

# sharptax

Grant Thornton periodical  
reporting on taxation issues  
for business owners.

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## In this edition of **sharptax** we explore the Commissioner's one-off opportunity to correct past Division 7A errors without penalty...

The Commissioner has released PS LA 2007/20 (the practice statement) which effectively allows a taxpayer to "self assess" the Commissioner's discretion and deem a dividend under Division 7A for certain benefits received by shareholders of private companies and their associates. Taxpayers do not need to write to the Commissioner to seek his discretion where certain criteria have been met.

The criteria that must be met in order for taxpayers to self assess the Commissioner's discretion are:

- it is clear from all the circumstances currently within the Commissioner's knowledge that the failure to comply with one or more of the provisions of Division 7A was the result of an honest mistake or inadvertent omission
- 'corrective action' has been taken by the taxpayer on or 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 2006-07 year of income, and
- the taxpayer has lodged all required income tax returns for the 2002 to 20007 income years if necessary.

### Honest mistake or inadvertent omission

The first criterion is by far the most subjective; hence care should be taken in weighing up the various factors before seeking to make a determination on the Commissioner's behalf. Circumstances that may be considered to be an honest mistake or inadvertent omission include:

- using the wrong interest rate on a loan
- not considering Division 7A in relation to a loan in the belief that the loan was made on commercial terms
- mistakenly thinking that Division 7A did not extend to loans made to trusts.

### Corrective action

Under the practice statement, corrective action will require a loan agreement to be put in place, an interest payment based upon the Division 7A benchmark rate and the outstanding balance at each intervening year, and a principle loan repayment that brings the outstanding balance to what it would have been if Division 7A had been complied with from the start.

If a loan agreement had previously been put in place but an inappropriate level of repayments were made then the corrective action would need to include topping up the repayments to bring them into line with Division 7A requirements.

Another interesting comment made in the practice statement is a reference to 'other circumstances' that may negate the effect of corrective action, resulting in the Commissioner not exercising his discretion should the taxpayer ever be subject to a review by the ATO. While the practice statement fails to shed further light on what 'other circumstances' may entail, we recommend that all relevant facts and circumstances concerning the parties involved in the Division 7A transaction be considered before exercising the Commissioner's discretion on his behalf.

# New Japanese double tax agreement

Australia has reached an in principle agreement with Japan on the terms of a new double tax agreement (DTA). Highlights of the new DTA include:

- dividend withholding tax rate to be reduced from 15% to:
  - 0% for inter-company dividends with ownership of at least 80%
  - 5% for inter-company dividends with ownership of more than 5% but less than 80%
  - 10% for all other dividends except for real estate investment trusts
- royalty withholding tax to be reduced from 10% to 5%
- financial and government institutions to be exempt from interest withholding tax
- taxing rights for income under Tokumei-Kumiai (TK) contracts to rest with the source country

## 'Wash sales' and Part IVA

The Commissioner has released draft Taxation Ruling TR 2007/D7 where he sets out his view that Part IVA should apply to 'wash sales'. By this, the Commissioner is referring to transactions by a taxpayer that give rise to a capital loss where the taxpayer ultimately retains control of the asset disposed of.

An example of a wash sale is where a taxpayer sells shares in a listed company (realising a loss) only to buy the shares back shortly after. The Commissioner is also concerned with transactions involving associates, such as a taxpayer selling an asset to a family trust to realise a loss.

Under TR 2007/D7, the Commissioner may apply Part IVA where:

- the arrangement is complicated, artificial or out of the ordinary
- a taxpayer has somehow disposed of their beneficial interest in an asset but continues to benefit from the asset
- the arrangement is conducted over a short period of time, and the arrangement coincides with either a capital gain or the end of the year
- the arrangement results in a capital loss that is immediately utilised by a taxpayer
- if an associate was involved, the financial position of the associate is substantially unchanged or is offset by an inverse change in the financial position of the taxpayer

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## Franking rules

While many are comfortable with the dividend franking rules in general, this area of the law has been known to catch many taxpayers off-guard, often only when it is too late for rectification. Some commonly encountered problems with franking accounts are set out below.

### Early tax payments do not give rise to franking credits

Companies will commonly reconcile their franking accounts during June each year and will make an early payment of income tax if their franking accounts are in deficit. However, this payment does not give rise to a franking credit until the tax return is lodged.

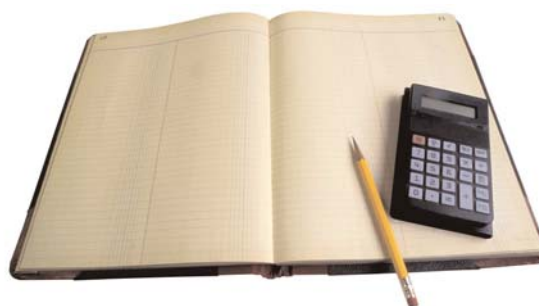
The only income tax payments that can give rise to a credit prior to lodging the income tax return are PAYG instalments. Even these instalments don't give rise to franking credits until either the first day after the end of a quarter or when the instalment is paid, whichever is later.

Therefore franking accounts should be reconciled before the third PAYG instalment is paid to the ATO, so that any anticipated franking account deficit can be rectified by varying the PAYG instalment upwards.

### The benchmark rule does not differentiate between classes of equity

Not all companies are aware that a benchmark rule applies evenly across all classes of equity issued by the company. This means that the first dividend paid in a year in respect of any equity interest in a company sets the franking benchmark that all other dividends must meet.

Following on from this, percentage interest paid on loans that are regarded as equity under the debt/equity rules must also meet the benchmark, or alternatively can set the benchmark for a company.



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