# JOINT SUBMISSION BY

**National Institute of Accountants, The Taxation Institute of Australia, the Institute of Chartered Accountants in Australia, CPA Australia and Taxpayers Australia**

***Draft Taxation Determination TD 2008/D19***

***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?***

**Date: 30 January 2009**

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The Professional Bodies welcome the opportunity to comment on Draft Taxation Determination TD 2009/D19 ("the Draft Determination").

**GENERAL COMMENTS**

The professional bodies generally agree with the principles outlined in the Draft Determination. Section 109Y clearly gives the Commissioner discretion to substitute an appropriate value to assets where the accounting records significantly undervalue the company's assets. We agree that this discretion is not limited where the value of the relevant asset is not shown in the accounting records. However, the Draft Determination lacks clarity and the example used in the ruling is confusing.

We agree with the statement in the Draft Determination that it will be appropriate for the Commissioner to exercise this discretion "where there has been a deliberate, significant understatement of the value of assets in the company's accounting record, with a view to circumventing the operation of Division 7A". However, the description in the Draft Determination of the circumstances under which the Commissioner may exercise this discretion could be seen as confusing. In particular, paragraphs 4 and 5 should be reviewed and rewritten to ease this confusion. In addition, the only example in the Draft Determination is vague and only shows a negative position i.e. where the discretion will be used. We recommend that the example be clarified and more examples be provided, particularly one where the Commissioner's discretion would not be used.

**SPECIFIC COMMENTS**

The Draft Determination tends to create confusion (rather than clarifying) the circumstances in which the Commissioner is likely to substitute a value for the company's assets. In particular paragraphs 3, 4 & 5 appear to have contradictory comments.

Paragraph 3 states that:

*"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."*

This would seem obvious enough, but paragraph 4 then goes on to seemingly contradict that by stating, *"the Commissioner will not exercise his power under subsection 109Y(2) whenever accounting standards require the total value of assets to be understated"* (e.g. internally generated goodwill). This statement is followed with the statement, *"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."*

It appears the second part of paragraph 4 contradicts the first part of paragraph. It could be construed as saying, if the company makes a payment or advances a loan, and the company has internally generated goodwill, the Commissioner is likely to substitute a higher value for the company's assets.

We are concerned that it may be difficult in practice to always identify situations where the company, its shareholders and directors have deliberately acted in a way that would be seen as a mischief against which Division 7A is directed.

Our concerns are highlighted by the rather vague example in paragraph 5, which describes a situation where the Commissioner would exercise his discretion to include a value for Goodwill in the value of the company's assets. The example states that, *"by their actions the shareholders/directors show that they regard the value of goodwill as sufficient to treat the earning as an available surplus"*. However, there is not enough explanation of what actions the shareholder/directors took that would lead to this conclusion. We are concerned that this example could be interpreted to justify the use of the Commissioner's discretion in any situation where the company makes a loan or payment to shareholders or their associates and the goodwill value is not included in the accounts because of the accounting standards.

We suggest that the example doesn't seem to make sense for the following reasons.

If the directors were taking the earnings of the company for private purposes the balance sheet would show retained earnings under equity of the company and the receivable (i.e. the amount of the loan) would be the corresponding asset. The example, however, suggests that the net assets are zero (based on book values) which implies that there are no retained earnings (i.e. no realised profits). So earnings are likely to mean revenue (or cash) in this example.

The fact that the value of goodwill needs to be included to give the company a distributable surplus implies that the Commissioner is seeking to tax unrealised gains. That is not beyond the ambit of Division 7A but we question whether Division 7A is the appropriate remedy for these circumstances. The reason we say this is that the example implies that the loans to shareholders (and any other assets) are, in substance, funded by "loan capital". It is not clear whether the loan capital is borrowings from (say) a bank, or whether it is sourced from related parties (i.e. shareholders or their associates).

Assuming that the loan capital is borrowings from a bank, Taxation Ruling TR 95/25 would suggest that the interest would be non-deductible on the basis that the distribution (or debit loan) was paid from the recognition of internally generated goodwill. We question whether the example of a company borrowing from a bank to make a loan to shareholders that represents an unrealised gain (on goodwill) is common following the issue of TR 95/25. The only reason for the borrowing by the company would appear to be if the company could claim a tax deduction. Since it cannot, the example does not make any practical sense.

On the other hand if the loan capital was contributed by the shareholders then a return of contributed (albeit loan) capital would seem to be permissible and outside the ambit of Division 7A. Again, the example does not seem to make any practical sense.

The second issue involves the lack of guidance as to the meaning of the word "significantly" in the context of the term "significantly undervalue of overvalue" in subsection 109Y(2).

Appendix 1 (which does not form part of the ruling) makes it clear that minor mistakes must be ignored (see paragraph 18 in Appendix 1). It also makes it clear that significant refers to the overall value of assets and not just in relation to any particular asset (see paragraph 22 in

Appendix 1).

In our view, this does not go near enough to communicating what the Commissioner thinks is significant. We therefore recommend the following:

- The example include a mock balance sheet with numbers so that the example is clearer, and the meaning of loan capital as used in the example is also clear;
- The example identifies the mischief because the current example states that there is a mischief but it is not clear that there is a mischief;
- The determination also include further examples that can be contrasted with "example 1" (i.e. an example of circumstances (including internally generated goodwill) where it would not be appropriate for the Commissioner to exercise the discretion under subsection 109Y(2); and
- The meaning of significant in (say) terms of materiality or some other concept is dealt with in the ruling.

Finally, while the Draft Determination addresses an undervalue of assets, subsection109Y(2) allows the Commissioner to exercise his discretion in circumstances where there has also been an overvalue. The Draft Determination is silent on this aspect and should be addressed given the heading implies the substitution of an 'appropriate value' for a private company's assets. Assets may be either under or overvalued.