

TAXATION RULING NO IT 2621

INCOME TAX: RETIRING ALLOWANCES, DETERMINATION OF
REASONABLE AMOUNT

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Reference no.:	Subject refs:	Legislative refs:
I 1012454	RETIRING ALLOWANCES	78(1)(c)
	REASONABLE AMOUNTS	109

OTHER RULINGS ON THIS TOPIC: IT 294, IT 2026, IT 2152

PREAMBLE The Federal Court of Australia considered the operation of paragraph 78(1)(c) and section 109 of the Income Tax Assessment Act 1936 ("the Act"), and in particular, the exercise of the Commissioner's discretion under section 109 in *Ferris v. Federal Commissioner of Taxation* 88 ATC 4755; (1988) 19 ATR 1705 and *Risby Forest Industries Pty Ltd v. Federal Commissioner of Taxation* 88 ATC 4683; (1988) 19 ATR 1663.

2. This Ruling deals with the consequences of these Federal Court decisions in administering the provisions of paragraph 78(1)(c) and section 109 of the Act.

3. Paragraph 78(1)(c) of the Act allows income tax deductions for pensions, gratuities, or retiring allowances paid by a taxpayer during an income year to employees, former employees or their dependants. The deductions are only allowable to the extent to which, in the Commissioner's opinion, they are paid in good faith in consideration of the past services of the employees in any business operations, which were carried on by the taxpayer for the purpose of gaining or producing assessable income.

4. Section 109 of the Act applies where a private company pays or credits the following amounts to an "associated person" (i.e., a past or present shareholder or director or to any "associate" of those persons as widely defined in subsection 26 AAB(14) of the Act):

- (i) remuneration for services rendered by the associated person; or
- (ii) a retirement or termination allowance, gratuity or compensation.

5. If the Commissioner forms the opinion that the amount exceeds what is reasonable, section 109 enables him to disallow

deductions claimed by the company. The amount disallowed as a deduction is deemed by the section to be a dividend paid by the company to the recipient as a shareholder out of profits. It will then be assessable income in the recipient's hands.

FACTS

6. In *Ferris v. FCT* the taxpayer was the managing director of a private company which he established in 1970 and was instrumental in ensuring its success. He had a nominal shareholding in the company. In 1984 he decided to leave this company and join another with which he had been involved.

7. The other directors of the first company decided to make an ex-gratia payment to the taxpayer in respect of past services. The Commissioner considered that the extent of the payment was unreasonable and, under section 109 of the Act, deemed a certain portion of the amount to be a dividend. The Court found that the Commissioner had incorrectly exercised the discretion under section 109 because:

- (i) he only considered whether the payment was excessive using the superannuation fund guidelines as set out in Taxation Ruling IT 2026; and
- (ii) he failed to take into account the particular circumstances of the taxpayer.

The Court was also concerned that there was no clear statement from the Commissioner that the amount was unreasonable.

8. In reaching its decision the Court emphasised that the question under section 109 is whether the payment was an unreasonable amount, not whether the payment was excessive for the purposes of section 23F of the Act (now repealed). In deciding whether an amount was reasonable in these circumstances the Court accepted that the Commissioner could, in an appropriate case, take into account the standard of maximum benefit, but this would not necessarily be relevant or decisive of the question of reasonableness under section 109. What is and what is not reasonable depends on the circumstances of the case and upon commercial practice.

9. Having determined that the discretion was incorrectly exercised the Court remitted the matter to the Commissioner for a reconsideration of the exercise of the discretion.

10. In *Risby Forest Industries v. FCT* the taxpayer was the former managing director of a company in which he was a significant shareholder and from which he retired after 50 years of service. The other directors determined to grant him a gratuity in recognition of this service. Additionally, he received lump sums from three superannuation funds.

11. The Commissioner disallowed the company's claim to deduct the gratuity under paragraph 78(1)(c) of the Act. The amount of retiring allowance was also considered unreasonable under section 109. The Court found that the Commissioner had erred in law in applying the test of unreasonableness to the decision whether the payment was made in good faith under paragraph

78(1)(c). The Court went on to find that the Commissioner had not made a separate determination of the reasonableness of the amount under section 109 notwithstanding that it was ultimately conceded that the payment was in good faith. Lockhart J accepted that the Commissioner could have regard to the guidelines set down for use under section 23F in considering whether an amount was reasonable for section 109 purposes.

RULING

12. The opinion to be formed by the Commissioner under paragraph 78(1)(c) is separate and distinct from the opinion to be formed under section 109. It is the opinion under paragraph 78(1)(c) which must be made first viz., whether the amount in question was paid in good faith in consideration of the past services of the employee in the business operations carried on for the purpose of gaining or deriving assessable income. If the amount was paid in good faith etc., an opinion is then made by the Commissioner as to the reasonableness of the amount under section 109.

13. When forming an opinion under section 109 as to the reasonableness of an amount it is clear that all the circumstances of the case must be taken into account. While it is relevant to have regard to the reasonable benefit limits applying to superannuation funds it is not sufficient simply to limit the consideration to the standard of maximum reasonable benefits as administered by the Insurance and Superannuation Commission. Indeed this is clearly stated in Taxation Ruling IT 2152 at paragraph 12:

"12. However, when a decision has to be made under paragraph 78(1)(c), or section 109, it is not a sufficient exercise of the discretionary power to simply apply the formula. The decision must take into account the circumstances of the case. There may well be cases, especially in respect of an employee at arm's length from the proprietors of a private company, where a payment in excess of the amount specified in superannuation guidelines would be the proper deduction for the purposes of paragraph 78(1)(c)."

14. The matters to which the now repealed paragraph 23F(2)(h) of the Act were directed are relevant as a guide to the opinion to be formed under section 109. The fact that paragraph 23F(2)(h) permitted the Commissioner to examine any other matters he considered relevant gives the flexibility required in exercising the discretion required by section 109. (See *Henry Comber Pty Ltd v. Federal Commissioner of Taxation* 85 ATC 4450 at p.4460; (1985) 16 ATR 693, at p.704).

15. Other factors that may be relevant include:

- . the terms of employment;
- . length of service;
- . level of remuneration during the period of service;
- . other benefits to which the retiree may be entitled;
- . commercial practice; and
- . advice sought as to the quantum of amount paid.

This list is not intended to be exhaustive.

16. After an examination of the particular circumstances of the payment an express opinion should be formed. If the payment or portion of the payment is considered to be unreasonable this should be clearly stated and the reasons for this view documented for future reference.

17. Nothing in paragraphs 12 to 16 of this Ruling is intended to restrict Deputy Commissioners of Taxation and authorising officers in forming the requisite opinions in paragraph 78(1)(c) and section 109. These directions obviously need to be exercised reasonably and in conformity with the purpose for which the powers were conferred. It is essential that Deputy Commissioners and authorised officers retain the flexibility to deal with each particular case in the light of all the surrounding circumstances and its own merits.

COMMISSIONER OF TAXATION

6 December 1990