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DIVISION 7A - Amnesty

Background

Division 7A of Part III of the ITAA 1936 is an integrity provision aimed at preventing private companies from making tax-free distributions of profits to shareholders (or their associates). In particular, advances, loans and other payments or credits to shareholders or associates are, unless they come within specified exclusions, treated as assessable dividends to the extent that there are realised or unrealised profits in the company.

When a deemed dividend arises under Division 7A the private company's franking account is debited and the shareholder or associate pays tax on the deemed dividend at their marginal rate of tax.

Amendments have been recently made to Division 7A that reduce both the extent to which taxpayers are inadvertently caught by the division and the punitive nature of the provisions. Specifically, the amendments will

- reduce the double-penalty nature of Division 7A by removing the automatic debiting of the private company's franking account when a deemed dividend arises under the Division;
- provide a discretion to the Commissioner to disregard deemed dividends (or allow them to be franked) where they have been triggered by honest mistakes or omissions by taxpayers;
- provide a discretion to the Commissioner to disregard a deemed dividend where minimum yearly repayments have not been made on a loan because of circumstances beyond the control of the taxpayer;
- make technical amendments to Division 7A and related areas of taxation law to provide more flexibility for taxpayers and to reduce the extent to which they can be caught by Division 7A inadvertently; and
- exempt Division 7A compliant loans from Fringe Benefits Tax.

Commissioner's Discretion – Practice Statement

The Commissioner has issued an important practice statement, providing where a deemed dividend has arisen as a result of an honest mistake or inadvertent omission between the 2001-2002 to 2006-2007 income years, there is a one-off opportunity to take corrective action before 30 June 2008 to "cure" that deemed dividend without the need to make a written request for the Commissioner to exercise his discretion, thereby making the requirements cheaper and easier to comply with.

The purpose of the Practice Statement is to provide guidance on the Commissioner's approach during the initial transitional period where taxpayers take specific "corrective action" to put themselves in a position that complies with the present Division 7A requirements.

Broadly, the Commissioner's discretion will be exercised in the taxpayer's favour where the following conditions are satisfied:

- it is clear from all the circumstances currently within the Commissioner's knowledge that the failure to comply with the provisions of Division 7A was the result of an honest and inadvertent omission by the taxpayer, a private company or other relevant party;
- corrective action has been taken by the taxpayer before 30 June 2008;
- the deemed dividend arose in respect of a transaction or action that occurred after 30 June 2001 and by the end of the 2006 / 2007 income year; and
- the taxpayer has lodged all the required income tax returns for the 2001-2002 to 2006-2007 income years (if necessary).

It is important to note however that there is no deemed exercise of discretion where the above conditions are satisfied and where other circumstances outweigh the corrective action taken by the taxpayer, the Commissioner's discretion may not be exercised.

What is considered to be an honest mistake and inadvertent omission?

The explanatory memorandum states that the question of whether such a mistake or omission has occurred is an objective one to be determined with reference to all the circumstances surrounding the failure to comply with the Division 7A requirements. Furthermore, it is likely that a taxpayer will need to be able to demonstrate to the Commissioner that the failure was the result of an honest mistake or inadvertent omission.

What is corrective action?

Essentially, the Practice Statement requires the taxpayer to take a form of corrective action that ensures that the taxpayer's actual loan balance is equivalent to what it would have been had the taxpayer complied with the requirements of Division 7A throughout the period that began with the year in which the deemed dividend arose.

The Practice Statement documents in detail the various types of corrective action required to be taken by a taxpayer. Broadly, these actions are as follows:

- If the deemed dividend arose because of a payment then corrective action means converting the payment into a loan and entering into a loan agreement and making repayments as outlined below.
- If the deemed dividend arose because of a debt forgiveness then corrective action means treating the amount of debt forgiven as the principal of a loan and entering into a loan agreement and making repayments as outlined below.
- If the deemed dividend arose because of payments, loans or debt forgiveness by trustees to shareholders (or associates) of private companies with unpaid present entitlements then similar corrective action must be taken in respect of those payments, loans or debts forgiven.

For more information on any aspect of the amendments to the Division 7A deemed dividend rules, please contact Michelle Saunders on (08) 6311 6911 or Marissa Bechta on (08) 6311 6933.

How are repayments calculated?

The repayments that form part of the corrective action must equal the total amount of the minimum yearly repayments that would have been payable had the taxpayer made minimum yearly repayments throughout the period that began with the year in which the deemed dividend arose. Such a payment is made up of two components:

- capital component – an amount equalling the difference between the original amount of the loan and the carried forward loan balance on 1 July 2008 if all complying minimum yearly repayments had been made (less any actual capital repayments made prior to 1 July 2008), and
- interest component – an amount equalling the sum of the annual interest that would have accrued on the loan from the date the loan should have commenced with interest compounding (less any interest actually paid prior to 1 July 2008).

Uncertainties

Both the changes to Division 7A and the introduction of the amnesty in the practice statement are good news!

Whilst the Practice Statement provides taxpayers with guidance on how the ATO may exercise the Commissioner's discretion, uncertainties exist as to the extent of reliance that can be placed on the Practice Statement. Accordingly, those taxpayers wanting certainty that the Commissioner will exercise his discretion in this regard may still prefer to consider obtaining a favourable private binding ruling.

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