TD 2007/28 - Income tax: what is a 'present legal obligation' of a private company for the purposes of subsection 109Y(2) of Division 7A of Part III of the Income Tax Assessment Act 1936?

This ruling is being reviewed as a result of a recent court/tribunal decision. Refer to Decision Impact Statement: Commissioner of Taxation v H (NSD 211 of 2010).

This document has changed over time. This is a consolidated version of the ruling which was published on *1 February 2012*

Taxation Determination

Income tax: what is a 'present legal obligation' of a private company for the purposes of subsection 109Y(2) of Division 7A of Part III of the *Income Tax Assessment Act 1936*?

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Ruling

1. A 'present legal obligation' of a private company for the purposes of subsection 109Y(2) of Division 7A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936)[1] is an immediate obligation binding at law, whether payable and enforceable presently or at a future time. Future provisions are not included in the distributable surplus calculation under section 109Y unless they are one of the accounting provisions specifically set out in, or prescribed under, paragraph (b) of the definition of 'net assets' in subsection 109Y(2).

[1] All legislative references in this Determination are to the ITAA 1936.

Date of effect

2. This Determination applies to income years commencing 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 (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Example 1

3. *Z Coy Pty Ltd (Z Coy) operates a small financial services business and on 30 May 2007 receives a quarterly rates demand from the local council in respect of its business premises. The demand is due for payment by 21 June 2007 but Z Coy does not make payment for a further 2 weeks. The amount of the rates demand is an immediate obligation binding at law and presently enforceable. It is therefore a present legal obligation for the purposes of subsection 109Y(2) at the end of the income year (30 June 2007).*[2]

Example 2

4. *X Coy Pty Ltd operates a small mixed goods retail business and on 20 June 2007 receives an electricity bill for supply in the preceding quarter which is not due for payment until 11 July 2007. The amount of the electricity bill is an immediate obligation binding at law and enforceable at a future time. It is therefore a present legal obligation for the purposes of subsection 109Y(2) at the end of the income year (30 June 2007).*

Example 3

5. *Y Coy Pty Ltd (Y Coy) operates a small lawn mower retail business and provides free repairs for selected customers for an additional 2 years after the manufacturer's warranty period expires. Y Coy does not advertise this service but it is known in the community that free repairs may be provided outside of the warranty period. Y Coy expects to provide 20 out of warranty repairs at a cost of approximately $5,000 as at 30 June 2007 in respect of completed sales as at that date. Y Coy takes $5,000 up as a 'provision for out of warranty repairs' when compiling its annual reports for the reporting period ending 30 June 2007. The provision taken up by Y Coy is not enforceable by legal action either presently or in the future and is therefore not a present legal obligation for the purposes of subsection 109Y(2) at the end of the income year (30 June 2007).*

[2] All examples assume a year of income and reporting period ended 30 June.

Example 4

6. *M Coy Pty Ltd (M Coy) operates a small advertising agency and, in most income years, having regard to staff performance and profitability determines to pay bonuses to its employees at 30 June. The bonuses are payable during the next 6 months and are entirely at the discretion of M Coy and do not form part of the employment contract between M Coy and its employees. On 30 June 2007, M Coy determines to pay bonuses totalling $50,000 and in its financial reports for the reporting period ending 30 June 2007, takes this amount up as a 'provision for employee bonuses'. The determination to pay bonuses taken up as a provision by M Coy is not enforceable by legal action either presently or in the future. Payment of the bonuses remains at the discretion of M Coy and therefore the bonuses do not qualify as a present legal obligation within the meaning of subsection 109Y(2) at the end of the income year (30 June 2007).*

Commissioner of Taxation
17 October 2007

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

7. Division 7A treats:

(i) certain payments and loans made by a private company to a shareholder or a shareholder's associate; and

(ii) certain debts owed by a shareholder or a shareholder's associate forgiven by the private company,

as dividends taken to have been paid by the private company out of the company's profits to the shareholder or shareholder's associate in their capacity as shareholder.[3] Accordingly those dividends are included in the assessable income of the shareholder or associate under section 44.

8. The total amount taken to have been paid as dividends under Division 7A is limited to the amount of a private company's 'distributable surplus' calculated in accordance with section 109Y.[4] Distributable surplus in effect limits the total amount of dividends taken to be included in assessable income in the same way as 'profits' limit how much of an actual distribution is included in assessable income.[5]

8A. In section 109Y a statutory conception of 'distributable surplus' is introduced to replace the looser notion of 'profit' in section 44.[5A] It reflects the approach taken in *Re Spanish Prospecting Ltd* [1911] 1 Ch 92 in that it is based on a comparison of the value of assets at two dates. This conception has two evident purposes, one is to bring greater certainty to the amount of the surplus and the other is to reduce scope for manipulation of that amount by taxpayers (as might be expected in a provision which is primarily an anti-avoidance provision). The broader purpose of 'profit' is retained by the use of the conception 'to prevent taxation of a return of capital', that is, of something which was not a gain to the company.

8B. In *Commissioner of Taxation v. H* [2010] FCAFC 128; 2010 ATC 20-218 (the H case) Downes J, Edmonds J and Greenwood JJ, after referring to the legislative context in which 'present legal obligation' is to be found as per the Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1998 stated at paragraphs 35 and 36:

> 35. The extract from the explanatory memorandum manifests both the legislative policy of Div 7A as a whole, and s 109Y in particular. Section 109Y is to provide a 'cap' or limit on such loans, advances or other credits being treated as assessable dividends, namely, up to but not exceeding the realised and unrealised profits of the company.

[3] Section 109Z.
[4] Subsection 109C(2), subsection 109D(1AA), subsection 109E(2) and subsection 109F(2) in conjunction with 109Y respectively.
[5] Under section 44 the assessable income of shareholder in a company includes dividends paid out of profits.
[5A] Division 7A replaces the former section 108 which operated through the mechanism of subsection 44(1) and hence required that the distributions to which it applied were paid by the company 'out of profits'.

36. The term 'distributable surplus' is to be understood in that context, namely, the realised and unrealised profits in the company available for distribution. The profits available for distribution are its 'after-tax' profits. A Fullager J observed in *Commonwealth v. O'Reilly* (1984) VR 931 and 938:

> 'In my opinion the profits out of which dividends may be paid are the profits remaining after deduction from gross profits of, *inter alia*, federal income tax, or at least a bona fide estimate thereof. A bona fide assessment of profits involved a bona fide estimate of income tax.'

9. The formula for calculating a private company's distributable surplus is contained in subsection 109Y(2), being 'Net assets + Division 7A amounts[5B] – Non-commercial loans – Paid-up share value – Repayments of non-commercial loans' (the 'distributable surplus formula'). A key element in the distributable surplus formula is the private company's net assets. Net assets are defined as follows:

> the amount (if any), at the end of the company's year of income, by which the company's assets (according to the company's accounting records) exceed the sum of:
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> (a) the present legal obligations of the company to persons other than the company; and
>
> (b) the following provisions (according to the company's accounting records):
>
> (i) provisions for depreciation;
>
> (ii) provisions for annual leave and long service leave;
>
> (iii) provisions for amortisation of intellectual property and trademarks;
>
> (iv) other provisions prescribed under regulation made for the purposes of this subparagraph.
>
> If the Commissioner considers that the company's accounting records significantly undervalue or overvalue its assets or undervalue or overvalue its provisions, the Commissioner may substitute a value that the Commissioner considers is appropriate.[6]

10. In the context of section 109Y, the phrase 'present legal obligation' is to be interpreted in accordance with its legal meaning. The phrase 'present legal obligation' requires that the obligation enforceable by legal action be presently existing. At law, a 'legal obligation' is an obligation, right or duty arising from contract, statute or the operation of general law which is enforceable by legal action immediately or in the future. In *Brett v. Barr Smith* (1919) 26 CLR 87 at 97 Higgins J stated:

> 'Obligation' is a technical term of law, with a clear definite meaning; and Statutes which make law must prima facie be treated as using technical words in their technical sense. There is no ground here for treating 'obligation' as meaning moral obligation, or social obligation, or business obligation (in the sense of commercial pressure or expediency), or anything but legal obligation. The test is: Is there any legal sanction – would an action lie (if there were no sec 54) against the mortgagors for failure to pay the income tax? 'Obligation' involves binding; and there is nothing here to bind the mortgagors to pay the amount of tax.

[5B] The formula was amended in relation to payments made, loans made and debts forgiven on or after 1 July 2009. One of the amendments was to add back 'Division 7A amounts' which are defined as the total of any amounts the company is taken under section 109C or 109F to have paid as dividends in the year of income apart from section 109Y.

[6] For income years prior to the year in which 1 July 2006 occurred, the Commissioner could only substitute a value where he considered the company's accounting records significantly undervalued its assets or overvalued its provisions.

10A. In the H case which concerned income tax the requirement that there be an obligation did not require the existence of a debt due and payable. Downes J, Edmonds J and Greenwood JJ stated at paragraph 43:

> 43. As the Tribunal observed at [42] of its reasons, income tax is imposed by the *Income Tax Act 1986* (Cth) (s 5(1) at the rates declared by the *Income Tax Rates Act 1986* (Cth)). The income tax so imposed is levied by s 7 of the Income Tax Act, which also requires it to be paid for the relevant financial year. The obligation to pay income tax so imposed arises by operation of the Income Tax Act itself and not by the issue of a notice of assessment.

The obligation exists at the end of the income year by operation of the Income Tax Act itself notwithstanding the lack of a notice of assessment and the inability of the Commissioner to recover an amount of income tax at that time. The fact that the obligation to pay is at a later date did not deny its standing as an existing obligation. With regard to this point Downes J, Edmonds J and Greenwood JJ stated at paragraph 41:

> At worst it may be a contingent obligation, contingent on an assessment being made and a notice of that assessment served, but that does not disqualify it as a present legal obligation.

10B. It does not follow that all contingencies can be a present legal obligation. As indicated, income tax for an income year is imposed by operation of legislation. There is an obligation, a requirement to settle that obligation and the amount of the obligation can be reliably determined.

11. Although the phrase 'present legal obligation' in subsection 109Y(2) takes its legal meaning, it is also useful to consider to what extent current Australian accounting standards and concepts would produce a similar result. The Australian Accounting Standards Board *Framework for the preparation and presentation of financial statements* (the *Framework*) defines a liability as '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'.[7] At paragraphs 60 to 63 of the *Framework* it is emphasised that an essential characteristic of a liability is that the entity has a *present obligation*, being a duty or responsibility to act or perform in a certain way. It is noted in the *Framework* that obligations may arise from normal business practice and custom, or may be legally enforceable as a consequence of a binding contract or a statutory requirement. However, obligations which have arisen from normal business practice and custom and which are not enforceable as a consequence of a binding contract or statutory requirement do not satisfy the legal meaning of the term 'present legal obligation' in subsection 109Y(2) and cannot be included in the calculation of the distributable surplus.

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[7] Australian Accounting Standards Board *Framework for the preparation and presentation of financial statements* (July 2009) at paragraph 49. The definition also appears in paragraph 10 of Accounting Standard AASB 137.

12. Accounting Standard AASB 137 concerns *Provisions, contingent liabilities and contingent assets* (AASB 137).[8] That standard does not apply where another standard deals with a specific type of provision, which is the case for the three types of provisions listed in paragraph 109Y(2)(b). Paragraph 10 of AASB 137 defines a 'provision' as 'a liability of uncertain timing or event'.[9]

13. Paragraph 10 of AASB 137 also defines a 'legal obligation' consistently with its technical legal meaning as:

> an obligation that derives from:
>
> (a) contract (through its explicit or implicit terms);
>
> (b) legislation; or
>
> (c) other operation of law.[10]

The definition of 'legal obligation' in AASB 137 is consistent with the technical legal meaning of the phrase 'present legal obligation' in subsection 109Y(2); that is, an obligation, right or duty arising from contract, statute or the operation of general law which is enforceable by legal action immediately or in the future. Legal obligations within the technical legal meaning of the phrase would also be 'legal obligations' under the definition in paragraph 10 of AASB 137.

14. Paragraph 14 of AASB 137 provides that a provision shall be recognised when, inter alia, an entity has a present obligation (legal or constructive) as a result of a past event. Paragraph 17 of AASB 137 provides that a past event that leads to a present obligation is an obligating event:

> For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:
>
> (a) where the settlement of the obligation can be enforced by law; or
>
> (b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.[11]

15. The obligations enforceable by law mentioned in paragraph 17(a) of AASB 137 will give rise to a present obligation (of a legal kind), and therefore coincide with the technical legal meaning of the phrase 'present legal obligation' in subsection 109Y(2). However, the constructive obligations mentioned in paragraph 17(b) of AASB 137 will not be present legal obligations within the meaning of that term in subsection 109Y(2).

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[8] AASB 137 has application from 1 January 2005 and replaced Accounting Standard AASB 1044 *Provisions, Contingent Liabilities and Contingent Assets* (AASB 1044) which applied from 1 July 2002 to 31 December 2004. AASB 1044 was based on Exposure Draft ED 88 'Provisions and Contingencies' which was released in December 1997. The release date for ED 88 is contemporaneous with the drafting of Division 7A.

[9] Paragraph 1.3.2 of AASB 1044 provides that: 'Provisions are a subset of liabilities. They are defined in paragraph 16.1 as liabilities for which the amount or timing of the future sacrifice of economic benefits that will be made is uncertain.'

[10] AASB 1044 is less express but states that where the settlement of the obligation can be enforced by law a legal obligation exists, and that the most common form or present obligation is a legal obligation (paragraphs 3.1.8 and 3.1.9).

[11] Similarly, paragraph 3.1.8 of AASB 1044 distinguishes between legal obligations and equitable or constructive obligations, and paragraph 4.2 of AASB 1044 provides: 'For a present obligation to exist, the entity must have no realistic alternative but to make the future sacrifice of economic benefits to settle the obligation'.

16. Under the current AASB accounting standards, a present obligation (of a legal nature) includes obligations that are legally enforceable, although they may not be immediately enforceable. For example, a dividend which has been declared but for which the stipulated date for payment has not yet arisen, or a trade invoice which has been rendered but for which the stipulated date for payment has not yet arisen.[12] Further, a present obligation (of a legal nature) might be classified as either a current or a non-current liability under the tests applicable to liabilities in paragraph 60 of Accounting Standard AASB 101 *Presentation of Financial Statements.*[13] In each case, these present obligations (of a legal nature) will qualify as present legal obligations for the purposes of subsection 109Y(2).

17. Therefore, as a practical matter, a present obligation of a legal nature under AASB accounting standards would also be a present legal obligation for the purposes of the distributable surplus formula in section 109Y. However, as already stated, the test is one of jurisprudence rather than accounting treatment.

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[12] AASB 1044 similarly provides that trade creditors and accruals are liabilities (paragraph 3.1.2).

[13] Paragraph 69 of Accounting Standard AASB 101 provides:

Current Liabilities

69. An entity shall classify a liability as current when:

(a) it expects to settle the liability in its normal operating cycle;

(b) it holds the liability primarily for the purpose of trading;

(c) the liability is due to be settled within twelve months after the reporting period: or

(d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). Terms of a liability that could, at the option of the counterpart, result in settlement by the issue of equity instruments do not affect its classification. An entity shall classify all other liabilities as non-current.

References

Previous draft:

TD 2007/D8

Related Rulings/Determinations:

TR 2006/10

Subject references:

- dividends

Legislative references:

- ITAA 1936 44
- ITAA 1936 Pt III Div 7A
- ITAA 1936 109C
- ITAA 1936 109C(2)
- ITAA 1936 109D(1AA)
- ITAA 1936 109E(2)
- ITAA 1936 109F
- ITAA 1936 109Y
- ITAA 1936 109Y(2)
- ITAA 1936 109Y(2)(b)
- ITAA 1936 109Z
- TAA 1953

Case references:

- Brett v. Barr Smith (1919) 26 CLR 87
- Commonwealth v. O'Reilly (1984) VR 931
- Federal Commissioner of Taxation v. H [2010] FCAFC 128; 2010 ATC 20-218
- Re Spanish Prospecting Company Ltd [1911] 1 Ch 92

Other references:

- Australian Accounting Standards Board Framework for the preparation and presentation of financial statements (July 2009)
- Accounting Standard AASB 101 Presentation of Financial Statements
- Accounting Standard AASB 137 Provisions, contingent liabilities and contingent assets
- Accounting Standard AASB 1044 Provisions, Contingent Liabilities and Contingent Assets
- Explanatory Memorandum to the Tax Laws Amendment Bill (No.3) 1998
- Exposure Draft ED 88 Provisions and Contingencies

ATO references

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