh in favour of exercise of the discretion.

What constitutes corrective action?

Appropriate corrective action should put the relevant parties in the position that they would have been in if Division 7A had not been breached.

Corrective action includes:

- converting the payment, loan or debt forgiveness to a loan that complies with section 109N, and
- making catch-up or shortfall minimum yearly repayments as if the transaction always complied with section 109N (plus interest compounded to reflect non-payment in earlier years).

The corrective action required in respect of specific breaches of Division 7A is contained in Appendix A of this practice statement.

⁷ For a discussion on what is considered a reasonably arguable position, see Miscellaneous Taxation Ruling MT 2008/2 *Shortfall penalties: administrative penalty for taking a position that is not reasonably arguable*.

What is the relevance of the time when corrective action is taken?

Where a taxpayer takes prompt corrective action after becoming aware of the Division 7A breach, this will weigh in favour of exercise of the discretion.

What if there is a delay in taking corrective action or the taxpayer is only willing to take corrective action if the Commissioner's discretion is exercised?

Taxpayers seeking exercise of the discretion to have the deemed dividends disregarded should have voluntarily and unilaterally implemented corrective action, unless it was unreasonable (for example, the corrective action would have been costly or unduly inconvenient).

A taxpayer may genuinely and reasonably believe that taking corrective action should be conditional on the exercise of the discretion. This will not weigh against the exercise of the discretion where the taxpayer makes a timely application to the Commissioner for the discretion,

What if the taxpayer is unwilling to take corrective action?

Where it is reasonable for a taxpayer to have taken corrective action and they are unwilling to do so, this will weigh against exercise of the discretion.

A taxpayer may genuinely and reasonably believe that corrective action is not warranted. This will not weigh against the exercise of the discretion where the taxpayer makes a timely application to the Commissioner for the discretion.

13. Has Division 7A been breached previously and if so, in what circumstances?

A taxpayer who has previously breached Division 7A (whether or not the Commissioner exercised his discretion in relation to this earlier breach), would be expected to show greater vigilance. Where there has been no increase in the care taken in relation to the application of Division 7A, this will weigh against the exercise of the discretion.

Where the relevant entities were aware that substantially the same transactions had previously breached Division 7A, this will generally weigh against exercise of the discretion.⁸

⁸ This is also relevant to determining whether the breach is a result of an honest mistake or inadvertent omission, see TR 2010/8 at paragraph 98.

14. Any other relevant matters: 109RB(3)(d)

The meaning of 'any other matters' is wide ranging.

A matter is relevant if:

- it provides further insight into circumstances surrounding the breach including discovery of the breach and any corrective action, and
- whether the purpose of Division 7A as an integrity provision (to prevent the tax free distribution of company profits) will be met if you exercise the discretion.

It may be relevant to look more widely at the conduct and knowledge of all of those who were in any way involved in the mistake or omission.

The longer the period of inaction after having discovered the breach without a satisfactory explanation, the greater likelihood that the discretion will not be exercised.

What if a person knew the transaction being undertaken would breach Division 7A but did nothing to prevent that result?

If a person knew the transaction being undertaken would breach Division 7A, then this would weigh against exercise of the discretion.

15. Making a decision under subsection 109RB(2) to either disregard a deemed dividend or allow it to be franked

You need to consider which of the two outcomes in subsection 109RB(2) is the most appropriate.

Subsection 109RB(2) allows either:

- a deemed dividend or the assessable amount under Subdivision EA, to be disregarded, or
- the deemed dividend be franked in accordance with Part 3-6 of the *Income Tax Assessment Act 1997*.

Any decision to disregard a deemed dividend, or allow it to be franked, should reflect these outcomes, as relevant:

- the retained profits of the private company are restored to the private company
- the private company receives the correct repayments of principal and interest that it would have received under a section 109N loan agreement, and pays tax on the amount of interest income, or
- the recipient of the benefit is appropriately taxed.

The power of the Commissioner to allow franking does not apply to the amount included in the assessable income of a shareholder's associate under Division 7A (including Subdivision EA).

What factors do I need to consider to disregard the dividend or allow it to be franked?

Relevant factors include:

- the extent and nature of corrective action including the capacity of the entities to take the corrective action
- the effect of franking a deemed dividend on the franking account
- whether the franking of a deemed dividend will result in franking credit streaming, and
- the period of review for the shareholder or their associate who has received the franked dividend.

Should I exercise the discretion subject to a condition?

Subsection 109RB(4) authorises the Commissioner to exercise his discretion subject to the following kinds of conditions:

- a condition that the recipient or other entity must make specified payments to the private company or another entity within a specified time, or
- a condition that a specified requirement in Division 7A must be met within a specified time.

If the Commissioner exercises his discretion subject to a condition, the relevant deemed dividend **is not disregarded until such time as any conditions imposed by the Commissioner are satisfied**.⁹ Therefore, any amount assessable as a result of Division 7A remains assessable if the condition is never satisfied.

Where appropriate corrective action hasn't been taken, it is only in exceptional cases that you should exercise the discretion to disregard the dividend without imposing conditions requiring remediation.

Exercise of the discretion by allowing a deemed dividend to be franked does not require conditions.

What is a reasonable time to require the corrective action be taken?

Any corrective or remedial action should normally be required in the income year in which the Commissioner's discretion is exercised. However you should consider:

- (a) circumstances that make it more appropriate to satisfy conditions in a later income year
- (b) the time reasonably required to undertake the corrective action, and
- (c) the period(s) of review for the income year in which the breaches occurred.

Your decision must be made in writing (see Appendix B of this practice statement)..

16. What review rights are there in respect of a decision made under section 109RB?

If a taxpayer is dissatisfied with an assessment affected by a decision not to exercise the discretion, they may object¹⁰ to the assessment on the grounds of a failure to properly exercise the section 109RB discretion.

If a taxpayer is dissatisfied with the objection decision, the taxpayer can either apply to the Administrative Appeals Tribunal (AAT) or to the Federal Court against the decision (section 14ZZ of the TAA). If any jurisdictional difficulty arises in the AAT or the Court, the Commissioner will co-operate with the taxpayer to have the issue properly tested.

17. Should I refer the tax agent to the tax practitioner's board?

Where you become aware of a tax agent who has demonstrated a lack of competence, you should consider referring them to the Tax Practitioners Board in respect of a potential breach of the Code of Professional Conduct under section 30-10 of the *Tax Agent Services Act 2009*.

18. More information

Relevant examples can be accessed on the ATO website. As these examples will be updated from time to time, you should refer to them at each time you are considering the discretion. For more information, follow these internal links:

- [Division 7A Portal on eLibrary Wiki](#)
- [Section 109RB](#)

⁹ Subsection 109RB(5).

¹⁰ Under section 175A of the ITAA 1936 in the manner set out in Part IVC of the *Taxation Administration Act 1953* (TAA).

- [Division 7A legislation on ATOLaw](#)
- [Section 109RB](#)

External links:

- [Fact Sheet with examples](#)

APPENDIX A

WHAT IS CORRECTIVE ACTION?

CATEGORY	APPROPRIATE CORRECTIVE ACTION
1. The deemed dividend arose in respect of a payment under section 109C or a loan under section 109D	<ul style="list-style-type: none"> The full amount of the payment is converted to a loan, a loan agreement is executed that complies with section 109N at all times from the time the deemed dividend arose, and the taxpayer makes 'catch up' minimum yearly repayments of interest and capital as if the loan existed from the time the deemed dividend arose.
2. The deemed dividend arose in respect of section 109E and modified for Subdivision EA	The taxpayer makes 'catch up' minimum yearly repayments of interest and capital as if the loan existed from the time the deemed dividend arose.
3. The deemed dividend arose in respect of a debt forgiveness under section 109F	<ul style="list-style-type: none"> A loan agreement is entered into that complies with section 109N at all times from the time the deemed dividend arose, the principal of the loan equals the amount of the debt forgiven, and the taxpayer makes 'catch up' minimum yearly repayments of interest and capital as if the loan existed from the time the deemed dividend arose.
4. The deemed dividend arose in respect of an assessable amount under section 109XB	<p><i>In the case of a subsection 109XA(1) payment:</i></p> <ul style="list-style-type: none"> the subsection 109XA(4) amount involved in the actual transaction is converted to a loan and a loan agreement is entered into that complies with section 109N at all times from the time the deemed dividend arose, <p><i>In the case of a subsection 109XA(2) loan:</i></p> <ul style="list-style-type: none"> a loan agreement between the taxpayer and the trustee is entered into for the subsection 109XA(4) amount that complies with section 109N at all times from the time the deemed dividend arose, <p><i>In the case of a subsection 109XA(3) forgiven debt:</i></p> <ul style="list-style-type: none"> the subsection 109XA(4) amount involved in the actual transaction is treated as the principal of a loan and a loan agreement is entered into that complies with section 109N at all times from the time the deemed dividend arose, and in any of the situations covered by the three preceding dot points the taxpayer makes 'catch up' minimum yearly repayments of interest and capital as if the loan existed from the time the deemed dividend arose.

APPENDIX B

WHAT section 109RB DECISIONS ARE POSSIBLE?

Most section 109RB decisions will fall into one of the following five categories:

CATEGORY	STEP 1 Outcome	STEP 2 Outcome
1. Exercise the Commissioner's discretion without conditions	Pass	Exercise the discretion without conditions, because corrective action is not necessary or has already been taken
2. Exercise the Commissioner's discretion with conditions	Pass	Exercise the discretion, but with conditions attached because corrective action has not occurred and must be taken
3. Decision not to exercise the Commissioner's discretion	Fail, because the Commissioner is unable to establish that there is an honest mistake or inadvertent omission.	Cannot go to Step 2 because Step 1 failed
4. Decision not to exercise the Commissioner's discretion	Pass	Commissioner decides not to exercise his discretion having considered the factors in subsection 109RB(3)
5. Based on the evidence presented, the Commissioner is unable to make a decision	Fail because of insufficient or ambiguous evidence	Cannot go to Step 2 because Step 1 failed

Decisions 3 and 5 are similar. Decision 3 assumes that there is not likely to be more evidence presented, whereas decision 5 enables the taxpayer or tax agent to provide more evidence if available.

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