TD 2007/D9 - Income tax: is income tax of a private company properly payable for an income year, but unpaid at the end of that year, 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?

Draft Taxation Determination

Income tax: is income tax of a private company properly payable for an income year, but unpaid at the end of that year, 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. Yes. Income tax of a private company properly payable for an income year, but unpaid at the end that year, is a 'present legal obligation' of the private company 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*.[1]

Date of effect

2. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the final 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 final Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

[1] All legislative references in this Determination are to the *Income Tax Assessment Act 1936*.

Example 1

3. *A private company (A Pty Ltd) has correctly self assessed taxable income for the 2006 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 2006). The first three PAYG instalments totalling $22,500 have already been paid on time. The amount unpaid at 30 June 2006 of $7,500 is a present legal obligation of A Pty Ltd for the purposes of the distributable surplus calculation performed at 30 June 2006.*

Example 2

4. *A private company (B Pty Ltd) derives assessable income during the 2000 income year of $100,000 and income tax of $30,000 is paid in full on 1 December 2000 with lodgement of the private company tax return. A loan of $100,000 is also made by B Pty Ltd to the majority shareholder Max during the 2000 income year. The loan was not made under a written agreement that met the criteria of section 109N.*

5. *On completion of an audit in the 2003 year, the Commissioner issued an amended assessment to Max for the 2000 year to include an amount taken to be a dividend under Division 7A. In determining the amount taken to be a dividend, B Pty Ltd's income tax unpaid at 30 June 2000 (that is, $30,000) is a present legal obligation for the purposes of the distributable surplus calculation under subsection 109Y(2).*

Example 3

6. *A private company (C Pty Ltd) derives assessable income during the 2000 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. On completion of an audit in the 2003 income year, an amended assessment issued to C Pty Ltd increasing assessable income for the 2000 year by $100,000 and resulting in additional tax payable of $30,000. This was paid by C Pty Ltd on 30 September 2003.*

7. *As a result of the audit, the Commissioner also issued an amended assessment to Sam to include an amount taken to be a dividend under Division 7A in his assessable income for the 2000 income year. In determining the amount taken to be a dividend, the income tax paid by C Pty Ltd on 30 September 2003 is a present legal obligation for the purposes of the distributable surplus calculation performed under subsection 109Y(2) at 30 June 2000.*

Commissioner of Taxation
23 May 2007

Appendix 1 – Explanation

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

8. Division 7A treats:

(i) certain payments and loans made by a private company to a shareholder or a shareholder's associate; and

(ii) certain debts owed by a shareholder or a shareholder's associate forgiven by the private company,

as unfranked dividends taken to have been paid by the private company. Those unfranked dividends are included in the assessable income of the shareholder or associate under section 44.

9. The total amount taken to have been paid as dividends under Division 7A is limited to a private company's distributable surplus.[2]

10. The formula for calculating a private company's distributable surplus is contained in subsection 109Y(2), being 'Net assets – 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;
>
> (iv) other provisions prescribed under regulation made for the purposes of this subparagraph.
>
> If the Commissioner considers that the company's accounting records significantly undervalue its assets or overvalue its provisions, the Commissioner may substitute a value that the Commissioner considers is appropriate.

11. As explained in draft Taxation Determination TD 2007/D8, the technical legal meaning of the word 'obligation' encompasses only 'legal obligations' which are obligations 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 and completely subjected to it, whether or not it can be sued for immediately in a court of law.

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[2] Subsection 109C(2), subsection 109D(1AA), subsection 109E(2) and subsection 109F(2) in conjunction with section 109Y respectively.

12. In *Clyne v. FCT* (1981) 81 ATC 4437; (1981) 150 CLR 1; (1981) 35 ALR 567; (1981) 12 ATR 173; (1981) 55 ALJR 552 Mason J said:

> ... the correct view in my opinion is that income tax is due when it is assessed and notice is served of that assessment and that tax does not become payable before the date fixed by sec. 204.

13. As noted at paragraph 8 of Taxation Determination TD 2004/20, the statement of Mason J in Clyne's case should be understood in the context in which it was made. The issue before the Court in Clyne was whether the use of the word 'due' in the former paragraph 218(1)(a) meant 'due and owing' or 'due and payable'. Ascertaining the meaning of the word 'due' in this context would determine when the Commissioner was able to require payment from debtors of a taxpayer in order to satisfy an amount 'due' by the taxpayer to the Commissioner. Mason J held that 'due' in that context meant 'due and owing', such that once an assessment was served on a taxpayer, the Commissioner could require payment from the taxpayer's debtors before the income tax assessed became due and payable under section 204.

14. The Commissioner considers that in appropriate contexts, a distinction can be drawn between an obligation sufficient to found a debt on the one hand and a debt that is 'due and owing' or 'due and payable' on the other. That is, there first exists an obligation sufficient to found a debt which on the happening of later events matures into a debt 'due and owing' or 'due and payable'.

15. This concept was stated in *MG Jones v. DFC of T & Anor* 98 ATC 4897; (1998) 39 ATR 525; (1998) 157 ALR 349 where Branson J said:

> There is plainly a distinction between the existence of an obligation sufficient to found a debt on the one hand, and the existence of a debt that is due, whether or not payable, on the other.

16. Similarly, in *Layala Enterprises Pty Ltd (in Liq) v. FC of T* (1998) 86 FCR 348; 98 ATC 4858; (1998) 39 ATR 502 the Full Federal Court determined an employer became liable for payroll tax assessed by the Commissioner of State Taxation under the *Pay-roll Tax Assessment Act 1971* (WA) when it paid or became liable to pay taxable wages even though payroll tax did not become due and owing until the payroll tax amount could be calculated at the end of the month.

17. As stated in TD 2007/D8, a 'legal obligation' is an obligation, right or duty arising from contract, statute or the operation of general law which is enforceable by legal action. An obligation that founds a debt ultimately enforceable by legal action meets this standard. There is no requirement in subsection 109Y(2) for the obligation to pay income tax to have already converted into a debt 'due and owing' or 'due and payable', only that the private company must be completely subjected to the obligation. It is the statutory scheme involving assessment and service of a notice of assessment which, in a particular case, determines a specified amount of income tax for an income year which becomes due and payable as the proper tax in that case.[3] If a private company has derived taxable income, then at the end of the income year the private company is completely subjected to the income tax properly payable thereon. The obligation to pay income tax for a year of income is enforceable in due course by the Commissioner in accordance with the income tax law.

[3] *Batagol v. FC of T 109 CLR 243* at 252.

18. Therefore, the meaning of 'present legal obligation' for the purposes of subsection 109Y(2) includes income tax properly payable under the income tax law as at the end of an income year. This approach produces symmetry of tax outcomes for shareholders (and their associates) notwithstanding when a private company pays its income tax properly payable for the income year.

19. This approach also accords with the conclusions of the AAT in *Fresta v. FC of T* [2002] AATA 337; 2002 ATC 2061; (2002) 49 ATR 1212 where it was held income tax properly payable at 30 June was a present legal obligation of the private company for that income year notwithstanding that an assessment was yet to issue.

Appendix 2 – Your comments

20. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel or relevant Tax officers. The Tax Office may use a version (names and identifying information removed) of the compendium in providing responses to persons providing comments. Please advise if you do not want your comments included in the latter version of the compendium.)

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TD 2004/20; TD 2007/D8

Subject references:

- deemed dividends
- disguised distributions
- dividends

Legislative references:

- ITAA 1936 44
- ITAA 1936 Div 7A
- ITAA 1936 109C(2)
- ITAA 1936 109D(1AA)
- ITAA 1936 109E(2)
- ITAA 1936 109F(2)
- ITAA 1936 109N
- ITAA 1936 109Y
- ITAA 1936 109Y(2)
- ITAA 1936 204
- ITAA 1936 218(1)(a)
- Pay-roll Tax Assessment Act 1971 (WA)

Case references:

- Batagol v. FC of T 109 CLR 243
- Clyne v. FCT (1981) 81 ATC 4437, (1981) 150 CLR 1 (1981) 35 ALR 567 (1981) 12 ATR 173 (1981) 55 ALJR 552
- Fresta v. FC of T [2002] AATA 337; 2002 ATC 2061; (2002) 49 ATR 1212
- Layala Enterprises Pty Ltd (in Liq) v. FC of T (1998) 86 FCR 348; 98 ATC 4858; (1998) 39 ATR 502
- MG Jones v. DFC of T & Anor 98 ATC 4897, (1998) 39 ATR 525 (1998) 157 ALR 349

ATO references

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