IT 2625 - Income tax: deductibility of audit fees

TAXATION RULING NO. IT 2625

INCOME TAX: DEDUCTIBILITY OF AUDIT FEES

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I 1012504	ACCRUED AUDIT FEES AUDIT FEES - DEDUCTIBILITY	51(1)

OTHER RULINGS ON THIS TOPIC:

PREAMBLE This Ruling considers the deductibility, under subsection 51(1) of the Income Tax Assessment Act 1936 (the Act), of audit fees, and in particular those audit fees which have been accrued but unpaid at the end of the year of income.

2. In most cases there is no specific agreement between the auditor and the client as to the time at which work is to be billed. An example of a common arrangement for billing is provided in the Specimen Audit Engagement Letter contained in Statement of Auditing Practice AUP 9, issued jointly by the Institute of Chartered Accountants and the Australian Society of Certified Practising Accountants. The paragraph in the letter on fees states:

> "Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus direct out-of-pocket expenses". (Emphasis added)

In practice, the time of billing for work done is generally left to the discretion of the auditor. The fee may be prepaid, payable during the course of an audit or payable after the completion of the audit.

3. The work to be performed under an audit contract may extend over two or more financial years. It has been common for many corporate taxpayers at year end to accrue in their books of account an amount equal to the fees that will be payable in respect of work to be performed in the subsequent financial year. Generally, no invoices are rendered in respect of the accrued fees until the work is actually performed. Since 1980 at least one Branch Office of the Australian Taxation Office has taken the view that accrued audit/accounting fees in respect of work yet to be undertaken by the auditor or accountant at balance date would not be disallowed if it was the taxpayer's practice to make reasonable accruals for these expenses in its

accounts. In this situation, an adjustment would be necessary to also take into account audit fees actually paid during the year of income that were accrued at the commencement of the financial year.

4. Audit/accounting fees will only qualify as an allowable deduction in the year in which they are incurred for the purposes of subsection 51(1) of the Act. The meaning of the word "incurred" was discussed by the High Court of Australia in Nilsen Development Laboratories Pty Ltd & Ors v. FCT 81 ATC 4031, 11 ATR 505. Barwick CJ stated, at ATC 4034-35, ATR 509:

> "In my opinion, the language of Dixon J. in New Zealand Flax Investments Ltd. v. FCT (1938) 61 CLR 179 at p.207 needs to be carefully perused and applied. Granted that exhaustive definition of what may be denoted by the word 'incurred' in sec. 51(1) may not be possible, there can be no warrant for treating a liability which has not 'come home' in the year of income, in the sense of a pecuniary obligation which has become due, as having been incurred in that year. Sir John Latham's language in Emu Bay Railway Co. Ltd. v. FCT (1944) 71 CLR 596 at p.606 clearly enough indicates that to satisfy the word 'incurred' in sec. 51(1) the liability must be 'presently incurred and due though not yet discharged'. The 'liability' of which Sir John speaks is of necessity a pecuniary liability and the word 'presently' refers to the year of income in respect of which a deduction is claimed. It may not disqualify the liability as a deduction that, though due, it may be paid in a later year. That part of Sir Owen Dixon's statement in New Zealand Flax Investment Ltd. v. FCT which presently needs emphasis is that the word 'incurred' in sec. 51(1) 'does not include a loss or expenditure which is no more than pending, threatened or expected': and I would for myself add 'no matter how certain it is in the year of income that that loss or expenditure will occur in the future'." [Emphasis added]

Mason, Aickin and Wilson JJ agreed with the Chief Justice on this point. Gibbs and Stephen JJ adopted a similar approach (see 81 ATC 4037 and 4039, 11 ATR 511-12 and 514).

5. A liability will be a loss or outgoing "incurred" within the meaning of subsection 51(1), even though it remains unpaid, if the taxpayer is definitively committed or has completely subjected itself to the liability (see FCT v. James Flood Pty. Ltd. (1953) 88 CLR 492 at 506). As the Federal Court of Australia (Beaumont J) said in FCT v. Lau 84 ATC 4929 at 4940; (1984) 16 ATR 55 at 68 "section 51 covers outgoings to which the taxpayer is 'definitively committed' in the year of income in the sense that he or she is then under a presently existing liability on that account."

RULING

6. Having regard to the principles referred to in the decided cases, the question when an audit fee has been incurred, for the purposes of subsection 51(1) of the Act, can only be determined

by reference to the particular facts of each case, and especially by reference to the terms of the contract or arrangement entered into between the auditor/accountant and the taxpayer (see Ogilvy and Mather Pty. Ltd. v. FCT 90 ATC 4836; Nilsen Development Laboratories per Gibbs J at ATC 4037, ATR 510). In particular it is necessary to determine when, under the contract or arrangement, there is a presently existing liability to make a payment either now or in the future. In the words of the High Court in James Flood (CLR at 507) "there was no debitum in praesenti solvendum in futuro. There was not an accrued obligation, whether absolute or defeasible." (see also Ogilvy and Mather ATC at 4845). Osborn's Concise Law Dictionary 7th ed. at p. 110 defines "debitum in praesenti solvendum in futuro" as "owed at the present time, payable (or to be performed) in the future" [Emphasis added].

7. Many State and Commonwealth Acts require companies, and other taxpayers, to undergo statutory audits. Those statutory provisions merely impose an obligation to have the audits performed. The provisions do not determine when the expense is actually incurred for taxation purposes. This latter question is still to be decided by reference to the principles in decided cases such as the Nilsen Development Laboratories case. Thus, the fact that taxpayers are required to incur statutory audit fees will not automatically entitle them to a deduction in the year in which the statutory audit is started. These taxpayers are only entitled to claim a deduction in respect of that part of the fee, if any, for which there is a presently existing pecuniary obligation that has become due.

8. Several different contractual conditions may apply between a taxpayer and an auditor/accountant. For example :

. Under the contract the auditor/accountant may only be entitled to payment at the completion of the entire audit process. A deduction for the audit fees would only be allowable to the taxpayer in the financial year in which the audit process is actually completed. Before completion the liability in respect of the fee is simply contingent rather than due and, thus, no more than pending, threatened or expected. However, where the audit is terminated prematurely, for instance, due to removal or resignation, the auditor/accountant may have an action in quantum meruit (i.e. in respect of the work performed before the termination). A deduction would be allowable to the taxpayer for the amount of the quantum meruit claim in the year in which termination occurs because the termination creates a presently existing liability to pay that amount.

. The contract may provide that the auditor/accountant is only entitled to receive fees progressively as particular work is performed. The contract might allow the auditor to receive payment for work done in a particular three month period in respect of which a bill had been presented. In such cases, in order to obtain a deduction in respect of the fees, the taxpayer must show that the fees are due. Thus, in the case where work is billed on a three monthly basis, the taxpayer

would only be entitled to a deduction in respect of those three month periods that were completed and billed during the financial year because, under the contract, it is only on the presentation of the bill that an amount becomes due. A deduction would be available in such circumstances even where the bill had not actually been paid because the liability had at that stage come home and was presently due. A deduction would not be available in respect of contracted work that is yet to be performed and billed, because the liability is still contingent.

. The contract might provide that payment in respect of work done during an agreed period is due after that period or on completion of a specific milestone in the audit. In cases where a bill is not required, the expense would be incurred either after that agreed period or at the time the auditor communicated to the taxpayer that the specific milestone had been completed, as the case may be.

. A company may be under a contractual liability to pay the agreed audit fee once the auditor has expressed an opinion on the company's financial statements. Precisely what work is done and when that work is done may be within the discretion of the auditor. The company would be entitled to a deduction, in respect of the audit fee, in the financial year in which the auditor expresses an opinion because it is only on the giving of such an opinion that the company has a presently existing liability which is due. Before the giving of the opinion no amount is owed.

. Where under the contract the taxpayer is required to pre-pay the full audit fee at the start of the audit, a deduction in respect of that audit fee would be allowable under subsection 51(1) in the year in which the audit commenced because there is in that year a presently existing obligation which is due. However, if the audit work to which the pre-payment relates will be performed over more than a 13 month period then that pre-payment will be apportioned in accordance with section 82KZM of the Act.

. The contract may provide that the full amount of the audit fee is due on entering into the contract but the auditor may accept the payment of the fee by instalments. It is accepted that in such cases the liability for the total fee becomes due on the entering into of the contract and the subsequent instalments are payments in settlement of a debt. In such cases the full amount is deductible in the year in which the contract is entered into (Case N108 81 ATC 600 at 610; 25 CTBR (NS) Case 62 at 484). Whether the contract is in fact of this type or one which makes each individual payment due at the time of each individual instalment will depend on the proper construction of the particular contract.

Date of effect

9. The approach set out in paragraphs 6 to 8 above is

materially different from the Branch Office view previously adopted and mentioned in paragraph 3 above. Consequently, in accordance with the principles contained in Taxation Ruling IT 2500, this Ruling will apply on a prospective basis to audit fees incurred after the date of effect of this Ruling. This means that (subject to paragraph 10) accrued audit fees allowed to taxpayers in reliance on the approach set out in paragraph 3 above prior to the issue of this Ruling will not be disturbed.

10. Where before the issuing of this Ruling a deduction for accrued audit fees has been incorrectly allowed in a prior year and the taxpayer wishes to claim a deduction for the same fees in a subsequent year, i.e., the year in which they are actually incurred, he/she should notify the relevant Deputy Commissioner. This will enable the previous year's assessment to be amended so as to disallow those accrued audit fees. Where the prior years assessment has been amended as a result of the taxpayer claiming the deduction in the current year no penalty tax will be levied in respect of the incorrect claim made in the prior year.

COMMISSIONER OF TAXATION
27 December 1990