TD 2006/59 - Income tax: consolidation: subsidiary in liquidation: are unsatisfied debts of a subsidiary at the time of deregistration, being debts owed to creditors outside of the consolidated group, accounting liabilities for the purposes of subsection 711-45(1) of the Income Tax Assessment Act 1997?

Taxation Determination

Income tax: consolidation: subsidiary in liquidation: are unsatisfied debts of a subsidiary at the time of deregistration, being debts owed to creditors outside of the consolidated group, accounting liabilities for the purposes of subsection 711-45(1) of the *Income Tax Assessment Act 1997*?

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Ruling

1. Yes. The unsatisfied debts of a subsidiary at the time of deregistration are recognised as accounting liabilities in accordance with accounting standards. Therefore they are accounting liabilities of the subsidiary just before the leaving time for the purposes of subsection 711-45(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) in accordance with the leaving entity's accounting principles for tax cost setting.

Date of effect

2. This Determination applies both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination.

Commissioner of Taxation
27 September 2006

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Explanation

3. Subsection 711-5(1) of the ITAA 1997 explains that Division 711 of the ITAA 1997 will have effect for head company core purposes 'if an entity (the ***leaving entity***) ceases to be a subsidiary member of a consolidated group (the ***old group***) at a particular time (the ***leaving time***)'.

4. Subsection 711-5(2) of the ITAA 1997 explains the object of Division 711 is to preserve the alignment of the head company's costs for membership interests in entities and their assets that is established when entities become subsidiary members. Subsection 711-5(3) of the ITAA 1997 explains that alignment is achieved by recognising the head company's costs for those membership interests, just before the leaving time, as an amount equal to the cost of the leaving entity's assets at the leaving time reduced by the amount of its liabilities.

5. Under section 711-20 of the ITAA 1997, if the 'allocable cost amount' for those membership interests is a negative figure (broadly, where the liabilities of the leaving entity exceed its assets) the head company is taken to have made a capital gain under CGT event L5.

6. In order to give effect to the objects and application of Division 711 of the ITAA 1997, subsection 711-45(1) of the ITAA 1997 determines the liabilities of the leaving entity just before the leaving time.[1A]

7. Subsection 711-45(1) of the ITAA 1997 states:

> For the purposes of step 4 in the table in subsection 711-20(1), the step 4 amount is worked out by adding up the amounts of each thing (an ***accounting liability***) that, in accordance with the leaving entity's *accounting principles for tax cost setting, is a liability of the leaving entity just before the leaving time.

7A. Subsection 711-45(1A) of the ITAA 1997 provides that the 'leaving entity's accounting principles for tax cost setting' are the accounting principles that the group would use if it were to prepare its financial statements just before the leaving time. Section 995-1 of the ITAA 1997 provides that a matter is in accordance with accounting principles if it is in accordance with accounting standards; or, if there are no applicable accounting standards - authoritative pronouncements of the Australian Accounting Standards Board that apply to the preparation of financial statements.

[1A] For how the law in relation to step 4 of the table in subsection 711-20(1) of the ITAA 1997 applies to an entity that left a consolidated group before 10 February 2010, refer to the Full Federal Court decision in *Handbury Holdings Pty Ltd v. Federal Commissioner of Taxation* (2009) 179 FCR 569; [2009] FCAFC 141.

8. Taxation Rulings TR 2004/14[1] and TR 2006/6[1B] consider, in the context of subsection 705-70(1) of the ITAA 1997, a number of concepts expressed in subsection 711-45(1) of the ITAA 1997. This Determination should be read in conjunction with interpretative views expressed in those Rulings.

9. 'Accounting standards' are defined in section 995-1 of the ITAA 1997 as having the same meaning as in the *Corporations Act 2001*. 'Accounting standard' is defined in section 9 of the *Corporations Act 2001* as meaning:

(a) an instrument in force under section 334; or

(b) a provision of such an instrument as it so has effect.

10. Section 334 of the *Corporations Act 2001* states relevantly:

> **334(1) [AASB's power to make accounting standards.]** The AASB may make accounting standards for the purposes of this Act. The standards must be in writing and must not be inconsistent with this Act or the regulations.
>
> **334(4) [Periods to which accounting standards apply]** An accounting standard applies to:
>
> (a) periods ending after the commencement of the standard; or
>
> (b) periods ending, or starting, on or after a later date specified in the standard.
>
> **334(5) [Early adoption]** A company, registered scheme or disclosing entity may elect to apply the accounting standard to an earlier period unless the standard says otherwise. The election must be made in writing by the directors.

11. For reporting periods beginning prior to 1 January 2005, a company can apply the Australian Accounting Standards. For reporting periods beginning on or after 1 January 2005, the Australian Standards that are equivalent to those of the International Accounting Standards Board will apply.

Australian Accounting Standards Board Statements of Accounting Concepts (relevant for reporting periods beginning prior to 1 January 2005)

12. Statement of Accounting Concepts 4 *Definition and Recognition of the Elements of Financial Statements* (SAC 4), defines 'liabilities' at paragraph 48:

> 48 'Liabilities' are the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events.

13. Paragraph 57 of SAC 4 states that '[t]here is no doubt that legally enforceable obligations of an entity are liabilities.' Paragraph 57 goes on to expand this definition to financial obligations resulting from legally enforceable contracts, from imposition by legally authorised bodies, from statutes or torts. Thus, liabilities arising from the normal course of business would satisfy this definition.

14. A liability is a present obligation to make future sacrifices of economic benefits. Paragraph 61 of SAC 4 explains that placing an order for goods does not give rise to a liability, as the entity normally has the discretion to avoid the future sacrifice of economic benefits. However, the receipt of goods would normally be the event giving rise to the obligation of a future sacrifice of economic benefits.

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[1] Income tax: consolidation: recognising and measuring the liabilities of a joining entity under subsection 705-70(1) of the ITAA 1997 where the entity becomes a subsidiary member of a consolidated group in a financial reporting period of the entity not beginning on or after 1 January 2005.

[1B] Income tax: consolidation: recognising and measuring the liabilities of a joining entity under subsection 705-70(1) of the ITAA 1997 where the joining time occurs in a financial reporting period of the joining entity beginning on or after 1 January 2005.

15. Paragraph 65 of SAC 4 lists the criteria for recognition of liabilities:

> 65 A liability should be recognised in the statement of financial position when and only when:
>
> (a) it is probable that the future sacrifice of economic benefits will be required; and
>
> (b) the amount of the liability can be measured reliably.

16. Paragraph 66 of SAC 4 expands on the explanation in Paragraph 61 of SAC 4, and goes on to state that:

> Mature and unconditional obligations clearly satisfy any criterion regarding the probability of the future sacrifice of economic benefits being required and, subject to meeting the test of reliable measurement, satisfy the criteria for recognition as liabilities.

17. Paragraph 72 of SAC 4 explains that 'a previously recognised asset or liability would cease to be recognised when, and only when, it ceases to satisfy the definition of the element or ceases to satisfy either or both of the criteria for its recognition'. Paragraph 73 of SAC 4 goes on to explain, '[t]he definition of liabilities would cease to be satisfied where the obligation is settled (through payment, forgiveness or conversion into equity) or where a creditor's claim against the entity lapses (for example, where an option written by the entity expires)'. In other words, events amounting to legal extinguishment are required before a liability can be derecognised.

Australian Standards equivalent to those of the International Accounting Standards Board (relevant for reporting periods beginning on or after 1 January 2005)

18. 'Liability' is defined in paragraph 10 of AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* and paragraph 49(b) of AASB *Framework for the Preparation and Presentation of Financial Statements* in the following way:

> A *liability* is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

19. In this definition the relevant expectation is that there will be an outflow of resources embodying economic benefits when (or if) the obligation is settled. It is not an expectation that settlement and the consequential outflow will, in fact, happen. Accordingly, it cannot be argued that a liability ceases to exist only because the circumstances of a debtor make it unable to settle the obligation.

20. AASB 139 *Financial Instruments: Recognition and Measurement*, provides guidance on when a financial liability may be removed from a [balance sheet]. Paragraph 39 states:

> 39 An entity shall remove a financial liability (or a part of a financial liability) from its balance sheet when, and only when, it is extinguished – that is, when the obligation specified in the contract is discharged or cancelled or expires.

21. The application guidance at Appendix A to AASB 139 states that a financial liability (or part of it) is extinguished when the debtor either:

> (a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
>
> (b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor (if the debtor has given a guarantee this condition may still be met).

Conclusion

22. Therefore, under the accounting standards applicable to reporting periods beginning both before and after 1 January 2005, legal extinguishment of a relevant obligation is necessary before it is no longer recognised as a liability for accounting purposes.

Effect of Winding Up

23. It was stated in *Hiley v. Peoples Prudential Assurance Co Ltd (In Liq)*[2] that, at the date of commencement of a winding up, 'the assets of the company, including the choses of actions or claims of the company, become a fund in the hands of a liquidator, and the liabilities of the company are converted into claims upon that fund.' It has been argued that, because of the conversion into claims upon a fund, the liabilities of the company no longer exist.

24. However, in the Federal Court decision of *Federal Commissioner of Taxation v. Macquarie Health Corporation Ltd and Others*,[3] Emmett J clarified that a winding up order changes the remedy of a creditor but does not cause a release or extinguishment of the relevant debt. Emmett J stated:

> There is no doubt that the effect of winding up and of sequestration is that there is a restriction imposed on the capacity of a creditor to enforce payment of a debt without the leave of the court. A creditor will not be entitled to payment from the debtor and if the creditor receives payment, he will be required to repay the amount to the liquidator or trustee in bankruptcy. In that sense, the creditor's **remedies** [emphasis added] are converted into a right to prove in the winding up or in the bankruptcy. However, it does not follow, in my view, that the debt ceases to exist. The right to enforce payment is restricted. Nevertheless, the right to prove in the winding up or bankruptcy is **a right to prove in respect of the debt which continues to exist** [emphasis added].

25. It is therefore considered that removal of a creditor's usual remedies and the substitution of a right to make a claim upon a fund does not amount to legal release of the company from its liabilities. In *Clyne v. Deputy Commissioner of Taxation (No. 3)*[4] it was stated that amounts 'owed by a debtor at the date of bankruptcy may, notwithstanding [the] bankruptcy, still be described as debts, and the Act refers to them as such…..' Similarly, section 478 of the *Corporations Act 2001* states that 'as soon as practicable after the Court orders that a company be wound up, the liquidator must…cause the company's property to be collected and applied in discharging the **company's liabilities** [emphasis added]'.

26. Furthermore, although the *Corporations Act 2001* (under section 480) provides for the payment of a 'final dividend' to creditors who have proved debts in the winding up, it does not provide for legal release of the company from liabilities remaining unsatisfied after realisation and distribution of the property of the company.

27. Of course, some debts may be legally extinguished prior to deregistration for other reasons (for example they might be released by deed). However, in the absence of legal extinguishment prior to deregistration, the unsatisfied debts of a company will remain liabilities for accounting purposes.

28. Accordingly, the unsatisfied debts of a subsidiary just before deregistration will be recognised as accounting liabilities just before the leaving time in the subsidiary's financial statements, under subsection 711-45(1) of the ITAA 1997.

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[2] (1938) 60 CLR 468 at 496.
[3] (1998) 88 FCR 451 at 472.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.

Alternative views

29. It has been argued that, in the context of an insolvent winding up, the inability of the company to pay its debts means that future sacrifices or outflows of economic benefits are improbable or no longer expected just prior to deregistration and, therefore, the relevant liabilities cease to exist for accounting purposes. The Tax Office does not accept this view because it would be inconsistent with a proper reading of the accounting standards to treat the inability to pay a debt as a trigger point for ceasing to recognise it as a liability. The alternative view is also inconsistent with the legal position of the company and would result in a statement of financial position that is not a true and fair representation of the affairs of the company.

[4] (1984) 154 CLR 589 at 594.

References

Previous draft:

TD 2006/D2

Related Rulings/Determinations:

TR 2004/14

Subject references:

- AASB
- accounting framework
- accounting principles
- accounting standards
- allocable cost amount
- company
- consolidated group
- consolidation - exiting
- consolidation - tax liabilities
- insolvency
- leaving entity
- leaving entity's accounting principles for tax cost setting
- leaving time
- liquidation
- member of a group
- notional statement of financial position
- ownership, interests, control & rights
- provisional liquidation
- recognising and measuring liabilities
- statement of financial position
- statements of accounting concepts
- subsidiary company
- subsidiary member of a consolidated group
- voluntary liquidation
- wholly owned
- wholly owned subsidiary

Legislative references:

- TAA 1953
- ITAA 1997 705-70(1)
- ITAA 1997 Div 711
- ITAA 1997 711-5(1)
- ITAA 1997 711-5(2)
- ITAA 1997 711-5(3)
- ITAA 1997 711-20
- ITAA 1997 711-20(1)
- ITAA 1997 711-45(1)
- ITAA 1997 711-45(1A)
- ITAA 1997 995-1
- Corporations Act 2001 9
- Corporations Act 2001 334
- Corporations Act 2001 478
- Corporations Act 2001 480

Case references:

- Clyne v. Deputy Commissioner of Taxation (No. 3) (1984) 154 CLR 589; (1984) 58 ALJR 398; (1984) 55 ALR 143
- Federal Commissioner of Taxation v. Macquarie Health Corporation Ltd and Others (1998) 88 FCR 451; (1998) 17 ACLC 171; (1998) 98 ATC 5214; (1998) 40 ATR 349
- Hiley v. Peoples Prudential Assurance Co Ltd (In Liq) (1938) 60 CLR 468; (1938) 10 ABC 159; (1938) 12 ALJ 175; [1938] ALR 469
- Handbury Holdings Pty Ltd v. Federal Commissioner of Taxation (2009) 179 FCR 569; [2009] FCAFC 141

Other references:

- AASB Framework for the Preparation and Presentation of Financial Statements
- AASB 137 Provisions, Contingent Liabilities and Contingent Assets
- AASB 139 Financial Instruments: recognition and Measurement
- SAC 4 Definition and Recognition of the Elements of Financial Statements

ATO references

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