TR 96/D18 - Income tax: subsection 51(1) - meaning of 'incurred' - timing of deductions

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Draft Taxation Ruling
Income tax: subsection 51(1) - meaning of 'incurred' - timing of deductions

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What this Ruling is about

1. This Ruling sets out the views of the Australian Taxation Office (ATO) on whether the word 'incurred', in subsection 51(1) of the *Income Tax Assessment Act 1936* (the Act), has the same meaning for taxpayers who return their income on a receipts basis as it does for those taxpayers who generally return their income on an earnings basis.

Class of person/arrangement

2. It applies to all taxpayers who claim a loss or outgoing under subsection 51(1) of the Act, whether or not the taxpayer accounts for income on a cash receipts or earnings basis.

Background

3. To qualify for deduction under subsection 51(1) a loss or outgoing must have been incurred.

Incurred

4. The courts have been reluctant to attempt an exhaustive definition of a term such as 'incurred'. The following propositions do not purport to do this, they help to outline the scope of the definition.

The following general rules, settled by case law, assist in most cases in defining whether and when a loss or outgoing has been incurred:

(a) a taxpayer need not actually have paid any money to have incurred an outgoing provided the taxpayer is definitively committed in the year of income. Accordingly, a loss or outgoing may be incurred within subsection 51(1) even though it remains unpaid, provided the taxpayer is 'completely subjected' to the loss or outgoing. That is, it is not sufficient if the liability is contingent or no more than pending, threatened or expected, no matter how certain it is in the year of income that the loss or outgoing will be incurred in the future. It must be a presently existing liability to pay a pecuniary sum;

(b) a taxpayer may have a presently existing liability, even though the liability may be defeasible by others;

(c) a taxpayer may have a presently existing liability, even though the amount of the liability cannot be precisely ascertained, provided it is capable of reasonable estimation (based on probabilities);

(d) whether there is a presently existing liability is a legal question in each case, having regard to the circumstances under which the liability is claimed to arise;

(e) in the case of a voluntary payment (where the money ceases to be the taxpayer's funds) a presently existing liability is not required, and the expense is incurred when the money is paid.

5. For the purposes of subsection 51(1) it is sometimes not enough that a loss or outgoing has been incurred. The outgoing must also be properly referable to the year of income in which the deduction is sought - refer *Coles Myer Finance Pty Ltd v. FC of T* 93 ATC 4214 at 4222; (1993) 25 ATR 95 at 105 (*Coles Myer*). The matter of the taxpayer's accounting system may be indicative, but not determinative of the income year to which an outgoing is properly referable.

Ruling

Accounting practice

6. The principles set out above relating to the interpretation of the word 'incurred' derive from cases where taxpayers operated on an earnings basis. However, the cases have not generally sought to limit the meaning of the word 'incurred' by reference to the nature of a taxpayer's accounting system.

7. In these circumstances, subject to the propositions outlined above, a taxpayer who uses a cash receipts based accounting system need not necessarily have paid or borne a loss or outgoing in order for that loss or outgoing to have been 'incurred' for the purposes of subsection 51(1).

Date of effect

8. The ATO recognises that there is a difference of opinion about the meaning of 'incurred' for taxpayers who use a cash based accounting system, and who do not keep elaborate books of account. This Ruling explains that, in certain circumstances, such taxpayers are able to claim relevant expenditure prior to the outgoing actually having been paid.

9. However, many small business taxpayers use a cash received and expenditure paid basis both for their accounts and for taxation purposes. Additionally, many non-business taxpayers use a cash received and cash paid basis for taxation purposes: few maintain an elaborate accounting system.

10. It has long been established practice, where the receipts basis is the appropriate method to account for income, to accept the returns lodged by taxpayers, notwithstanding that both income and expenses have been accounted for on a cash receipts basis. However, we have insisted that this basis should be adopted consistently year by year, and that there be no doubling up of deductions. That is, you cannot claim an unpaid expense in one year on the basis that it has been incurred, and then claim again in a subsequent year when it is paid.

11. In the interests of practical administration, there is no intention to disturb this practice - refer *FC of T v. Solling; FC of T v. Pepper* 85 ATC 4518 at 4538; (1985) 16 ATR 753 at 776-777.

12. If taxpayers now want to claim deductible outgoings incurred but not claimed in a previous year, they can seek amendment(s) of their assessment(s), subject to the four year limitation set by subsection 170(3) (refer Taxation Ruling IT 2613). Alternatively, as a transitional measure to avoid unnecessary compliance costs, where a taxpayer has incurred a deductible outgoing in the 1995/96 year, but not claimed that deduction in the return because it was unpaid, the Commissioner will accept a claim for the deduction when it is actually paid in the 1996/97 year, in addition to other outgoings actually incurred in the 1996/97 year. A taxpayer who adopts this approach in 1996/97, or seeks amendments as outlined above, whether in 1996/97 or later, is expected to continue to claim deductions on this same basis for subsequent years.

Explanations

13. It is often the case that an outgoing will be both incurred and paid in the same year of income, and no issue of timing arises. However, the point in time when an outgoing may be taken to be deductible becomes an issue of practical concern to taxpayers who have unpaid liabilities at year end or outgoings which relate to two or more income years.

Presently existing liability

14. A loss or outgoing may be incurred for the purposes of subsection 51(1) even though no money has actually been paid out. In *W. Nevill & Company Ltd v. FC of T* (1937) 56 CLR 290 at 302 it was said:

> 'the word used is 'incurred' and not 'made' or 'paid'. The language lends colour to the suggestion that, if a liability to pay money as an outgoing comes into existence, [the section is satisfied] even though the liability has not been actually discharged at the relevant time...it is only the incurring of the outgoing that must be actual; the section does not say in terms that there must be an actual outgoing - a payment out.'

(See also *New Zealand Flax Investments Ltd v. FC of T* (1938) 61 CLR 179 at 207 (*New Zealand Flax*); *FC of T v. James Flood Pty Ltd* (1953) 88 CLR 492 at 506 (*James Flood*); *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T* (1981) 144 CLR 616 at 624 (*Nilsen Development Laboratories*); *FC of T v. Firstenberg* 76 ATC 4141 at 4148; (1976) 6 ATR 297 at 305.)

15. This proposition was recently confirmed by the High Court in *FC of T v. Energy Resources of Australia Limited* 96 ATC 4536; (1996) 33 ATR 52 (*Energy Resources*) when, quoting from *James Flood*, it said (ATC at 4539; ATR at 56):

> 'Section 51(1) "has been interpreted to cover outgoings to which the taxpayer is definitively committed in the year of income although there has been no actual disbursement".'

16. The liability must be 'more than impending, threatened or expected' - refer *New Zealand Flax* (CLR at 207). '[W]hat is clearly necessary is that there should be a presently existing liability' - *Nilsen Development Laboratories* (CLR at 624). It is not a presently existing liability if it is contingent - refer *James Flood* (CLR at 506); *Nilsen Development Laboratories* (CLR at 207); *Marbren Pty Ltd v. FC of T* 84 ATC 4783 at 4788 - 4789; (1984) 15 ATR 1145 at 1152.

Defeasible

17. A taxpayer can be completely subjected to a liability even though it is defeasible - refer *Commonwealth Aluminium Corporation Ltd* (77 ATC 4151 at 4161; (1977) 7 ATR 376 at 386).

18. But, it is to be emphasised that the taxpayer must be definitively committed to the outgoing, even though it may be defeasible. A taxpayer who takes goods on approval for example could not be said to be definitively committed to their purchase.

Voluntary payments

19. Generally, a deduction is allowable because a liability arises or will arise necessitating the payment of an expense. However, some expenses are not necessitated by a liability, and they are incurred only upon payment. Examples of such expenses include gifts, insurance premiums, licence renewals and motor vehicle registration fees - these expenses are at the discretion of the taxpayer, if the taxpayer wants those benefits.

Accounting practice

20. The determination that an outgoing has been incurred depends on a jurisprudential analysis of whether there is a presently existing pecuniary liability, having regard to the terms of the contract or other instrument giving rise to that liability, rather than a commercial view of the arrangements - refer *James Flood* (CLR at 506); *Nilsen Development Laboratories* (CLR at 624); and see also *FC of T v. Citibank Ltd & Ors* 93 ATC 4691 at 4699; (1993) 26 ATR 423 at 432-433 (*Citibank Ltd & Ors*); *Ogilvy and Mather Pty Ltd v. FC of T* 90 ATC 4836 at 4842; (1990) 21 ATR 841 at 848; *Coles Myer* (ATC at 4221; ATR at 103).

21. The reliance on a jurisprudential analysis, and the place of accounting evidence in determining whether an outgoing has been incurred were discussed in *Citibank Ltd & Ors* by Hill J who said (ATC at 4699; ATR at 432):

> 'While in the area of s.51(1) of the Act the courts have, as was pointed out in *Coles Myer Finance Ltd v Federal Commissioner of Taxation* ... adopted a legal or jurisprudential analysis rather than a commercial view, this does not mean that accounting evidence has been seen to be irrelevant, the true position being, as Barwick CJ, Kitto and Taylor JJ said in the *Arthur Murray*

> case..., speaking of the decision of the High Court in *Federal Commissioner of Taxation v James Flood Pty Ltd*...:
>
> "The Court there held that, while commercial and accountancy practice may assist in ascertaining the true nature and incidence of an item as a step towards determining whether the item answers the test laid down in the Act for allowable deductions, it cannot be substituted for the test." '

Refer also *Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314 at 320; *Coles Myer* (ATC at 4221; ATR at 103).

22. Hill J then went on to note (ATC at 4699; ATR at 432):

> 'Accounting evidence may also have particular significance in determining the timing of a deduction, that is to say not whether it is incurred, but whether it is incurred in respect of a year of income.'

That is, he does not consider accounting principles as relevant to the question whether an outgoing has been incurred, but only as to what year of income it is to be treated as being properly referable.

23. Although the cases which raise the meaning of the word 'incurred' involve the ascertainment of taxable income on an earnings basis, there is no suggestion in those cases that the general principles necessarily differ where different accounting methods are used.

Properly referable

24. A determination of the year of income to which the loss or outgoing is properly referable is required at least in relation to cases involving financing transactions and liabilities which accrue either daily or periodically (and perhaps more broadly) - refer Taxation Ruling TR 94/26.

25. As is illustrated by *Coles Myer*, *Citibank Ltd & Ors* and *Australian and New Zealand Banking Group Limited v. FC of T* 94 ATC 4026; (1994) 27 ATR 559, accounting principles, though never determinative, may indicate the time during which the benefit from incurring the loss or outgoing is put to profitable advantage.

Alternative views

Incurred equals paid

26. An alternative view is that there is a common measure under ordinary principles for incomings and outgoings. Only with a common measure can you have a logically coherent measurement of taxable income. For example, it would be inappropriate to measure

receipts in Australian dollars but outgoings in US dollars. It is equally inappropriate, the argument runs, to measure incomings on a cash receipts basis and outgoings on an earnings basis.

27. A symmetrical approach provides a logical measurement of your taxable income. If what comes in is assessable to you **when** it comes in, then what goes out is only deductible **when** it goes out. On the other hand, if what comes in is assessable to you when it has accrued, even if not yet received, then outgoings made to gain that amount should be deductible when you are committed to paying them, even if you haven't paid them yet.

28. If incomings are measured on one accounting basis and outgoings on another, there is no clear idea of what you are seeking to measure. On the other hand, under a consistent accounting basis, there is a much clearer conception of taxable income. For example, if a cash basis applies to incomings and outgoings, taxable income is the excess of revenue receipts over revenue payments.

29. This alternative view seems to be the position under English income tax law (see *Inland Revenue Commissioners v. Morrison* (1932) SC 638 at 642; 17 TC 325 at 330). There is support for the alternative view in R W Parsons, *Income Taxation in Australia* (1985) Law Book Co at para 11.174 and in *Case 49/94* 94 ATC 429 at 430; *AAT Case 9749* (1994) 29 ATR 1138 at 1140, and *Case H46* (1957) 8 TBRD. The Asprey Committee report also took this view (*Taxation Review Committee, Full Report*, 31 January 1975, para 8.16).

30. However, we think that the better view is that 'incurred' has a consistent meaning in the income tax law and does not vary according to the accounting treatment of the corresponding item of income. There are several reasons for this conclusion.

31. First, from a strictly legal viewpoint, the several judicial explanations of what 'incurred' means do not say that the meaning varies according to the proper accounting treatment of the corresponding item of income, or when the income is derived under the law.

32. Secondly, if 'incurred' did mean different things in different circumstances, there would often be significant practical difficulties in calculating the amount of the loss or outgoing incurred. For example, if an outgoing related indiscriminately to different income items, it would be difficult to know how much was incurred immediately and how much only on payment.

33. Thirdly, the argument for a coherent logical measurement is theoretical only. The law already departs from that position by providing a range of specific timing rules for specific items of income (e.g., section 44 assesses a dividend when paid to a taxpayer and not

when declared even though many taxpayers receiving a dividend would account for their other income on an earnings basis and claim expenses related to their dividend income when the relevant liabilities arise, rather than when they were paid). The law also departs from that position for items of ordinary income. For example, interest is accounted for by most taxpayers as income on a cash receipts basis (which includes when it is credited to the taxpayer's bank account), even for taxpayers whose main income is accounted for on an earnings basis.

Properly referable

34. This alternative view proceeds on the basis that the law on whether a taxpayer has incurred an outgoing applies in the same way to all taxpayers. But, it also suggests that the outgoings accounted for on a cash based accounting system are only properly referable to the year in which they are actually paid.

35. It is said that accounting evidence is relevant to determining the year to which an outgoing is properly referable, and that for a cash based accounting system the evidence provided by that system of accounting points to the year of payment.

36. However, the decision in *Coles Myer* does not advocate a literal adoption of what the accounting records say. It proceeds, in the ATO's view, on the basis that the accounting records may show the period of time during which the benefit from incurring the outgoing is put to profitable advantage, and therefore the extent to which the outgoing is incurred in the relevant year for the purpose of producing assessable income in terms of subsection 51(1).

Examples

Example 1

37. Marilyn is a Government employee. However, she also operates a small sales business from her home in the evening. She has a telephone dedicated exclusively to that business. On 28 June 1996 Marilyn receives a telephone account for her business phone, which gives rise to a presently existing liability. She pays the account on 4 July 1996. Marilyn has incurred the outgoing in the year ended 30 June 1996 as it is properly referable to that year.

Example 2

38. Dolores is employed by a tax accountant and is studying tax law. She orders a taxation loose-leaf series from a commercial publisher on 15 June 1996, which arrives on 27 June 1996. The books are sent on the basis that they are on 10 days approval from date of arrival, and can be returned if not wanted. This outgoing will not be incurred until Dolores finally commits to the outlay - in this case that will be when the books are not returned at the expiration of the 10 day approval period or when payment is made, whichever occurs first.

Example 3

39. Sue has a sickness insurance policy that will pay a weekly benefit and is renewable in advance each July. She receives the renewal notice each June and pays it in July. The outgoing will be incurred in July when the premium is paid as the payment is voluntary.

Example 4

40. Bob is an employee superannuation expert who has a contract with a commercial publisher to supply him with a loose-leaf service. He receives the annual invoice for the next 12 months service on 12 June 1996 and pays it by direct debit over the next 12 months commencing 15 July 1996. Notwithstanding that an annual invoice is received, Bob may cancel the service at any time, and the direct debiting will cease. The outgoing will be incurred when each direct debit is made.

Your comments

41. If you wish to comment on this Draft Ruling, please send your comments by: 7 February 1996

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- Australian and New Zealand Banking Group Limited v. FC of T 94 ATC 4026; (1994) 27 ATR 559
- Coles Myer Finance Pty Ltd v. FC of T 93 ATC 4214; (1993) 25 ATR 95
- Commonwealth Aluminium Corporation Ltd v. FC of T 77 ATC 4151; (1977) 7 ATR 376
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