

## update

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## Making mistakes, Division 7A style!

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In his article "Division 7A - Now at your Discretion?", at 2007 WTB 35 [1528], Mark Pizzacalla makes the salient point that it will always be a very difficult task in determining whether or not an honest mistake or an inadvertent omission has been made. Mark says 'The examples given in Practice Statement PS LA 2007/20 ["PS"] deserve some grass roots examples which would be well received by practitioners.'

I commend Mark's view. The examples provided in the PS are either unrealistic, already substantially comply with Div 7A, or in themselves exhibit no mistake, let alone an honest mistake.

The PS says that a taxpayer can only take corrective action on or before 30 June 2008 if, and only if, 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 Div 7A was the result of an honest mistake or an inadvertent omission.

In this article, I want to talk about honest mistakes, because unlike an inadvertent omission where something happens which didn't require a preceding act, an honest mistake happens if someone does something, and the consequence of that act is an unintended or unwanted outcome.

### *An inherent problem with the PS*

When one reads s 109RB in its entirety, it becomes clear that there is an inherent problem with the PS. This is because the Act requires that if the Commissioner is satisfied that there is an honest mistake and then makes a decision, it must be in writing. This is the law. The PS has no such requirement.

There is also another argument that taxpayers should not be given the opportunity to essentially self-assess whether they satisfy the threshold condition of having previously made an honest

mistake before taking corrective action. It is argued that the PS rewards those taxpayers who were aware of an obligation to pay income tax because of Div 7A, but for whatever reason, decided to refrain from making full disclosure to the Commissioner, unlike other taxpayers who made such disclosure and paid additional taxes.

Those "honest" taxpayers are now disadvantaged because they now need to go through the objection process, provided they are still in time.

### *So what is the threshold test?*

Mark Pizzacalla referred to the two-stage decision making process that the Commissioner needs to undertake. The first stage is the ability to establish to the Commissioner's satisfaction that there has been an honest mistake. Unless the first stage is established, the Commissioner cannot proceed to the next stage.

I'd like to think that there is a further two stage decision making process within the first stage i.e. is there a mistake, and if so, is the mistake itself honest?

It is the overall circumstances in which the mistake was made by a taxpayer that clothes the mistake in honesty and then allows the Commissioner to exercise his discretion. There is no "reasonable person" test. Asking if a reasonable person would have done the same thing is incorrect and will invariably lead to an erroneous result.

### *Example*

It is submitted that the "honesty" requirement will prove to become problematic for the Commissioner, the AAT and the Courts. To illustrate this difficulty, consider the following factual scenario.

*Iphigenia controls a private company and the family trust. The private company has a*

*substantial distributable surplus and cash resources.*

*In 2004, the family trust constructed a commercial property and rented it to the private company. The trust did not have the resources to undertake the construction and a commercial bank required the private company to lend funds to the trust before advancing further funds.*

*Iphigenia wanted the construction to happen in the trust which is why she made the loan without a written loan agreement.*

*Iphigenia had been told some years earlier that loans by the private company could be taxed but overlooked this at the time of the loan.*

*In subsequent income tax returns for the company, the presence of the debit loan account in the company's balance sheet was not disclosed to the Commissioner, although it was partially reduced by the company declaring dividends.*

Has Iphigenia made a mistake and if so, was it honest?

### *Honest mistake*

Paragraph 1.33 of the *Explanatory Memorandum* introducing the changes to Div 7A says that whether or not there is an honest mistake is an objective question to be determined by reference to all the circumstances surrounding the failure to satisfy the requirements of Div 7A.

A mistake happens when something was done when it shouldn't have been done. It is the consequence of the act that generally determines if a mistake was made. Usually, it is because of ignorance of the consequences. For example: "I did not know that I may have to pay tax if a private company lent money to a related trust".

It can also be because of forgetfulness. For example: "I forgot that that I may have to pay tax because a private company lent money to a related trust."

The concept of "mistake" is settled under the law. There is a rule that ignorance of the law does not excuse those who break the law. The policy of the changes to Div 7A now effectively overrules that principle. In fact, it appears that it is only ignorance of Div 7A that can allow a taxpayer to take corrective action or to get the benefit of the Commissioner's discretion.

Another principle of the law is that a person who does or omits to do an act under an honest and reasonable, but mistaken, belief in the existence of any state of things is not criminally responsible for the act or omission to any greater extent than if the real state of things had been such as he believed to exist. This is commonly referred to in the law as a mistake of fact.

For example: "I did not know that I may have to pay tax if a private company lent money to a related trust", may be a mistake of fact as to the consequences, but the transaction itself was not a mistake. In other words, a taxpayer needs to objectively show that because of the income tax consequences, the transaction would not have occurred.

### *The difficulty with the new law*

And this is the difficulty with the new changes to the law. If we consider Iphigenia above, it is clear that there is no mistake in making the loan. It was necessary for it to be effected. Despite what Iphigenia knew in her own mind subjectively, if she wanted to rely on the PS, she would have to show that the loan would not have occurred if there were adverse tax consequences.

This simple example clearly shows that the relevant "mistake" is not the making of the loan, but that there would be adverse income tax consequences because of the loan.

How does Iphigenia objectively show her "honesty", given that she knew the broad policy of Div 7A but still effected the loan anyway? It is submitted that it would be virtually impossible for her to prove she did not know about the way in which Div 7A operated.

It becomes a circular argument, and it is this precise requirement that illustrates the difficulty the courts and the AAT will have.

Put another way, Iphigenia can prove she knows about Div 7A today, but how can she prove she didn't know about Div 7A in 2004?

On these simple facts, how can the Commissioner ever be satisfied about "honesty" within a "mistake"? What could a taxpayer possibly do to prove "honesty"?

### *Conclusion*

It is submitted that if the Commissioner applies the new provisions of Div 7A, there will only be a limited number of occasions when the discretion will be properly exercised.

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