



Public advice and guidance compendium – TR 2023/2

❶ Relying on this Compendium

This Compendium of comments provides responses to comments received on Draft Taxation Ruling TR 2019/D6 *Income tax: application of paragraph 8-1(2)(a) of the Income Tax Assessment Act 1997 to labour costs related to the construction or creation of capital assets*. It is not a publication that has been approved to allow you to rely on it for any purpose and is not intended to provide you with advice or guidance, nor does it set out the ATO's general administrative practice. Therefore, this Compendium does not provide protection from primary tax, penalties or interest for any taxpayer that purports to rely on any views expressed in it.

Summary of issues raised and responses

Issue number	Issue raised	ATO response
1	The draft Ruling places an unreasonable amount of compliance burden on taxpayers The approach outlined in the draft Ruling would create an unreasonable practical compliance burden on taxpayers. It appears that the Commissioner is asserting an evidentiary standard that is beyond the capacity of practical business systems.	Labour costs covered by this Ruling can be prevented from being deductible under paragraph 8-1(2)(a) of the <i>Income Tax Assessment Act 1997</i> (ITAA 1997) where they are on capital account. There can be no presumption that labour costs are always on revenue account. The Ruling acknowledges that labour costs are <i>generally</i> revenue in nature and it only addresses a particular category of labour costs, being capital asset labour costs. It is only where labour is <i>specifically</i> employed or contracted for the construction or creation of a capital asset that it will be on capital account. Employees or contractors engaged in the day-to-day and ongoing operations of a business, and who spend an infrequent, minor or incidental amount of time on functions or activities related to the construction or creation of capital assets, or whose functions have a remote connection with such activities, will not be regarded as specifically employed or contracted for the construction or creation of capital assets and any of their capital asset labour costs will be on revenue account. We consider that taxpayers should generally be able to show the essential character of capital asset labour costs and any fair and reasonable method of apportionment by using established systems, processes, policies and procedures, and other existing records and information that the taxpayer has in place for general business purposes. If we are reviewing the tax treatment of

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		capital asset labour costs adopted by a taxpayer, we will generally seek to confirm that a taxpayer has made a reasonable attempt to consider these existing business records and information when substantiating the tax treatment of their capital asset labour costs. Paragraph 78 and Example 5 of the final Ruling have been amended to clarify that taxpayers can generally rely on existing records that are maintained (for example, the types of records outlined in paragraph 34 of the final Ruling) in determining the essential character of labour costs and to support the apportionment of such expenditure, if required. It is noted that the law does not mandate a particular methodology for apportionment be applied. It is open for taxpayers to adopt any methodology that is fair and reasonable to their circumstances that is supported by the available evidence.
2	More practical guidance is required More practical guidance should be included to ensure that taxpayers know how to apply their situation to the Ruling. The draft Ruling does not provide sufficient clarity or reasoning to assist taxpayers in determining whether labour costs are capital or revenue in the wide variety of situations faced by businesses. This could take the form of a practical compliance guideline or additional examples which better illustrate the types of scenarios which taxpayers are likely to find themselves in.	The characterisation of labour costs will ultimately depend on the facts and circumstances of each case. In view of the feedback received, the examples in the final Ruling have been amended to demonstrate the practical application of the legal principles. Examples 1 and 2 of the final Ruling have been expanded to consider the relevance of the accounting treatment of labour costs in determining the nature of labour costs. Example 1 demonstrates that notwithstanding that some of the general manager labour costs are capitalised for accounting purposes, the tax characterisation may be on revenue account taking into account all relevant facts and circumstances. The example also demonstrates that the same outcome would apply to a broader range of employees to the extent that they devote an incidental or infrequent amount of their time to the construction of capital assets. Example 4 of the final Ruling has been amended to more clearly reflect that characterisation must be determined first and then apportionment, if required. The examples in the final Ruling are directed at providing a good balance covering businesses of different sizes and in diverse industries. Examples 6 and 7, and the footnote to Example 5 of the final Ruling have been added to demonstrate the application of the legal principles to a broader range of industries and circumstances.

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		We will continue to monitor the treatment of labour costs and the situations faced by business with a view of potentially issuing further guidance where necessary. If taxpayers have any concerns about the application of the final Ruling to their situation, they are encouraged to approach us for advice on their specific circumstances.
3	More examples are required The final Ruling should consider more complex cases where expenses are hard to classify and apportion, for example, bonuses, long service leave payments, and other forms of leave-related payments made to workers whose labour is partly attributable to the creation of capital assets. The final Ruling should address these more complex cases which are likely to occur frequently in practice.	The treatment of costs associated with the employment of labour (such as long service leave, annual leave, sick leave and similar leave) can be complex where the role changes over time or the costs are only in part capital labour asset costs. While recognising in these cases that it can be challenging to determine with precision the amount of such costs that are capital, the Commissioner expects a practical approach will be adopted to the claiming of such costs which is aligned to the principles in the final Ruling and seeks to achieve a fair and reasonable outcome. If taxpayers have any concerns about the application of the final Ruling to their situation, they are encouraged to approach us for advice on their specific circumstances.
4	Inclusion of other industries The final Ruling should offer a more balanced view and greater awareness of the economic factors relevant to the use of labour in capital-intensive industries and the broader economy, not just taxpayers in the oil and gas industry. The draft Ruling addresses a narrow scope of issues and is targeted at the oil and gas industry (being the only industry explicitly referred to in the majority of the examples). Any Ruling dealing with this topic must be capable of broader application. The final Ruling should be expanded to incorporate examples relevant to a broader range of industries and size of taxpayer.	The legal principles in the final Ruling apply equally across all industries and taxpayers to the extent that labour is <i>specifically</i> employed or contracted for the construction or creation of a capital asset. The Ruling does not generally concern the cost of workers or employees whose roles or functions might have something to do with capital assets in an incidental or remote way. The examples in the final Ruling are directed at providing a good balance covering businesses of different sizes and in diverse industries. Examples 6 and 7, and the footnote to Example 5, have been added to the final Ruling to demonstrate the application of the legal principles to a broader range of industries and circumstances. The final Ruling makes the point (see, for example, paragraphs 6, 57 and 85, and the Examples) that the principles apply equally to the creation and development of intangible capital assets such as software as they do to tangible assets. Capital labour costs incurred in relation to the creation of intangible assets that strengthens the income-producing structure or enlarges the profit-yielding structure of the business will be capital in nature. This view is consistent with the principles outlined in Taxation Ruling TR 2016/3 <i>Income</i>

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		<i>tax: deductibility of expenditure on a commercial website.</i> TR 2016/3 also provides guidance on when losses or outgoings for activities associated with the creation of software will be on capital account. Regular minor upgrades and yearly maintenance of software for fixing errors or bugs, updating information contained in the software (such as, regulatory changes, tax rates, inflation indexes) are likely to be revenue in nature. However, the determination of whether the upgrade and maintenance performed on software is on capital or revenue account is dependent on the facts and circumstances of each case. As explained in TR 2016/3, if the upgrade and maintenance to a commercial website is significant enough to strengthen the income-producing structure or enlarge the profit-yielding structure of the business, then the labour costs specifically employed for those activities would be capital or capital in nature, and will not be immediately deductible under section 8-1 of the ITAA 1997.
5	Commissioner's view on apportionment presents higher compliance costs The approach currently suggested by the draft Ruling to focus on apportionment at an employee or timesheet level is impractical and administratively burdensome.	The law requires that any apportionment is to be conducted on a fair and reasonable basis. Where apportionment is appropriate, and in the absence of evidence to the contrary, we expect a taxpayer to use established business records and information to determine a fair and reasonable basis for apportionment. A fair and reasonable basis of apportionment should take into account the taxpayer's specific facts and circumstances (which includes the records and information available to them). Where apportionment is required (that is, capital asset labour costs are partly, but not wholly, capital in nature), the use of time-writing records which are already maintained for general business purposes to apportion a salary paid to an employee, may be appropriate. However, we also accept that counting the number of hours an employee is engaged in activities may not always be a fair and reasonable method of apportionment (particularly if such information is not readily available). A fair and reasonable basis requires all relevant circumstances to be considered, including what information is available. We have amended Example 5 of the final Ruling to reflect that taxpayers may adopt an apportionment methodology which represents a fair and reasonable basis. This may or may not include timesheets. The example also illustrates that the analysis may be undertaken at a team level rather than an individual employee level.

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6	Why is accounting treatment relevant? The final Ruling should clarify the relevance of accounting treatment to determining the nature of labour costs. The draft Ruling places a high degree of reliance on the accounting treatment of costs and does not highlight the extent of the discretion available to organisations to treat expenditure under accounting standards.	Paragraph 80 of the final Ruling discusses the relevance of accounting principles. The final Ruling makes it clear that the accounting treatment is not definitive but is a relevant consideration. All relevant factors must be considered when making a determination as to the appropriate characterisation of labour costs. Amendments to the examples make it clear that the accounting treatment is not determinative. In Example 1 of the final Ruling, notwithstanding that a portion of the relevant employee's labour costs are capitalised for accounting purposes, it does not alter the conclusion that they are considered to be immediately deductible for income tax purposes. In Example 2 of the final Ruling, while the accounting treatment is consistent with the tax outcome, it is not considered to be a determinative factor.
7	Prospective application only The ATO should confirm that the final Ruling will only apply prospectively because the position in the draft Ruling appears to be contrary to some previously adopted positions. The ATO should confirm that it will not apply compliance resources to reviewing the apportionment of labour costs for income years ending prior to the date of the final Ruling.	The views in the final Ruling apply both before and after its date of issue. The legal principles (both in terms of characterisation and apportionment) as set out in the final Ruling are well-established and have not changed. There are no previous ATO publications or conduct that could be reasonably seen as conveying or supporting a different view of the law to that set out in the final Ruling. Accordingly, there is no basis for the final Ruling to apply on a prospective basis only.
8	Labour costs are ordinarily revenue in nature <i>Goodman Fielder Wattie Ltd v Commissioner of Taxation</i> [1991] FCA 264 (<i>Goodman Fielder</i>) has been misinterpreted and should be authority that counting hours is not the answer. The recurrent nature of labour costs points to it being on revenue account. The draft Ruling does not take this into account.	The final Ruling acknowledges that labour costs are <i>generally</i> revenue in nature. The final Ruling only addresses a particular category of labour costs, being capital asset labour costs, and when these costs will be considered to be on capital account. Our view on <i>Goodman Fielder</i>, set out in paragraphs 75 to 77 of the final Ruling, makes it clear that it is authority about what is the essential character of an outgoing. <i>Goodman Fielder</i> is not authority for the proposition that labour costs are not, in any circumstances, apportionable. Nor is it authority for what apportionment methodology would be considered fair and reasonable once it is determined that expenditure on labour costs is, to some extent (but not wholly), capital in nature. Depending on the taxpayer's particular circumstances, apportionment based on the number of hours may be fair and reasonable.

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9	<i>Associated Minerals Consolidated Ltd v Commissioner of Taxation</i> [1994] FCA 570 (<i>Associated Minerals</i>) was not addressed in the draft Ruling considering that it was found that labour costs associated with removal of a capital asset was found to be immediately deductible.	It was found (at first instance) in <i>Associated Minerals Consolidated Ltd v The Commissioner of Taxation of the Commonwealth of Australia</i> [1994] FCA 28 that the labour costs for employees of Associated Minerals Consolidated Ltd for the removal of a capital asset was incurred as part of the gaining and producing of assessable income and on revenue account. This was on the basis that the labour costs were for the provision of the employee's services that were incidental and were in the course of ordinary employment of a continuing nature. In contrast, costs of contracted labour employed specifically for the purpose of assisting in the removal of the capital asset was found to be on capital account. Although the activity of removing the capital asset was ultimately found to be of a revenue nature on appeal in <i>Associated Minerals</i>, the Commissioner's view is that the first-instance decision in that case provides a useful example of where a distinction can be made between an ongoing employee who is involved in a capital activity on an incidental or infrequent basis (such that the essential character of their labour costs are wholly revenue in nature) and a contractor who is specifically engaged to undertake the capital activity (such that the essential character of their labour costs would be wholly capital in nature) and is consistent with the approach adopted in <i>Goodman Fielder</i>. The final Ruling has been amended to reference the first-instance decision in <i>Associated Minerals</i> where the essential character of the capital asset labour cost of an employee is <i>wholly</i> revenue in nature and apportionment is not relevant. This is to be distinguished from where labour is specifically employed or contracted for the construction of a capital asset, which will be on capital account.