TD 2009/5 - Income tax: Division 7A: in exercising the discretion under subsection 109Y(2) of Division 7A of Part III of the Income Tax Assessment Act 1936 to substitute an appropriate value for a private company's assets, can the Commissioner take into account the value of the company's assets not shown in the company's accounting records?

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Taxation Determination
TD 2009/5

Taxation Determination

Income tax: Division 7A: in exercising the discretion under subsection 109Y(2) of Division 7A of Part III of the *Income Tax Assessment Act 1936* to substitute an appropriate value for a private company's assets, can the Commissioner take into account the value of the company's assets not shown in the company's accounting records?

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Ruling

1. Yes. For the purpose of working out a private company's distributable surplus under subsection 109Y(2) of the *Income Tax Assessment Act 1936,*[1] the Commissioner's power to adjust the value of the company's assets is not limited by the omission to assign a value to a particular asset in the company's accounting records.

2. In exercising the discretion to substitute an appropriate value for a company's assets, it is necessary to compare the value assigned in the company's accounting records to the totality of the company's assets and to consider whether that value is substantially correct.

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[1] All legislative references are to the *Income Tax Assessment Act 1936* unless otherwise stated.

3. It is evident from the purpose of the provision that the power to substitute the value should be exercised in a case where there has been a deliberate, significant understatement of the value of assets (or overstatement of specified provisions), in the company's accounting records, with a view to circumventing the operation of Division 7A.

4. Where the company's accounting records understate the value of the company's assets because they are required to do so (for example where accounting standards require the value of internally generated goodwill to be omitted),[2] the understatement is not itself an attempt to circumvent the operation of Division 7A. Subject to the qualification which follows, the Commissioner will not exercise his power under subsection 109Y(2) whenever accounting standards require the total value of assets to be understated; to do so would defeat the compliance simplification objective of the provision. However, where it is plain that the company, its shareholders and directors have acted, in making loans or other payments, in a way that treats the real and higher value of assets as their true value, that is, regardless of their value shown in the accounting records, and that the mischief against which Division 7A is directed is present, the Commissioner may, and generally will, substitute their true value.

Example 1

5. A Co has a large internally generated goodwill, the value of which is not shown in the accounting records of the company because accounting standards will not permit it. A value for the company's goodwill is assessed by the shareholders and disclosed to third parties.

6. The earnings of A Co are taken by the shareholders (who are also the directors) into their own hands and spent on living expenses and other forms of private consumption. In A Co's books, the moneys so spent are then shown as an 'at call' loan to the shareholders, with no interest payable. The loan is recognised as an asset in the company accounts and for accounting purposes the owner's equity is not affected.

7. A Co's books show no distributable surplus when goodwill is omitted. However, by their actions in accessing the value of goodwill not shown in the books of account the shareholders/directors show that they regard the value of goodwill as sufficient to treat the earnings as an available surplus which may be safely appropriated by the owners of the company.

8. In such a case it is appropriate to substitute the real value of assets and include a value for goodwill, for the book value of assets. In this case the omission of goodwill represents a significant amount in relation to the value of assets disclosed in the books of account. Without the inclusion of this amount the shareholders would receive a tax free informal distribution equivalent to the amount of living expenses and private consumption.

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[2] For example, Accounting Standard AASB 138 Intangible Assets states at paragraph 48 that the 'Internally generated goodwill shall not be recognised as an asset'. Paragraph 49 goes on to say that it does not meet the recognition criteria in the Standard because it is not an identifiable resource controlled by the entity that can be measured reliably at cost.

Example 2

9. B Co is a private company operating from premises it has owned for ten years. Since the purchase, the value of its premises has substantially increased due to the burgeoning property market. The value of the premises is accounted for in B Co's books using the cost model in accordance with accounting standards. However, a higher value for the premises, based on a market assessment, is disclosed to third parties.

10. B Co's shareholders (who are also the directors) use company funds for private purposes via an 'at call' loan with no interest payable recorded in B Co's books. The loan is recognised as an asset in the company accounts and for accounting purposes the owner's equity is not affected.

11. B Co's books show no distributable surplus when the premises are valued using the cost model. However, by their actions in accessing the true value of the premises not shown in the books of account, the shareholders/directors show that they regard the value of the premises as sufficient to treat the earnings as an available surplus which may be safely appropriated.

12. It is appropriate to substitute the real value of assets and include a market value for the premises as the cost model used in the books would lead to the overall assets of B Co being significantly understated. Without the inclusion of this amount, the shareholders would receive a tax free informal distribution equivalent to the amount of funds used for private purposes.

Date of effect

13. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will 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 this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
25 March 2009

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Explanation

Background

14. Division 7A is an anti-avoidance or 'integrity' provision, directed to ensuring that disguised or informal distribution of company profits to shareholders or their associates should be included in the assessable income of the shareholders or associates. In construing its provisions it is necessary to bear in mind its context, history, and legislative purpose.

15. The context of Division 7A includes the main taxing provisions for company distributions, that is, sections 44 and 47. These provisions are essentially concerned to tax company earnings which find their way into the hands of shareholders regardless of whether they are received as ordinary income or as capital.[3] *Federal Commissioner of Taxation v. Slater Holdings Ltd*[4] *(Slater Holdings)* and *MacFarlane v. Federal Commissioner of Taxation*[5] (*MacFarlane*) discuss the relevant principles. It is to be observed that the source of the distribution in company income is the basis of liability to tax, rather than its character as income in the hands of the shareholders. The primary taxing provisions for company distributions therefore require that the dividends be paid out of profits (section 44) or represent income (section 47). However, they do not rely on, or require, the existence of the conditions necessary to declare a lawful dividend under the Companies legislation: *MacFarlane.*[6] 'Profits' is used in section 44 in a sense essentially equivalent to 'income' or 'earnings' and not in the accounting sense. It takes as its starting point the well-known formulation in *In Re The Spanish Prospecting Company Ltd*[7] *(Spanish Prospecting),* that is the amount of gain made by a business in a period ascertained by a comparison of the assets of the business at two dates.

16. The predecessor to Division 7A, section 108, was similarly concerned to tax in the shareholders' hands informal distributions out of the company's income or profits regardless of whether the requirements for the distribution of dividends were, or could have been, met: *MacFarlane.*[8] The principal question upon which that section turned was whether the advance, loan, payment or distribution represented, in the opinion of the Commissioner, a distribution of income or profits. For the purpose of that section it essentially sufficed if the payments in question were made out of earnings. Therefore in regard to both the primary taxing provisions for company distributions and the predecessor of the present Division, it may be said that it is the main object of the provisions to tax income or profits of the company which have found their way into the hands of the shareholders, whether formally or informally.

17. Division 7A re-enacts in self-executing form the main elements of the former section 108, and has the same legislative purpose.

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[3] However, if received as ordinary income a distribution may be assessable income even though section 44 does not apply, see *Federal Commissioner of Taxation v. McNeil* (2007) 229 CLR 656; [2007] HCA 5; 2007 ATC 4223; (2007) 64 ATR 431.
[4] (1984) 156 CLR 447; 84 ATC 4883; (1984) 15 ATR 1299.
[5] (1986) 13 FCR 356; 86 ATC 4477; (1986) 17 ATR 808.
[6] (1986) 13 FCR at 376; 86 ATC at 4493; (1986) 17 ATR at 827.
[7] [1911] 1 Ch 92 at 98.
[8] (1986) 13 FCR at 375; 86 ATC at 4492-3; (1986) 17 ATR at 827.

Distributable surplus not the same as book profits

18. In section 109Y a statutory conception of 'distributable surplus' is introduced to replace the looser notion of 'profit' in section 44.[9] It reflects the approach taken in *Spanish Prospecting* 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.

19. Section 109Y takes the value of the company's assets disclosed by its accounting records and subtracts the amount of present legal obligations, certain specified provisions, and the paid-up capital to arrive at the distributable surplus.[10] That is, it adopts the book value of assets but does not adopt the book value of liabilities. The substitution of present legal obligations, with the addition of only four specified provisions, for book values of liabilities leaves the accounts less open to understatement by taxpayers and increases certainty (because it substitutes the actual amount of liabilities as they accrue for an earlier estimate of them by way of provision).[11]

20. In the case of the value of the assets of the company, however, the amount of that value is the amount shown by the company's accounting records. 'Net assets' is defined in subsection 109Y(2):

> ***net assets*** means 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: … [present legal obligations and specified provisions].
>
> If the Commissioner considers that the company's accounting records significantly undervalue or overvalue its assets or undervalue or overvalue its provisions, the Commissioner may substitute a value that the Commissioner considers is appropriate.

21. These 'accounting records' include, but are not confined to, the company's books of account, financial statements and balance sheet. In the Commissioner's opinion, records of asset valuations (or costs of acquisition) would form part of the accounting records in the relevant sense provided that it was evident that they were adopted or relied upon by the company at the relevant time as showing the value of the assets.

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[9] 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'.

[10] The total amounts of any non-commercial loans taken to have been paid as dividends in previous years of income as are shown as assets in the company's accounting records at the end of the year of income, and repayments of non-commercial loans, are also subtracted in calculating the distributable surplus.

[11] This means that timing differences will result between 'profits' as ascertained in accordance with accounting standards and the 'distributable surplus' ascertained under the statutory formula (because the recognition of liabilities is deferred). These differences might either increase or decrease the distributable surplus for a particular year.

Assets

22. The section is not concerned with the identification of particular assets[12] but rather with the value of all the company's assets, because its object is to compute the surplus value of those assets over paid-up capital. The reference to 'the amount by which the assets (according to the company's accounting records) exceed' the sum of the present legal obligations and specified provisions,[13] is therefore a reference to the **amount** shown in the company's records for the **value** of the assets rather than a reference to the **assets** shown in the records. If this were not so, the 'amount' would not be identified. In other words, the phrase in parentheses, 'according to the company's accounting records' is referring to 'value' rather than simply to the 'assets'. The provision which equips the Commissioner with power to change the values shown in the company's books shows this construction is the correct one.

23. The Commissioner therefore considers 'assets' to be a reference to all assets, not particular assets.[14] Therefore, it is not necessary to consider what particular assets are recognised as such in the books, or even strictly the value of any particular asset,[15] but rather what value is assigned to the totality of the company's assets in the company's accounting records. Of course, if the company's accounting records omit to recognise an asset it will usually[16] follow that the value assigned to the company's assets will be less than the actual value of its assets.

24. The value of the assets shown by the accounting records is taken as the starting point of the calculation of the distributable surplus even if the value assigned is wrong. This includes the case where the value assigned to 'the assets' is wrong because assets have been left out of the accounts, cases where the value assigned has been computed inconsistently with accounting standards, and cases where the value is computed on the basis of wrong valuation principles.

The power to correct values

25. To provide integrity and prevent avoidance (and to correct significant mistakes) the Commissioner has the power to substitute the correct value for a 'significantly' wrong value for assets. This power must be exercised for the purposes for which it was conferred, having regard to the usual principles of administrative law. The principal purpose for which it was conferred was to enable taxation of what is, in substance, an informal distribution of gains and earnings of the company to its owners, and this should be the principal focus when consideration is given to exercising the discretion. Only significant differences are to be adjusted. To adjust insignificant differences would defeat the certainty and simplicity of compliance which the law also aims to achieve. Therefore, minor mistakes must be ignored.

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[12] The unqualified use of the word 'asset' means, in the Commissioner's opinion, that anything of commercial value recognised in ordinary use as an asset is an asset for the purpose of Division 7A. As stated above, the purpose of the provision is directed to identifying the worth of a company, and anything contributing to its worth is prima facie relevant to the calculation of the distributable surplus.

[13] Being provisions for depreciation, annual leave and long service leave, amortisation of intellectual property and trademarks and other provisions prescribed under regulations.

[14] 'Assets' was originally a singular word. Its original, and still its main meaning, is the property which is available to satisfy claims. It therefore normally refers to the property or valuable rights possessed by a person, considered as a whole.

[15] Because if the value of one asset were assigned to another asset, the total value of the assets is not affected.

[16] Only 'usually', because it is possible for the value of one asset to be attributed to some other asset, so that the value of all assets is not affected.

26. It is evident from the purpose of the provision that the power to substitute the value should be exercised in a case where there has been a deliberate, significant understatement of the value of assets (or overstatement of specified provisions) in the company's accounting records, with a view to circumventing the operation of Division 7A. The deliberate omission from the company's books of valuable assets ought to be corrected in all but truly exceptional circumstances. More generally, serious errors in the preparation of accounts should also be corrected, even if not deliberate, where it is clear that the income of the company has been effectively distributed by a payment, loan or debt forgiveness to which Division 7A applies.

27. It is possible for a taxpayer to value its assets properly in accordance with accounting standards, but for the accounting standards to result in the undervaluation of the assets. The clearest example is 'goodwill', which if internally generated is generally not permitted to be valued by the standards.[17] Goodwill is an asset in the legal and ordinary meaning of the word, and to omit the value of goodwill from a calculation of the surplus value of a company's assets will result in its understatement. The considerations which cause accounting standards to preclude valuation of goodwill are not directly, or even at all, relevant to the taxation of informal company distributions. Just as it is not to the point to show that 'profits' for company law purposes may diverge from the 'distributable surplus' for tax purposes, so it is not in itself conclusive against the exercise of the power to revalue assets to show that the company's accounting records are correctly prepared in accordance with the accounting standards.

28. However, as a matter of practice, the Commissioner would not adjust the book value of assets shown in properly prepared accounts merely because the value of internally generated goodwill is omitted, and, more generally, would respect book values shown in proper accounts[18] in the absence of matters pointing to an attempt to circumvent the Division. When, however, it is plain that the company, its shareholders and directors have acted in a way that treats the real and higher value of assets as the true value, regardless of the books, and that the mischief against which Division 7A is directed is present, the Commissioner will substitute those values. In other words, the discretion is there to protect the integrity of the Act, and it will be exercised when it is necessary to do so for that purpose.

29. The Commissioner does not accept that the power to adjust the value of assets is confined to cases where a value has been assigned to a particular asset in the company's books. This would defeat the purpose of the provision, since a taxpayer might escape tax by the simple device of keeping incorrect books. Moreover, the Commissioner does not think that the value of any particular asset is important, but rather, whether the value of assets in total is substantially correct. That is, 'significant' means 'significant overall' and not 'significant in relation to an asset'.

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[17] For example, Accounting Standard AASB 138 Intangible Assets states at paragraph 48 that the 'Internally generated goodwill shall not be recognised as an asset'. Paragraph 49 goes on to say that it does not meet the recognition criteria in the Standard because it is not an identifiable resource controlled by the entity that can be measured reliably at cost.

[18] These are accounts which are not affected by serious errors of fact and which comply with relevant standards and principles.

30. The power in question is also available to adjust the value of specified provisions. The same considerations would apply. This power is limited to adjusting only those liabilities which actually feature in the statutory calculation (because unlike assets the subsection concerns itself only with specific categories of liability). This means that provisions which are not taken into account at all cannot be adjusted. (Of course, any liability against which provision might be made will be taken into account when it accrues as a present legal obligation. The difference is one of timing.) This accords with the scheme of the law, which is to take into account the total value of assets but to deduct liabilities only when due, except in the four specified cases where an estimate of a future obligation may be taken into account.

31. However, in some cases it will be indirectly relevant, when exercising the power under section 109Y to adjust values and to consider provisions left out of account. This will occur when asset values shown in the books appear to be understated because unrealised accretions in value are omitted. In such a case one must be careful to ensure that the distributable surplus is not effectively overstated by a lop-sided approach. The focus must be on whether it is necessary to exercise the discretion to tax what is in substance an informal distribution of earnings, not simply on whether asset values are understated.

References

Previous draft:

TD 2008/D19

Related Rulings/Determinations:

TR 2006/10

Subject references:

- anti avoidance measures
- deemed dividends
- dividend income

Legislative references:

- ITAA 1936
- ITAA 1936 44
- ITAA 1936 44(1)
- ITAA 1936 47
- ITAA 1936 108
- ITAA 1936 109Y
- ITAA 1936 109Y(2)
- ITAA 1936 Pt III Div 7A
- TAA 1953

Case references:

- Federal Commissioner of Taxation v. McNeil (2007) 229 CLR 656; [2007] HCA 5; 2007 ATC 4223; (2007) 64 ATR 431
- Federal Commissioner of Taxation v. Slater Holdings Ltd (1984) 156 CLR 447; 84 ATC 4883; (1984) 15 ATR 1299
- In Re The Spanish Prospecting Company Ltd [1911] 1 Ch 92
- MacFarlane v. Federal Commissioner of Taxation (1986) 13 FCR 356; 86 ATC 4477; (1986) 17 ATR 808

Other references:

- Accounting Standard AASB 138 Intangible Assets

ATO references

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