TR 94/25 - Income tax: implications of the decision in Coles Myer Finance Ltd v. FC of T for the timing of deductions for prepaid expenses

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Taxation Ruling

Income tax: implications of the decision in *Coles Myer Finance Ltd v. FC of T* for the timing of deductions for prepaid expenses

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TR 94/26

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This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling considers whether the decision in *Coles Myer Finance Ltd v. FC of T* 93 ATC 4214; (1993) 25 ATR 95 requires prepaid expenses, as defined in paragraph 4, to be apportioned over the period to which they relate.

2. This Ruling does not consider whether a prepaid expense is deductible under subsection 51(1), but merely the timing of an otherwise allowable deduction. Nor does this Ruling deal with the deductibility of so called 'prepaid discount' expenses. That issue will be the subject of a separate Ruling.

Ruling

3. If, prior to the High Court's decision in *Coles Myer Finance*, a prepaid expense was considered fully deductible, under subsection 51(1) of the *Income Tax Assessment Act 1936*, in the income year in which the payment is made, then it will continue to be treated as fully deductible, under that subsection, in the year of payment. However, if the prepayment is in respect of a thing which will not be wholly done within 13 months it may be necessary to apportion the expense under section 82KZM.

Definition

4. In this Ruling a prepayment or a prepaid expense means a payment which extinguishes an existing liability or prevents a liability coming into existence at some time in the future, provided that the payment is:

(a) in respect of goods and services to be provided, in full or in part, on or after the date the payment is made; and

(b) on revenue account.

Date of effect

5. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling 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 issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

6. The joint majority judgment in *Coles Myer Finance* could possibly be read as applying to all losses and outgoings including prepayments, and that, consequently, such losses and outgoings should be apportioned over the years to which they are properly referable (ATC 4220, ATR 103).

7. However, the question of prepayments was not argued before the High Court nor did the joint judgment specifically deal with either prepayments or the long line of High Court and Federal Court decisions specifically on prepayments. That line of authority generally accepts that a prepaid expense which is on revenue account is fully deductible in the year in which the payment is made. For example, see *Emu Bay Railway Co Ltd v. FC of T* (1944) 71 CLR 596 per Latham CJ at 606; *Foxwood (Tolga) Pty Ltd v. FC of T* 80 ATC 4096 per Deane J at 4100, (1980) 10 ATR 676 at 680; *FC of T v. Ilbery* 81 ATC 4661, (1981) 12 ATR 563; *Alloyweld Pty Ltd v. FC of T* 84 ATC 4328, (1984) 15 ATR 614; *FC of T v. Lau* 84 ATC 4929, (1984) 16 ATR 55; *FC of T v. Solling & Pepper* 85 ATC 4518, (1985) 16 ATR 753; *FC of T v. Creer* 86 ATC 4318, (1986) 17 ATR 548; *FC of T v. Gwynvill Properties Pty Ltd* 86 ATC 4512; (1986) 17 ATR 844.

8. As was unanimously stated by the Full Federal Court in *FC of T v. Raymor (NSW) Pty Ltd* 90 ATC 4461 at 4467; (1990) 21 ATR 458 at 464:

> 'A mere payment made in the absence of an obligation to make it might well not, in the circumstances of a particular case, be an outgoing incurred, but **there is no case to which counsel for the Commissioner could refer us or which our researches have been able to locate where it has been held that an outgoing has been incurred in a year later than the year where the liability arose and was discharged**. Nor would we expect such a case to exist'. (emphasis added)

9. In *FC of T v. Ilbery* 81 ATC 4661, (1981) 12 ATR 563; Toohey J, with whom the other two judges agreed, stated (at ATC 4666, ATR 569), after referring to Latham CJ's dictum in *Emu Bay Railway Co. Ltd v. FC of T* (1944) 71 CLR 596 at 606, that:

> 'The dictum takes for granted that expenditure actually made is an outgoing incurred, as do dicta in a number of other cases. And the prepayment of interest was an outgoing incurred in the relevant tax year.'

In that case the prepayment was voluntary in the sense that the taxpayer was under no legal obligation to make the payment in the year in which it was actually made.

10. In our view nothing in the joint judgment of the High Court in *Coles Myer Finance* indicates that they intended to overturn the existing interpretation of the law governing the deductibility of prepayments under subsection 51(1). The High Court in *Coles Myer Finance* was primarily concerned with the situation of a liability which came into existence in one year and was not discharged until a subsequent year. They stated (ATC 4222, ATR 105) that:

> 'The relevance of the present existence of a legal liability on the part of the taxpayer to meet the bills and notes at a future date is that **it establishes that the taxpayer has "incurred" in the year of income** an obligation to pay an amount which gives rise to a net loss or outgoing, being the recurrent cost of acquiring working or circulating capital. But there remains the question: how much of that net loss or outgoing is referable to the year of income.' (emphasis added)

They also stated (ATC 4222, ATR 105) that:

> 'Although the legal liability to pay is incurred in the year of income, **the amount in question is not payable until the subsequent year of income** and, more importantly, the net loss or outgoing represents the cost of acquiring funds which the taxpayer puts to profitable advantage in both years of income.' (emphasis added)

11. The fact that the liability was not to be met until a future year was also of concern to the Court in its reference to the distortionary effects of such a situation (ATC 4222, ATR 105).

12. In the case of a prepayment, the payment is made in order to discharge a present or future liability and as such a liability does not continue into a new income tax year.

13. For these reasons we believe that *Coles Myer Finance* was concerned with factual circumstances fundamentally different from those of a prepayment, which should remain to be considered in accordance with the case law directly on point.

Commissioner of Taxation

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case references
- Coles Myer Finance v. FC of T 93 ATC 4214; (1993) 25 ATR 95
- Emu Bay Railway Co Ltd v FC of T (1944) 71 CLR 596
- Foxwood (Tolga) Pty Ltd v. FC of T 80 ATC 4096; (1980) 10 ATR 676
- FC of T v. Ilbery 81 ATC 4661; (1981) 12 ATR 563
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- FC of T v. Raymor (NSW) Pty Ltd 90 ATC 4461; (1990) 21 ATR 458