


TD 2007/D8 - 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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This document has been finalised by 2007/28.



Draft 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*?

❗ This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner’s preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the way explained below. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don’t have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

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*¹ is an immediate obligation binding at law, whether payable and enforceable presently or at a future time. Future provisions and contingencies 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, subparagraph (b) of the definition of ‘net assets’ in subsection 109Y(2).

Date of effect

2. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the final 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 final Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

¹ All legislative references in this Determination are to the *Income Tax Assessment Act 1936*.

Example 1

3. *Z Coy Pty Ltd (Z Coy) operates a small financial services business and as at 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 paragraph 109Y(2)(a).*

Example 2

4. *X Coy Pty Ltd operates a small mixed goods retail business and at 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 paragraph 109Y(2)(a).*

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 paragraph 109Y(2)(a).*

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 volition of M Coy and do not form part of the employment contract between M Coy and its employees. At 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 provision taken up by M Coy is not enforceable by legal action either presently or in the future and therefore does not qualify as a present legal obligation within the meaning of paragraph 109Y(2)(a).*

Appendix 1 – Explanation

① *This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed 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 unfranked dividends taken to have been paid by the private company. Those unfranked 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. 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.²

9. The formula for calculating a private company’s distributable surplus is contained in subsection 109Y(2), being ‘Net assets – 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:

- (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 its assets or overvalue its provisions, the Commissioner may substitute a value that the Commissioner considers is appropriate.

² Under section 44 the assessable income of shareholder in a company includes dividends paid out of profits.

10. In the context of section 109Y, the phrase ‘present legal obligation’ is to be interpreted in accordance with its legal meaning. 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. 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.

11. Although the phrase ‘present legal obligation’ takes its legal meaning, current Australian accounting standards and concepts would produce a similar result. The AASB *Framework for the preparation and presentation of financial statements* 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’.³ 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 that obligations may be legally enforceable as a consequence of a binding contract or a statutory requirement, or arise from normal business practice and custom.

12. AASB Accounting Standard 137 concerns *Provisions, contingent liabilities and contingent assets* (AASB 137).⁴ 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’.⁵

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’.⁶

The application of the definition of ‘legal obligation’ in AASB 137 to subsection 109Y(2) coincides with the technical legal meaning of the phrase discussed above, 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.

³ Australian Accounting Standards Board *Framework for the preparation and presentation of financial statements* (July 2004) at paragraph 49. The definition also appears in paragraph 10 of AASB 137.

⁴ AASB 137 has application from 1 January 2005 and replaced AASB Accounting Standard 1044 *Provisions, Contingent Liabilities and Contingent Assets* 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.

⁵ 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.

⁶ 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).

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 provides that a past event that leads to a present obligation is an obliging event:

For an event to be an obliging 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.⁷

15. 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.⁸

16. 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.

⁷ Similarly, paragraph 3.1.8 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'.

⁸ AASB 1044 similarly provides that trade creditors and accruals are liabilities (paragraph 3.1.2).

Appendix 2 – Your comments

17. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel or relevant Tax officers. The Tax Office may use a version (names and identifying information removed) of the compendium in providing responses to persons providing comments. Please advise if you do not want your comments included in the latter version of the compendium.)

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- dividends

Legislative references:

- ITAA 1936 44
- ITAA 1936 Pt III Div 7A
- ITAA 1936 109Y
- ITAA 1936 109Y(2)
- ITAA 1936 109Y(2)(a)
- ITAA 1936 109Y(2)(b)

Case references:

- Brett v. Barr Smith (1919) 26 CLR 87

Other references:

- Australian Accounting Standards Board Framework for the preparation and presentation of financial statements (July 2004)
- AASB Accounting Standard 137 Provisions, contingent liabilities and contingent assets
- AASB Accounting Standard 1044 Provisions, Contingent Liabilities and Contingent Assets
- Exposure draft ED 88 Provisions and Contingencies

ATO references

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