

Having it both ways – Division 7A fails the Commissioner

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In *Paper to Paper International Pty Ltd and Anor and Commissioner of Taxation* [2010] AATA 78, the AAT considered whether each of the liabilities to pay tax, penalties, and interest because of amended assessments for prior periods constituted “present legal obligations” for the purposes of determining the “distributable surplus” of a private company for each of those periods, in accordance with section 109Y of the *Income Tax Assessment Act 1936* (Cth) (“ITAA36”).

The Commissioner argued that:

1. the prior period liabilities should not be taken into account to reduce the private company’s distributable surplus, which would necessarily have the effect that;
2. payments ultimately received by the company’s shareholder from the company in each of the prior periods would give rise to a substantial amount of assessable deemed dividends in the shareholder’s hands.

Therefore, the Commissioner would have hoped to recover tax, interest and penalties from both the company as well as from the shareholder.

Unfortunately for the Commissioner, the AAT concluded that the company’s distributable surplus in each of the periods would have been nil, so that the shareholder was spared from being assessed on the deemed dividends.

Background

The case involved various sham transactions over a 5 year period, from 1999 to 2003, in relation to Paper to Paper International Pty Ltd (“P2P”), a private company, and its shareholder, Mr Holland.

The most significant of the sham transactions involved P2P making payments to a Hong Kong entity, and 90 percent of such monies being paid into the Mr Holland’s personal bank account (unbeknownst to Mr Holland). Mr Holland did not declare such payments as having been received, and P2P claimed deductions in relation to the payments under the guise of “marketing expenses.”

Deemed Dividends

Section 109C(1) of the ITAA36 provides that a private company is taken to pay a dividend to an entity, at the end of the company’s year of income, if the company pays an amount to the entity during the year and, for the purposes of the transactions in this case, a reasonable person would conclude (having regard to all the circumstances) that the payment is made because the entity has been a shareholder or associate at some time.

Importantly, the dividend is taken to equal the amount paid, subject to section 109Y of the ITAA36.

Section 109Y generally provides that if the total amount of the deemed dividend is greater than the company’s “distributable surplus”, only the amount that is equal to the distributable surplus is treated as a dividend. Further, the section provides a formula for determining the company’s “distributable surplus” which takes into account the company’s “net assets.”

“Net assets” is defined in section 109Y(2) to mean the amount (if any), at the end of the company’s year of income, by which the company’s assets exceed the sum of the present legal obligations of the company to persons other than the company (amongst other things).

The main issue for determination by the AAT was whether the prior period liabilities of P2P for tax, penalties and interest were “present legal obligations” of P2P as at 30 June in each income year during which the sham transactions took place.

Income Tax

Mr Holland contended that as at 30 June in each income year, the liability to pay income tax on the taxable income for that year was a “present legal obligation” (despite the fact that the amount had not yet been calculated nor was “due and payable”, either because there was no assessment or

the due date fixed had not yet arrived). Conversely, the Commissioner argued that “present legal obligation” in relation to tax, includes only ascertained or assessed tax.

The AAT agreed with Mr Holland, holding that the obligation to pay income tax is imposed by the *Income Tax Act 1986* (Cth), and is a “present legal obligation” once the taxable income is derived during the relevant financial year, and does not depend on the tax being quantified as due and payable on or after assessment.

As such, the AAT held that the amount of tax duly assessed against P2P in each prior income year had to be deducted from its “net assets” in that year, in accordance with the formula for determining a private company’s “distributable surplus.”

Penalties

On the issue of penalties, the AAT noted that, whilst the liability to a penalty is triggered by the making of a false or misleading statement, unlike income tax, the amount of the penalty is not fixed or ascertainable at that time. That is, the amount of a penalty is subject to a number of factors relating to culpability which are not capable of being known at the time when the liability to the penalty arises.

For instance, the penalty may be increased if the taxpayer takes steps to prevent or obstruct the Commissioner from discovering the shortfall amount, or the penalty may be reduced where the taxpayer makes a voluntary disclosure about the tax shortfall.

For that reason, the AAT held that a penalty cannot be regarded as a “present legal obligation” until such time as it is quantified (and the taxpayer is notified of the amount). The penalty did not become a “present legal obligation” of P2P until the Commissioner issued to P2P a notice of assessment of penalty.

Interest

In terms of the general interest charge (“GIC”), section 204(3) of the ITAA36 provides that a person’s liability to the GIC accrues on a daily basis because tax remains unpaid after the due date. Accordingly, for the purposes of section 109Y, the AAT held that the GIC becomes a “present legal obligation” on each day on which tax that should have been paid, remained unpaid.

Increasing the Distributable Surplus

The AAT also considered whether the “distributable surplus” of P2P should be increased (pursuant to the Commissioner’s power to revalue assets under section 109Y(2)) by the amounts wrongly claimed as deductions arising from the payments to the Hong Kong entity.

In this regard, it was held that once the payments to the Hong Kong entity were made, P2P’s assets were less than they were prior to such payments, but were not undervalued. Even though the payments were part of a sham transaction, there was no reason to “add back” the payments for the purposes of the calculation in section 109Y.

In other words, despite the sham payments, P2P’s assets were not understated. Section 109Y looks at a company’s net asset position as at the end of its income year, not how that balance may have been affected during the year.

Conclusions

This is a case which shows how Division 7A can act as a double-edged sword. Had the AAT found that the prior period tax liabilities and GIC because of the amended assessments did not affect P2P’s distributable surplus, the Commissioner would have been able to collect tax from both P2P and Mr Holland.

However, because the AAT excluded those amounts from the calculation, Mr Holland was spared from the pain of paying income tax on the payments that were returned to him from Hong Kong.

It is not known at this time if the Commissioner will appeal the AAT’s decision to the Federal Court. It would be no surprise if he did do so, because the decision sets a precedent which, if followed, will invariably reduce the severity and impact of the application of Division 7A in similar fact situations.