TD 2007/28A1 - Addendum - Income tax: what is a 'present legal obligation' of a private company for the purposes of subsection 109Y(2) of Division 7A of Part III of the Income Tax Assessment Act 1936?

Addendum

Taxation Determination

Income tax: what is a 'present legal obligation' of a private company for the purposes of subsection 109Y(2) of Division 7A of Part III of the *Income Tax Assessment Act 1936*?

This Addendum is a public ruling for the purposes of the *Taxation Administration Act 1953.* It amends Taxation Determination TD 2007/28 to reflect the decision of the Full Federal Court in *Federal Commissioner of Taxation v. H* [2010] FCAFC 128; 2010 ATC 20-218.

TD 2007/28 is amended as follows:

1. Paragraph 1

Omit 'and contingencies'.

2. Paragraph 8

Insert:

8A. In section 109Y a statutory conception of 'distributable surplus' is introduced to replace the looser notion of 'profit' in section 44.[5A] It reflects the approach taken in *Re Spanish Prospecting Ltd* [1911] 1 Ch 92 in that it is based on a comparison of the value of assets at two dates. This conception has two evident purposes, one is to bring greater certainty to the amount of the surplus and the other is to reduce scope for manipulation of that amount by taxpayers (as might be expected in a provision which is primarily an anti-avoidance provision). The broader purpose of 'profit' is retained by the use of the conception 'to prevent taxation of a return of capital', that is, of something which was not a gain to the company.

[5A] Division 7A replaces the former section 108 which operated through the mechanism of subsection 44(1) and hence required that the distributions to which it applied were paid by the company 'out of profits'.

8B. In *Commissioner of Taxation v. H* [2010] FCAFC 128; 2010 ATC 20-218 (the H case) Downes J, Edmonds J and Greenwood JJ, after referring to the legislative context in which 'present legal obligation' is to be found as per the Explanatory Memorandum to Taxation Laws Amendment Bill (No. 3) 1998 stated at paragraphs 35 and 36:

> 35. The extract from the explanatory memorandum manifests both the legislative policy of Div 7A as a whole, and s 109Y in particular. Section 109Y is to provide a 'cap' or limit on such loans, advances or other credits being treated as assessable dividends, namely, up to but not exceeding the realised and unrealised profits of the company.
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> 36. The term 'distributable surplus' is to be understood in that context, namely, the realised and unrealised profits in the company available for distribution. The profits available for distribution are its 'after-tax' profits. A Fullager J observed in *Commonwealth v. O'Reilly* (1984) VR 931 and 938:
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>> 'In my opinion the profits out of which dividends may be paid are the profits remaining after deduction from gross profits of, *inter alia*, federal income tax, or at least a bona fide estimate thereof. A bona fide assessment of profits involved a bona fide estimate of income tax.'

3. Paragraph 9

After 'Net assets –'; insert 'Division 7A amounts[5B] –'.

4. Paragraph 10

(a) After 'which is enforceable by legal action'; insert 'immediately or in the future'.

(b) Insert:

10A. In the H case which concerned income tax the requirement that there be an obligation did not require the existence of a debt due and payable. Downes J, Edmonds J and Greenwood JJ stated at paragraph 43:

> 43. As the Tribunal observed at [42] of its reasons, income tax is imposed by the *Income Tax Act 1986* (Cth) (s 5(1) at the rates declared by the *Income Tax Rates Act 1986* (Cth)). The income tax so imposed is levied by s 7 of the Income Tax Act, which also requires it to be paid for the relevant financial year. The obligation to pay income tax so imposed arises by operation of the Income Tax Act itself and not by the issue of a notice of assessment.

The obligation exists at the end of the income year by operation of the Income Tax Act itself notwithstanding the lack of a notice of assessment and the inability of the Commissioner to recover an amount of income tax at that time. The fact that the obligation to pay is at a later date did not deny its standing as an existing obligation. With regard to this point Downes J, Edmonds J and Greenwood JJ stated at paragraph 41:

> At worst it may be a contingent obligation, contingent on an assessment being made and a notice of that assessment served, but that does not disqualify it as a present legal obligation.

[5B] The formula was amended in relation to payments made, loans made and debts forgiven on or after 1 July 2009. One of the amendments was to add back 'Division 7A amounts' which are defined as the total of any amounts the company is taken under section 109C or 109F to have paid as dividends in the year of income apart from section 109Y.

10B. It does not follow that all contingencies can be a present legal obligation. As indicated, income tax for an income year is imposed by operation of legislation. There is an obligation, a requirement to settle that obligation and the amount of the obligation can be reliably determined.

5. Footnote 7

Omit '2004'; substitute '2009'.

6. Paragraph 14

Omit all occurrences of 'obliging'; substitute 'obligating'.

7. Footnote 13

Omit; substitute:

[13] Paragraph 69 of Accounting Standard AASB 101 provides:

Current Liabilities

69. An entity shall classify a liability as current when:
   - (a) it expects to settle the liability in its normal operating cycle;
   - (b) it holds the liability primarily for the purpose of trading;
   - (c) the liability is due to be settled within twelve months after the reporting period: or
   - (d) it does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period (see paragraph 73). Terms of a liability that could, at the option of the counterpart, result in settlement by the issue of equity instruments do not affect its classification. An entity shall classify all other liabilities as non-current.

8. Case references

Insert:

- Commonwealth v. O'Reilly (1984) VR 931
- Federal Commissioner of Taxation v. H [2010] FCAFC 128; 2010 ATC 20-218
- Re Spanish Prospecting Company Ltd [1911] 1 Ch 92

9. Other references

(a) Omit

- Australian Accounting Standards Board Framework for the preparation and presentation of financial statements (July 2004)

Substitute:

- Australian Accounting Standards Board Framework for the preparation and presentation of financial statements (July 2009)

(b) Insert:

- Explanatory Memorandum to the Tax Laws Amendment Bill (No.3) 1998

This Addendum applies both before and after its date of issue.

Commissioner of Taxation
11 January 2012

ATO references
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