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Taxation Determination

Income tax: capital gains: small business concessions: what 'liabilities' are included in the calculation of the 'net value of the CGT assets' of an entity in the context of subsection 152-20(1) of the *Income Tax Assessment Act 1997*?

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Ruling

1. The term 'liabilities' in the context of subsection 152-20(1) of the *Income Tax Assessment Act 1997*[1] has its ordinary meaning. 'Liabilities' extend to legally enforceable debts due for payment and to presently existing legal or equitable obligations to pay either a sum certain or ascertainable sums. It does not extend to future obligations, expectancies or liabilities that are uncertain as both a theoretical and a practical matter (*Commissioner of Taxation v. Byrne Hotels Qld Pty Ltd* [2011] FCAFC 127 at 122) (*Byrne Hotels)*.'

[1] All legislative references are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

Example 1

2. *Cool Tool Pty Ltd is selling its business. The assets and liabilities of the company are as follows:*

Assets:	***$***	***$***
Plant and machinery	*1,500,000*	
Freehold premises	*3,500,000*	*5,000,000*
Liabilities:		
Mortgage (secured over the premises)	*2,000,000*	
Provision for leave of employees	*500,000*	
Provision for rebates	*200,000*	
Provision for possible damages payout	*100,000*	*2,800,000*
Net assets:		*2,200,000*

3. *The net value of the CGT assets of the company is calculated as follows:*

Assets:	***$***	***$***
Plant and machinery	*1,500,000*	
Freehold premises	*3,500,000*	*5,000,000*
Liabilities:		
Mortgage (secured over the premises)	*2,000,000*	
Provision for leave of employees	*500,000*	*2,500,000*
Net value of CGT assets:		*2,500,000*

4. *The following items are not taken into account in working out the net value of the CGT assets of Cool Tool Pty Ltd because they are future obligations, expectancies or liabilities that are uncertain as both a theoretical and a practical matter:*

- *provision for possible damages payout; and*
- *provision for rebates.*

(Note: Although the provision for leave of employees is not a liability, it is separately taken into account under paragraph 152-20(1)(b) to determine the net value of CGT assets.)

Example 2

5. *Pretty in Pink Pty Ltd is selling its clothing business. The assets and liabilities of the company are as follows:*

Assets:	***$***	***$***
Fixtures and fittings	*300,000*	
Freehold premises in Parramatta	*4,500,000*	
Freehold premises in Penrith	*2,500,000*	*7,300,000*

Liabilities:

Bank overdraft	*600,000*	
Mortgage (secured over Parramatta premises)	*500,000*	
Bill of exchange for Penrith premises	*400,000*	*1,500,000*
Net value of CGT assets:		*5,800,000*

6. *The fixtures and fittings may be depreciating assets and the gains from them may be treated as income rather than capital gains but they are still CGT assets. Hence, they are included in the calculation of the net value of CGT assets of Pretty in Pink Pty Ltd.*

7. *The bank overdraft is taken into account in working out the net value of the CGT assets of Pretty in Pink Pty Ltd because it is a general liability that relates to all the assets of the company.*

Example 3

8. *Cassandra operates a dancing school. Five years ago, Fancy Foot Pty Ltd, which is wholly owned by Cassandra, bought a dancing studio where she conducts the dancing school. Fancy Foot Pty Ltd has no other CGT assets. The studio has a current market value of $6 million with $0.5 million of the loan used to purchase the studio still outstanding.*

9. *Last year, Wanadance Pty Ltd, also wholly owned by Cassandra, bought a warehouse to store dancing costumes and stage materials. Wanadance Pty Ltd has no other CGT assets. The market value of the warehouse subsequently fell, and is now $2 million. $2.8 million of the loan to purchase the warehouse is still outstanding.*

10. *Cassandra has accepted a leading role in a Broadway show overseas. A contract has been entered into to sell both the studio and the warehouse.*

11. *Both Fancy Foot Pty Ltd and Wanadance Pty Ltd are connected with Cassandra for the purposes of small business concessions. Cassandra has no affiliates. She has other CGT assets, which have a net value of $1 million.*

12. *The net value of Cassandra's CGT assets is calculated as follows:*

Net value of CGT assets of Cassandra	*$1.0m*
Net value of CGT assets of Fancy Foot Pty Ltd – Studio: ($6m less $0.5m)	*$5.5m*
Net value of CGT assets of Wanadance Pty Ltd – Warehouse: ($2m less $2.8m)	*($0.8m)*
Total net value of CGT assets:	*$5.7m*

13. *Cassandra qualifies for the small business CGT concessions because she satisfies the $6 million maximum net asset value test. Note that the $0.8 million excess liability in respect of Wanadance Pty Ltd's CGT asset (the warehouse) can be offset against the value of Cassandra's assets or Fancy Foot Pty Ltd's CGT asset (the studio)..*

Date of effect

14. This Determination applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of the determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
9 May 2007

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Explanation

15. To qualify for the small business CGT concessions, at least one of the conditions in paragraph 152-10(1)(c) must be satisfied. One of these conditions is the maximum net asset value test in section 152-15. Under this test, the net value of the CGT assets of the taxpayer and certain related entities must not exceed $6 million just before the relevant CGT event.

16. The 'net value of the CGT assets' of an entity is the amount (whether positive, negative or nil) obtained by subtracting from the sum of the market values of those assets the sum of:

- the liabilities of the entity that are related to the assets; and
- the following provisions made by the entity:
  - provisions for annual leave
  - provisions for long service leave
  - provisions for unearned income, and
  - provisions for tax liabilities (subsection 152-20(1)).

17. The term 'liabilities' is not defined for the purposes of the 'net value of the CGT assets' definition. Accordingly, it has its ordinary meaning reflecting the context in which it is used. *The Macquarie Dictionary,* revised 3rd edition, defines liability to mean: 'an obligation, especially for payment; debt or pecuniary obligation'.

18. In the context of subsection 152-20(1), 'liabilities' extend to legally enforceable debts due for payment and to presently existing legal or equitable obligations to pay either a sum certain or ascertainable sums. The term does not extend to future obligations or expectancies. The question of whether the term 'liabilities' extends to contingent liabilities was considered by the Full Federal Court in *Commissioner of Taxation v. Byrne Hotels Qld Pty Ltd* [2011] FCAFC 127.

19. A 'contingent liability' is a liability which will become due only on the occurrence of an event that may or may not happen. An example is a possible obligation to pay damages in future if the judgment in a pending lawsuit is unfavourable.

19A. In *Byrne Hotels,* the taxpayer had retained the services of a real estate agent and a solicitor in relation to the proposed sale of its hotel business. The real estate agent's commission was payable on completion of the contract of sale on 19 January 2004. The solicitor's fees, not governed by a written agreement, were charged on a periodic basis by the issue of invoices for work performed. Relevant work was performed by the solicitor both before and after the date of entry into the sale contract.

19B. The issues were whether the commission and unbilled solicitor's fees were liabilities under subsection 152-20(1) just before the CGT event (that is, just before the time the sale contract was entered into on 24 October 2003) for the purpose of determining the net value of the CGT assets of the taxpayer. The Court (by majority) found that the commission was a liability at the relevant time, while all three judges held that the unbilled solicitor's fees were also liabilities at the relevant time <u>to the extent</u> they related to work performed prior to that time.

19C. Bennett J held that, because 'contingent assets' were within the scope of subsection 152-20(1), there was no reason why 'contingent liabilities' should not also be included in the net asset calculation. By 'contingent assets', Bennett J was referring to the broad definition of 'assets' in the CGT law which extends to legal or equitable rights that are not property. Accordingly, by 'contingent liabilities' she meant legal or equitable obligations that are not property, including 'obligations existing at the relevant time under a contract which can be enforced by the other party or parties to a contract'.

19D. On this basis, she held that unbilled solicitor's fees for work performed prior to the date of entry into the sale contract were to be included as liabilities even though the invoice was not issued until after that date. However, she held that the fees relating to work performed after that date and the real estate agent's commission were not liabilities at the relevant time.

19E. Greenwood J (with whose reasons Dowsett J agreed) broadly agreed with the reasoning of Bennett J but reached a different conclusion about the real estate agent's commission which he held to be a liability at the relevant time. Although he referred to the agent's commission as a contingent liability or a contingent burden (at paragraphs 123, 125, 126, 127), he noted (at paragraph 122) that, while the agent's entitlement to be paid its commission was dependent on the contingency of the taxpayer entering into the sale contract, immediately before the signing of the contract all terms had been agreed and nothing remained to be done by the agent to perfect its entitlement to the commission. The only contingency was the formality of signing. Greenwood J went on to say (at paragraph 122):

> just before the CGT event, a liability resided in the taxpayer arising out of the pre-existing contract with [the agent] subject only to the translation of the decision already made to sell …into the act of execution of the contracts. Just before the CGT event the obligation was not 'truly contingent' in the sense of being 'uncertain as both a theoretical and practical matter'.

And further at paragraph 124:

> However, it is important to recognise that just before the CGT disposal event occurred by entering into the written instruments with MGW thus giving legal effect to the decision to sell on the terms of the contracts, the obligation had arisen subject to the formal step of signing.

19F. There was, of course, the further contingency that the sale contract might not proceed to completion as a result of events subsequent to execution. In respect of this, Greenwood J said at paragraph 125:

> Just before the CGT disposal event, the taxpayer was a ready and willing seller and the buyer was a ready and willing buyer, intending to complete the transaction by settlement of each contract……Although the liability of the entity was, just before the CGT disposal event, a contingent one, the [potential] events subsequent operated as a qualification on the obligation rather than matters which, properly construed, give rise to a conclusion about the nature of the relationship between the agent and the taxpayer such that no obligation concerning the benefits and burdens of the contract subsisted.

19G. Although the Court referred to 'contingent liabilities' as relevant for the purpose of the net asset calculation under subsection 152-20(1), it is clear that the judges were contemplating presently existing legal or equitable obligations where the only contingency is enforcement (the solicitor's fees) or obligations that are technically, but not 'truly', contingent because the contingencies are formalities or procedural matters where nothing remains to be done by the relevant party to perfect its entitlement (the agent's commission). As such, the Commissioner is of the view that the decision does not stand for any principle that contingent liabilities in general fall within the meaning of the term 'liabilities' for the purpose of subsection 152-20(1). A 'truly contingent' liability in the sense of a future or potential obligation, expectancy, or liability that is otherwise uncertain as a theoretical and practical matter will not be included as a liability for the purpose of subsection 152-20(1).

20. Examples of amounts that are not included in 'liabilities' for the purposes of determining the 'net value of the CGT assets' of an entity include:

- provisions for possible obligation to pay damages in a pending lawsuit;
- provisions for liabilities in respect of an earn-out contract;
- provisions for guarantee of a loan;
- provisions for long service and annual leave entitlements;
- provisions for income and other taxes prior to the liability arising;
- accounting liabilities arising as a result of receiving prepaid income; and
- provisions in general for such things as quantity rebates and the like.

(Note: provisions for annual leave, provisions for long service leave, provisions for unearned income and provisions for tax liabilities are not within the meaning of the term 'liabilities' but are separately taken into account in determining the net value of the CGT assets of an entity.)

Liabilities that are related to the assets

21. The 'liabilities of the entity that are related to the assets' in subsection 152-20(1) include liabilities directly related to particular assets that are themselves included in the calculation, for example, a loan to finance the purchase of business premises.

22. The 'liabilities of the entity that are related to the assets' also include liabilities that, although not directly related to one particular asset, are related to the assets of the entity more generally, for example, a bank overdraft or other short term financing facility that provides working capital for the operation of the business.

23. [Omitted.]

Note

24. As noted in the Treasurer's Press Release No. 38 of 2006 (9 May 2006), the Board of Taxation's report on its Post-Implementation Review of the small business CGT concessions contains a number of administrative recommendations. This Taxation Determination is part of the Commissioner's response to Recommendation 6.1 of the Board's report.

25. The Board's report also contains a number of legislative recommendations. *Taxation Laws Amendment (2006 Measures No. 7) Act 2007*, which received Royal Assent on 12 April 2007, gives effect to the Board's legislative recommendations accepted by Government. The changes apply to CGT events happening in the 2006-07 income year or later income years. There are two changes relevant to this Determination:

- amended subsection 152-20(1) allows the possibility of a negative net value of the CGT assets of any entity to be calculated; and
- new paragraph 152-20(1)(b) allows provisions for annual leave, provisions for long service leave, provisions for unearned income and provisions for tax liabilities to be taken into account in determining the net value of the CGT assets of an entity but does not affect the meaning of the term 'liabilities' as discussed in this Determination.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.

Alternative view: accounting meaning of 'liabilities'

26. An alternative view is that in the context of subsection 152-20(1), 'liabilities' has its accounting meaning.

27. The Commissioner considers the term 'liabilities' should not have its accounting meaning in the context of subsection 152-20(1) as, unlike the thin capitalisation provisions in Division 820, for example, where the term has its accounting meaning (see Taxation Ruling TR 2002/20), there are insufficient contextual factors for that interpretation.

References

Previous draft:

TD 2006/D27

Related Rulings/Determinations:

TR 2002/20; TR 2006/10

Subject references:

- basic conditions for relief
- capital gains tax
- CGT assets
- CGT events
- CGT small business relief
- contingent liabilities
- maximum net asset value test

Legislative references:

- ITAA 1997 152-15
- ITAA 1997 152-20(1)
- ITAA 1997 152-20(1)(b)
- ITAA 1997 Div 820
- TAA 1953
- Taxation Laws Amendment (2006 Measures No. 7) Act 2007

Case references

- Commissioner of Taxation v. Byrne Hotels Qld Pty Ltd [2011] FCAFC 127; 2011 ATC 20-286; (2011) 83 ATR 261

Other references:

- The Macquarie Dictionary, 2001, rev. 3rd edn, The Macquarie Library Pty Ltd, NSW
- Treasurer's Press Release No. 38 of 2006

ATO references

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