


***TD 95/D15 - Income tax: will an assessable gain arise where an amount claimed as a deduction, but not paid, exceeds the amount actually required to be paid in a later year?***

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## Draft Taxation Determination

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### **Income tax: will an assessable gain arise where an amount claimed as a deduction, but not paid, exceeds the amount actually required to be paid in a later year?**

1. No, unless the difference is a profit or gain made in the ordinary course of, or incidental to, the particular taxpayer's assessable income producing activity. This could arise in cases where the taxpayer is carrying on a business or as a result of an isolated transaction.
2. Generally there are two situations where a profit or gain may occur:
  - deductions for variable or estimated amounts; and
  - deductions that are fixed in amount but subsequently defeased (e.g., where a debt is forgiven).

#### **Variable amounts**

3. The amount of a variable liability or an estimated liability may not finally be determined until it is actually paid. We think the principles discussed in *International Nickel Australia Ltd v. FC of T* 7 ATR 739; 77 ATC 4383 and *Commonwealth Aluminium Corporation Ltd v. FC of T* 7 ATR 376; 77 ATC 4151 support the proposition that in all cases involving a variable or estimated liability that has been allowed as a deduction, a reduction in the amount required to defray the expense in a subsequent year will give rise to an assessable gain because the difference has the character of income under ordinary concepts.

4. In *International Nickel* Mason J said (at ATC 4394; ATR 751) that there is 'a general concept of income which includes within its embrace a reduction in the amount of an outgoing on revenue account'. In his Honour's opinion, the exchange gain cases give expression to this general concept. In *Commonwealth Aluminium* Newton J said (at ATC 4161; ATR 386):

'If in one year of income an unpaid liability is allowed as a deduction under sec. 51 at an estimated amount, then if the estimate later proves incorrect, the necessary adjustments can be made in the year of income when the liability is actually paid, either by way of addition to the assessable income of that year (if the estimate was too high) or by way of a further deduction under sec. 51 in calculating the taxable income of that year (if the estimate was too low).'

#### **Fixed amounts subsequently defeased**

5. Where a taxpayer pays a liability on revenue account in one year and is subsequently reimbursed or the amount is refunded, the receipt will be included in the assessable income if it constitutes income according to ordinary concepts. In *HR Sinclair v. FC of T* (1966) 14 ATD 194 the taxpayer paid royalties to the Victorian Forest Commission calculated according to a formula, but disputed by the taxpayer and paid under protest. The amount was ultimately refunded and the High Court held that the refund was assessable income. Taylor J said (at ATD 195-6) that the taxpayer had engaged in 'protracted representations and negotiations' and that its attempts to secure repayment were 'just as much an activity of the business as would have been an attempt to avoid an overcharge in the first instance'. Owen J stated (at ATD 198):

'The Company's business was that of a sawmiller. It was in that capacity that it paid royalties for timber cut by it for the purposes of its business and it was in that capacity that it received the amount refunded. It was part of the proceeds of the business carried on by it.'

See also *Automatic Totalisators Limited v. FC of T* (1968) 15 ATD 170.

6. The character of such a gain is not determined by the fact that a deduction has previously been allowed in respect of the expense to which the reimbursement or refund relates. 'The character of the amount that the appellant received cannot, in the absence of some appropriate statutory provision, be thought to vary according to whether or not deductions were claimed and allowed of expenditure which includes the sum now reimbursed': per Taylor J in *H R Sinclair* at 14 ATD 195.

7. Like the refund cases, a gain which results from the defeasance of a liability can have the character of income under ordinary concepts. This approach was adopted in *Commonwealth Aluminium* where the question was whether a royalty paid by the taxpayer but also challenged by it as an expense not properly levied by the Department of Mines, was deductible. Newton J said the defeasible nature of the liability was no bar to its deductibility. At ATR 386, ATC 4161 he said:

'If in one year of income a defeasible liability is allowed as a deduction under sec. 51, and in a later year the defeasance occurs, so that the liability is divested or destroyed, then it would appear that the amount of the liability will be included in the assessable income of the taxpayer for that later year, provided that the amount can properly be characterised as assessable income of that year, although not simply because it had been allowed as a deduction in the earlier year.'

8. In the ordinary case of debt forgiveness due to a lack of capacity to pay, it could be expected that the forgiveness gain would not amount to assessable income, as it would not usually be concluded that such a gain was an ordinary part of the taxpayer's business or income producing activity. However, if the circumstances are such that the gain may be characterised as an ordinary incident of the business being carried on by the debtor, an amount may properly be included in the assessable income. In each case it will be a question of applying principles similar to those discussed in *FC of T v. The Myer Emporium Ltd* 87 ATC 4363; 18 ATR 693; *G P International Pipecoaters Pty Ltd v. FC of T* 90 ATC 4413; 21 ATR 1 and *FC of T v. Cooling* 90 ATC 4472; 21 ATR 13.

9. For example, in *FC of T v. Unilever Australia Securities Ltd* 95 ATC 4117; 30 ATR 134 Lockhart J decided that a defeasance arrangement, whilst unusual even in the context of carrying on business as a finance company, nevertheless generated a profit or gain in the course of that business which was income according to ordinary concepts. Hill J found that the profit was derived in the course of the taxpayer's business activity and was a proceed of that activity. On the other hand, Beaumont J noted the view of Mason J in *International Nickel* that the release of a debt on revenue account in *British Mexican Petroleum Co Ltd v. IRC* (1932) 16 TC 570 was an 'unusual' transaction and held (at ATC 4135; ATR 154) that:

'a partial release...in the present circumstances to relieve the respondent of some of its primary responsibility, both in legal and practical terms, with a view to winding down its activities, should not be regarded as something "ordinarily encountered" in that business.'

His Honour concluded that the extraordinary extrinsic circumstances provided an explanation for what occurred that was inconsistent with the inference that a notional 'surplus' was income generated in the hands of the taxpayer.

## Commissioner of Taxation

13/9/95

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