


TD 2012/D1 - Income tax: when is income tax of a private company a 'present legal obligation' for the purposes of the distributable surplus calculation under 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 TD 2012/10.



Draft Taxation Determination

Income tax: when is income tax of a private company a ‘present legal obligation’ for the purposes of the distributable surplus calculation under subsection 109Y(2) of Division 7A of Part III of the *Income Tax Assessment Act 1936*?

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Ruling

1. If a private company has a liability to pay instalments for an income year under Part 2-10 of Schedule 1 to the *Taxation Administration Act 1953* (TAA), and some or all of an instalment is unpaid as at 30 June then the unpaid amount of that instalment is a ‘present legal obligation’ for the purposes of the distributable surplus calculation worked out at that time.

TD 2012/D1

2. If a private company which is a full self assessment taxpayer has an amount due and payable (after credits for instalments payable for the income year¹) by reason of subsection 5-5(4) of the *Income Tax Assessment Act 1997* (ITAA 1997),² then this amount is a present legal obligation for the purposes of the distributable surplus calculation worked out at 30 June of the income year which is subject to the deemed assessment under section 166A of the *Income Tax Assessment Act 1936* (ITAA 1936). The fact that the tax is due on the day the return is lodged which is after the end of the year of income is not relevant for the purposes of the distributable surplus calculation.

3. If the Commissioner issues a private company with an amended assessment for any income year, then the amount payable under the amended assessment will be a present legal obligation for the purposes of the distributable surplus calculation worked out at the end of the income year subject to the amended assessment.

Example 1

4. A private company (A Pty Ltd) has correctly self assessed taxable income for the 2009-10 income year of \$100,000, and the fourth quarterly PAYG instalment of \$7,500, is unpaid as at the end of the income year (30 June 2010). The first three PAYG instalments totalling \$22,500 have already been paid on time. The amount of the unpaid instalment at 30 June 2010 of \$7,500 is a present legal obligation of A Pty Ltd for the purposes of the distributable surplus calculation under subsection 109Y(2) of the ITAA 1936 at 30 June 2010.

Example 2

5. A private company (M Pty Ltd) is not registered for the GST and does not have an instalment rate for the 2006-07 income year for the purposes of Part 2-10 of Schedule 1 to the TAA. During the 2006-07 income year, M Pty Ltd made a \$5,000 loan to a shareholder Beth which was neither repaid nor put under a qualifying section 109N of the ITAA 1936 written agreement before M Pty Ltd's lodgement day for the 2006-07 income year. M Pty Ltd's 2007 income tax return was lodged on 28 February 2008 with the income tax due and payable of \$15,000.

6. In determining the amount of the dividend taken to be paid to Beth at the end of the 2006-07 income year under Division 7A of Part III of the ITAA 1936, M Pty Ltd's 2006-07 income tax of \$15,000 is taken into account for the purposes of the distributable surplus calculation under subsection 109Y(2) of the ITAA 1936 at 30 June 2007. It is a present legal obligation for the purposes of the distributable surplus calculation under subsection 109Y(2) of the ITAA 1936 at 30 June 2007.

Example 3

7. A private company (B Pty Ltd) has correctly self assessed taxable income for the 2009-10 income year of \$100,000. The tax assessed is \$30,000.

¹ Section 45-30 of Schedule 1 to the TAA.

² Subsection 5-5(4) is part of the rewrite of section 204 of the *Income Tax Assessment Act 1936* and is effective from 1 July 2010. It applies from the 201011 financial year and later income years. It replaces the repealed subsection 204(1A). The rewrite contains no substantive policy changes.

TD 2012/D1

Status: **draft only – for comment**

Page 3 of 9

8. *The total of the company's PAYG instalments for the 2009-10 income year amounted to \$28,000 of which the fourth quarterly instalment of \$7,000 is unpaid at 30 June 2010.*
9. *In calculating the total amount of the tax payable on the deemed assessment the company is entitled to a credit for its PAYG instalments even if it has not actually paid a particular instalment. In this case the tax payable amount is \$2,000 (\$30,000 less \$28,000).*
10. *The total present legal obligation for income tax for the purposes of the distributable surplus calculation under subsection 109Y(2) of the ITAA 1936 at 30 June 2010 is \$9,000 comprising the amount of the unpaid instalment and the amount of the tax payable on the deemed assessment. The fact that the tax is due on the day the return is lodged which is after the end of the year of income is not relevant for the purposes of the distributable surplus calculation.*

Example 4

11. *A private company (C Pty Ltd) derives assessable income during the 2007-08 income year of \$100,000 which is taken as a loan by the majority shareholder (Sam) and not returned as assessable income by C Pty Ltd. The loan was not made under a written agreement that met the criteria of section 109N of the ITAA 1936. On completion of an audit in the 2009-10 income year, an amended assessment issued to C Pty Ltd increasing assessable income for the 2007-08 income year by \$100,000 and resulting in additional tax payable of \$30,000. This was paid by C Pty Ltd on 30 September 2010.*
12. *As a result of the audit, the Commissioner also issued an amended assessment to Sam to include an amount taken to be paid as a dividend under Division 7A of Part III of the ITAA 1936 in his assessable income for the 2007-08 income year. In determining the amount taken to be a dividend, the income tax paid by C Pty Ltd on 30 September 2010 is a present legal obligation for the purposes of the distributable surplus calculation under subsection 109Y(2) of the ITAA 1936 at 30 June 2008.*

Date of effect

13. *When the final Determination is issued, it is proposed to apply 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 to 76 of Taxation Ruling TR 2006/10).*
14. *As a result of the decision in *Commissioner of Taxation v H* [2010] FCAFC 128; 2010 ATC 20-218 (the H case) the Tax Office has changed its view since Taxation Determination TD 2008/28 issued.*

Commissioner of Taxation

11 January 2012

Appendix 1 – Explanation

❶ *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

Division 7A

15. Division 7A of Part III of the ITAA 1936 treats:
- (i) certain payments and loans made by a private company to a shareholder or a shareholder’s associate;
 - (ii) certain debts owed by a shareholder or a shareholder’s associate forgiven by the private company; and
 - (iii) certain trustee payments, loans and debt forgiveness made to a shareholder (or their associate) of a private company with unpaid present entitlement.³

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.⁴

Accordingly, those dividends are included in the assessable income of the shareholder or associate under section 44 of the ITAA 1936.

16. The total amount taken to have been paid as dividends under Division 7A of Part III of the ITAA 1936 is limited to a private company’s distributable surplus.⁵

17. The formula for calculating a private company’s distributable surplus is contained in subsection 109Y(2) of the ITAA 1936, being ‘Net assets – Division 7A amounts⁶ – 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; or
 - (iv) other provisions prescribed under regulation made for the purposes of this subparagraph.

³ Subdivision EA of Division 7A of Part III of the ITAA 1936.

⁴ Section 109Z of the ITAA 1936.

⁵ Subsection 109C(2), subsection 109D(1AA), subsection 109E(2), subsection 109F(2) and subsection 109XB(2) of the ITAA 1936 in conjunction with section 109Y of the ITAA 1936 respectively.

⁶ 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 of the ITAA 1936 to have paid as dividends in the year of income apart from section 109Y of the ITAA 1936.

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.⁷

18. As explained in Taxation Determination TD 2007/28, the technical legal meaning of the word 'obligation' is an obligation which is enforceable by legal action. The phrase 'present legal obligation' requires that the obligation enforceable by legal action be presently existing. The company must be bound by the legal obligation, whether or not it can be sued for immediately in a court of law.

19. Division 7A of Part III of the ITAA 1936 is an anti-avoidance or 'integrity' provision, directed to ensuring that disguised or informal distribution of company profits to shareholders or their associates should be included in the assessable income of the shareholders or associates.

Distributable surplus not the same as book profits

20. In section 109Y of the ITAA 1936 a statutory conception of 'distributable surplus' is introduced to replace the less precise notion of 'profit' in section 44 of the ITAA 1936. Section 109Y of the ITAA 1936 takes the value of the company's assets disclosed by its accounting records and subtracts the amount of present legal obligations, certain specified provisions, and the paid-up capital to arrive at the distributable surplus. That is, it adopts the book value of assets but does not adopt the book value of liabilities. The substitution of present legal obligations, with the addition of only four specified provisions, for book values of liabilities leaves the accounts less open to understatement by taxpayers and increases certainty (because it substitutes the actual amount of liabilities as they accrue for an earlier estimate of them by way of provision). However, this means that timing differences will result between 'profits' as ascertained in accordance with accounting standards and the 'distributable surplus' ascertained under the statutory formula (because the recognition of liabilities is deferred). These differences might either increase or decrease the distributable surplus for a particular year.

21. In 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.

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.

⁷ 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.

TD 2012/D1

PAYG Instalments

22. The PAYG Instalment regime is contained in Part 2-10 of Schedule 1 to the TAA. That regime prescribes when liability arises and when the instalments are due. For example, for a quarterly payer, there is a liability to pay the quarterly instalment at the end of each quarter (subsections 45-50(1) and (2) of Schedule 1 to the TAA) and that instalment is due on, or before, the 21st or 28th day of the month after the end of the quarter depending on whether the private company is a 'deferred BAS payer' (subsections 45-61(1) and 45-61(2) of Schedule 1 to the TAA).

23. Therefore, where a private company has an instalment outstanding at 30 June of an income year, there is an obligation to which the private company is bound which is enforceable by legal action in due course. It is therefore a present legal obligation of the private company for the purposes of Division 7A of Part III of the ITAA 1936.

Deemed Assessments

24. Section 166A of the ITAA 1936 was inserted by *Taxation Laws Amendment Act (No. 5) 1989* with a start date of 17 January 1990. Paragraph 166A(1)(a) of the ITAA 1936 was substituted by *Taxation Laws Amendment Act (No. 1) 1995* and amended by *Taxation Laws Amendment (Repeal of Inoperative Provisions) Act 2006*. Section 166A of the ITAA 1936 was therefore operative at the start date of Division 7A of Part III of the ITAA 1936.⁸

25. Section 166A of the ITAA 1936 in its present form provides (effectively in relation to: (i) companies; and (ii) full self-assessment taxpayers) that where a taxpayer gives a return in respect of a year of income, the Commissioner is deemed to have made an assessment of the taxable income or net income and the tax payable on that income, equal to those respective amounts specified in the return, on the day on which the return was lodged, and the return is taken to be a notice of assessment which has been served on the day it was taken to have been made.

26. When the Commissioner makes an assessment of the income tax that the company is liable to pay the company is entitled to a credit for instalments payable for the income year even if not yet paid. The making of the assessment, and the resulting credit entitlement, does not affect the liability to pay an instalment (subsections 45-30(2) and (3) of Schedule 1 to the TAA).

Amended assessments

27. Section 173 of the ITAA 1936 states that 'Except as otherwise provided every amended assessment shall be an assessment for the purposes of the Act'.

28. Therefore, under the Act (ITAA 1936) the amended assessments are to be treated in the same way as original assessments.

⁸ Being 4 December 1997.

Assessments and present legal obligations

29. The question of which income year an income tax liability arising under an amended assessment is taken up as a present legal obligation was considered in the H Case. In that case it was held that income tax properly payable on the company's taxable income for a year of income is, as at the end of that year of income, a present legal obligation notwithstanding that no notice of assessment had issued. Downes J, Edmonds J and Greenwood JJ relevantly stated the following at paragraphs 37 to 41:

37. It is within this legislative context, informed by the legislative policy and purpose referred to in the explanatory memorandum, that the ingredients of what goes to make up 'distributable surplus', including the term 'present legal obligations', fall to be considered. A construction of those ingredients which gives the term 'distributable surplus' a measure which approximates the profits (realised and unrealised) available for distribution is to be preferred to a construction which results in a divergence between the measure of the distributable surplus so construed and the measure of the profits (realised and unrealised) available for distribution.

38. The requirement that there be an 'obligation' does not require the existence of a debt due, in the sense of owing, any more than it requires the existence of a debt due, in the sense of being payable. The term 'obligation' embraces situations outside the confines of a creditor/debtor relationship.

39. Prior to the making of the assessment and service of notice of that assessment, the taxpayer had an obligation to pay income tax in the future, and that obligation came into existence on 30 June of the year of income in respect of which the income was derived.

40. The obligation is no less an obligation because the Commissioner cannot, until he makes an assessment and serves notice of that assessment, enforce it as a debt due and payable. So understood, the obligation to pay income tax 'matures as a debt due and payable after assessment', to use the words of the Full Court in *Jones* at 290, but that maturation does not deny the existence of the obligation prior to the making of the assessment and service of notice of that assessment: see *Kavich* at 527 per Lockhart J

41. The obligation is a present one in the sense that it exists; the fact that the obligation is to do something at a future date does not deny its standing as an existing obligation. At worst it may be a contingent obligation, contingent on an assessment being made and notice of that assessment served, but that does not disqualify it as a present legal obligation.

30. In determining a private company's present legal obligation relating to income tax, the practical application of the formula in section 109Y of the ITAA 1936 will take the income tax amount from the notice of assessment. If an amended assessment is issued then the distributable surplus will require amendment to take account of the amount of additional tax payable arising from the amended assessment.

31. The amount taken up as a present legal obligation relating to income tax must however be net of PAYG instalments paid or payable towards that income tax liability as at 30 June. PAYG instalments paid or payable are to be deducted so there is no double counting. PAYG instalments unpaid as at 30 June are themselves a present legal obligation as explained at paragraphs 22 and 23 of this draft Determination.

TD 2012/D1

Appendix 2 – Your comments

32. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

33. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the Tax Office website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: 17 February 2012
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TD 2007/28; TD 2007/D9;
TD 2008/28

Subject references:

- anti avoidance measures
- deemed dividends
- shareholder debt forgiveness
- shareholder loans
- shareholder payments

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 109F(2)
- ITAA 1936 109N
- ITAA 1936 Pt III Div 7A Subdiv EA
- ITAA 1936 109XB(2)
- ITAA 1936 109Y
- ITAA 1936 109Y(2)
- ITAA 1936 109Z
- ITAA 1936 166A
- ITAA 1936 166A(1)(a)
- ITAA 1936 173

- ITAA 1936 204 former
- ITAA 1936 204(1A)
- ITAA 1997 5-5(4)
- TAA 1953
- TAA 1953 Sch 1 Pt 2-10
- TAA 1953 Sch 1 45-30
- TAA 1953 Sch 1 45-30(2)
- TAA 1953 Sch 1 45-30(3)
- TAA 1953 Sch 1 45-50(1)
- TAA 1953 Sch 1 45-50(2)
- TAA 1953 Sch 1 45-61(1)
- TAA 1953 Sch 1 45-61(2)
- Taxation Laws Amendment Act (No. 5) 1989
- Taxation Laws Amendment Act (No. 1) 1995
- Taxation Laws Amendment Act (No. 1) 1995 Taxation Laws Amendment (Repeal of Inoperative Provisions) Act 2006

Case references:

- Commissioner of Taxation v. H [2010] FCAFC 128; 2010C 20-218
- Commonwealth v O'Reilly (1984) VR 931

Other references:

- Explanatory Memorandum to A New Tax System (Tax Administration) Bill (No. 2) 2000
- Explanatory Memorandum to Taxation Laws Amendment Bill (No.3) 1998

ATO references

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