

TD 2007/14A3 - Addendum - 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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Addendum

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*?

This Addendum is a public ruling for the purposes of the *Taxation Administration Act 1953*. It amends Taxation Determination TD 2007/14 to include the Commissioner's view of the implications of the Full Federal Court decision of *Commissioner of Taxation v. Byrne Hotels Qld Pty Ltd* [2011] FCAFC 127 (*Byrne Hotels*).

The Addendum acknowledges that the Court referred to 'contingent liabilities' as relevant for the net asset value calculation under subsection 152-20(1), but only where the contingency is enforcement of existing legal or equitable rights or the obligation is not 'truly contingent' in the sense of being 'uncertain as both a theoretical and practical matter'. The Addendum further states that the Commissioner is of the view the decision does not stand for any principle that contingent liabilities in general are within the meaning of the term 'liabilities' for the purpose of subsection 152-20(1).

In determining whether certain legal fees were 'liabilities' for the purpose of subsection 152-20(1), the Court had regard to the particular contractual arrangement between the taxpayer and the solicitors in relation to unbilled work completed prior to the CGT event. In TD 2007/14 there are currently brief references to unbilled expenses or expenses not yet due (in Example 1 and paragraph 20). These references have been removed by this Addendum because, applying the *Byrne Hotels* case, the factual detail necessary to determine the issue is not present in the Taxation Determination.

TD 2007/14 is amended as follows:

1. Paragraph 1

Omit the second and third sentences; substitute "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*).".

2. Paragraph 2

(a) In the calculation, under the heading '**Liabilities**' omit the third item.

'Unbilled expenses (business consultant) 200,000'

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- (b) In the third column of the calculation against the item '*Provision for possible damages payout*' omit '3,000,000'; substitute '2,800,000' and against the item '**Net assets**' omit '2,000,000'; substitute '2,200,000'.

3. Paragraph 4

- (a) In the first sentence of the paragraph, omit '*because they are contingent liabilities, future obligations or expectancies*'; substitute '*because they are future obligations, expectancies or liabilities that are uncertain as both a theoretical and a practical matter*'.
- (b) Omit the first and second dot points; substitute:
- *provision for possible damages payout; and*

4. Paragraph 18

Omit the paragraph; substitute:

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.

5. Paragraph 19

After paragraph 19 insert:

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 to the extent 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).

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6. Paragraph 20

Omit dot points six and seven; substitute:

- accounting liabilities arising as a result of receiving prepaid income; and

7. Case references

Insert:

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

This Addendum 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 Addendum (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

16 April 2014

ATO references

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