TR 2017/D8 - Income tax: tax treatment of long term construction contracts

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This document has been finalised by TR 2018/3.

Australian Government
Australian Taxation Office

Draft Taxation Ruling

Income tax: tax treatment of long term construction contracts

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Summary – what this ruling is about

1. This draft ruling explains the methods acceptable to the Commissioner for returning income derived and recognising expenses incurred in long term construction projects. This draft ruling affirms that the completed contracts method remains unacceptable under the income tax law.

Definitions

2. For the purposes of this draft ruling, **'long term'** construction contracts refer to contracts under which construction work extends beyond one year of income. A construction contract which runs for less than twelve months, but straddles two or more income years is therefore regarded as a long term construction contract. The word '**construction**' takes its ordinary meaning.

3. A long term construction contract does not include a contract for the sale and supply of what may ordinarily be regarded as the sale of trading stock, for example, it does not include a contract for the supply and installation of office furniture in a new building even though the furniture may need to be assembled upon delivery.[1]

[1] Income from the sale of trading stock is derived for income tax purposes when the stock is sold and a debt created notwithstanding that the debt is not payable until a future year: *J Rowe & Son Pty Ltd v. Federal Commission of Taxation* [1971] HCA 80.

Ruling

4. In contracts which extend beyond one income year, it is not permissible to defer the bringing of profits or losses to account until the contract is completed. [See **Unacceptable methods**]

5. The principles and practices which apply in recognising for income tax purposes, income derived from and expenses incurred in long term construction contracts are:

(a) All progress and final payments received in a year are to be included in assessable income and income tax deductions allowed for losses and outgoings to the extent permitted by law. [See **Basic approach**]

(b) Notwithstanding (a) any method of accounting which has the effect of allocating, on a fair and reasonable basis, the ultimate profit or loss on a contract over the years taken to complete the contract will be acceptable. [See **Estimated Profits Basis**]

Consistency of method

6. Whichever of the acceptable methods of determining taxable income from long term construction contracts is adopted by an entity, it is to be applied consistently to all years during which the particular contract runs and to all similar contracts entered into by the entity. (Service or maintenance contracts, being for the provision of services rather than for construction, are not within the scope of this draft ruling and are not therefore 'similar contracts'.)

Basic approach

7. All payments received or receivable are returned as assessable income in the year in which they are derived and expenditure is deductible in the year in which it is incurred.

Progress and final payments

8. All progress and final payments received in a year should be included in assessable income and income tax deductions allowed for losses and outgoings to the extent permitted by the income tax law.[2]

9. Assessable income arising from long term construction contracts includes not only progress and final payments actually received in a year but also amounts billed or billable to customers in a year for work carried out and certified as acceptable for payment by the appropriate person authorised to do so in the contract.[3] A

[2] Income assessable under section 6-5 and deductions allowed under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).
[3] *Henderson v. Federal Commissioner of Taxation* [1970] HCA 62.

taxpayer cannot defer assessment of contract income by refraining from or postponing billing until after the close of the income year when there was an entitlement under the contract to bill before the year end. Nor can the assessment of contract income be deferred by refraining from or postponing the obtaining of certification from the relevant party.

Up-front payments

10. For taxpayers who use the basic approach in determining taxable income, up-front payments[4] of contract price or advance progress payments are assessable income.

11. As a general rule an up-front payment or advance progress payment should be recognised as assessable income between its receipt and when the next progress payment is due. There may be situations where the circumstances surrounding an up-front payment warrant it being included in assessable income in a different period[5] or over a longer period. For example, if the payment was to enable the purchase of equipment etc for use over the whole of the contract it would be proper to spread it over the whole period of the contract.

Retention clauses

12. For taxpayers who use the basic approach in determining taxable income, amounts retained under a retention clause[6] should not be included in assessable income until the taxpayer either receives them or is entitled to receive them from the customer.[7] Symmetrically, if the taxpayer, being a contractor, retains amounts from sub-contractors, the amounts so retained are not deductible until such time as they are due to the sub-contractors.

13. Where retention money is conditionally[8] paid by the customer to the contractor before it is actually due, the money will not be assessable income until the contractor is entitled to it.

14. Where contractors obtain bank guarantees (in lieu of customers retaining amounts from progress or final payments), in which the customers are guaranteed payment by the bank if the contractors become liable under the terms of warranties during the retention period, the inclusion in assessable income of amounts due to the contractors should not be reduced by the amounts guaranteed.

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[4] An up-front payment is part of the contract price, paid to a contractor at the time of, or prior to, beginning work.

[5] Cf *Arthur Murray (NSW) Pty Ltd v. Federal Commissioner of Taxation* [1965] HCA 58.

[6] A 'retention clause' is a provision in the contract for the customer to retain a portion of the contract price until the maintenance period specified in the contract has passed.

[7] *HW Coyle Ltd v. Commissioner of Inland Revenue (New Zealand)* 80 ATC 6012; 11 ATR 122.

[8] For example, on condition that the contractor remedies any defects before the building is handed over or accepted by the owner.

If a contractor is required to pay to a bank any amount under the terms of a guarantee arrangement the amount so paid will qualify for income tax deduction when it is paid.

Work-in-progress

15. Work-in-progress does not represent trading stock. Work-in-progress is not on hand in the sense contemplated by Subdivision 70-C of the ITAA 1997. Property in it would normally belong to the client or customer, with the contractor having rights to sue for work done.

Expected costs

16. Accounting standards and practices cannot supplant the income tax law in determining whether deductions are allowable.[9] Tax law does not permit deductions for costs or losses which are expected to arise in performance of long term construction contracts. For taxpayers who use the basic approach, it is only losses and outgoings which are incurred during an income year which may be allowed as deductions.

Estimated Profits Basis

17. This basis permits a taxpayer to spread the ultimate profit or loss on a long term construction project over the years taken to complete the contract provided the basis is reasonable, is in accordance with accepted accountancy practices and appropriate adjustments are made for tax purposes.

18. In this context, '**ultimate profit or loss**' refers to the overall taxable income expected to arise from a particular contract. It requires the total receipts expected to be received under the contract to be regarded as assessable income and income tax deductions to be allowed for expected losses and outgoings to the extent permitted by tax law on the assumption that the losses and outgoings would actually be incurred over the period of the contract. In this context, 'ultimate profit or loss' does not mean:

- the result of the comparison between receipts and expenditure, or
- a figure determined by the application of accountancy principles.

19. Ultimate profit or loss is in effect notional taxable income expected to arise under a particular contract and it is the notional taxable income which may be spread over the years taken to

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[9] *HW Coyle Ltd v. Commissioner of Inland Revenue (New Zealand)* 80 ATC 6012; 11 ATR 122; *Grollo Nominees Pty Ltd v. Commissioner of Taxation* (1997) 97 ATC 4585; (1997) 36 ATR 424.

complete the contract. Another way of determining notional taxable income is to begin with the expected overall net profit or loss for accounting purposes and make appropriate adjustments for income tax purposes.

20. Because the estimated profits basis focuses on the end result of a long term construction contract the question of when an income tax liability attaches to up-front payments, advance progress payments and amounts withheld under retention clauses does not arise.

Accounting standard

21. The estimated profits basis is similar to the accounting standard AASB 15 *Revenue from Contracts with Customers*[10] but, as was held by the Full Federal Court in *Grollo Nominees*[11] and noted at paragraphs 18 and 19 above, appropriate adjustments must be made for income tax purposes.

22. The introduction of AASB 15 does not necessarily bring into line the accounting recognition of revenue with the tax law. Revenue is recognised under accounting principles when performance obligations of the contract are satisfied, that is, when control has passed to the customer.[12] In contrast, the tax law recognises income when it is derived and expenses when they are incurred.

Costs taken into account

23. Only costs that are identified as likely to be incurred over the period of the contract and which are properly deductible are taken into account in calculating notional taxable income. These costs are estimated relying upon the taxpayer's experience in the construction industry and using sound commercial or business principles. The estimations must be well documented and can vary from year to year.

24. Costs of materials and labour are examples of properly deductible costs. General claims for a 'management reserve' or for 'additional costs arising from wet weather, industrial disputes etc' are not sufficiently informative about the actual costs involved to be properly deductible.

25. It is not sufficient to make a general claim for unspecified costs likely to arise on the happening of some future event. The calculation of notional taxable income needs to be more exact. The likely effect those future events will have on costs must be quantified. For example, where operations are conducted in a region with an

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[10] The Australian Accounting Standards Board (AASB) published AASB 15 *Revenue from Contracts with Customers* in December 2014 with an effective start date of 1 January 2018.

[11] *Grollo Nominees Pty Ltd v. Commissioner of Taxation* (1997) 97 ATC 4585 at 4608-09; (1997) 36 ATR 424 at 452.

[12] AASB 15 *Revenue from Contracts with Customers* at paragraph 31.

average historical rainfall of 500ml per year, it would be reasonable to estimate the impact of that weather on the project and calculate the delay costs in respect of the contract activities.

26. It is permissible to take into account a reasonable amount for probable costs in remedying defects etc during the maintenance period.

Tender costs

27. Tender costs are not taken into account in the estimated profits basis.[13] Although tender costs are attributable to the construction contract, they are severable from it and occur at a time before the beginning of the contract.

Methods of allocating notional taxable income

28. There are a number of acceptable methods of allocating notional taxable income over the years taken to complete a long term construction contract. They each seek to recognise notional taxable income in a manner that reflects the progress of a contract. The particular method used will depend upon the nature of a contract.

29. In a cost plus contract[14], the amount of notional taxable income to be included in assessable income in each year will be determined by ascertaining the percentage that notional taxable income bears to agreed cost and applying the percentage to costs incurred in a year.

30. In fixed price contracts it will be a matter of determining the notional taxable income year by year and including an appropriate amount of the notional taxable income in assessable income of each year.

31. Any other method which achieves the same broad result would also be acceptable. Whatever method is used, it must be applied consistently. [See **paragraph 6**]

32. A basic principle of the income tax law is that liability to income tax is an annual event and, if it appears at the end of an income year that there is a profit element in a long term construction contract - regardless of the stage reached – the law operates so that an appropriate amount of the profit converted to notional taxable income must be returned. In the very early stages of a long term construction contract, it may not be apparent that any profits have been derived.

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[13] They may be deductible under section 8-1 of the ITAA 1997 in the year in which they are incurred.

[14] A contract where the contractor is to be paid for agreed cost plus a percentage or fixed fee.

Recognising a loss

33. An estimated contract loss is to be spread over the period taken to complete the contract in a manner that reflects the progress of the contract.

Example 1

34. *A construction company is in the fourth year of a five year contract. At the end of the fourth year it seems probable that the company will incur an ultimate loss of $1,000 from the contract. The contract at the end of this income year is 80% complete with 20% having been performed during this income year. The construction company will return in this income year a loss sufficient to recognise the company has completed 80% of the contract, that is, the loss returned will be an amount which, together with the amounts returned in the previous three years, will equal a loss of $800 representing 80% of the ultimate loss under the contract and thus reflecting progress on the contract. In the next income year if the probable loss is realised, the company will return a loss of $200 representing the final 20% of the work on the contract.*

Changes over the contract period

35. In many cases, particularly where the contract price is fixed as a certain amount, the notional taxable income will not remain the same over the life of the contract. Estimates of costs and forecasts of profits prepared during contract negotiations are likely to change. The end result may differ markedly from initial expectations as a result of increases in costs, industrial issues, delays, inclement weather, disputes etc.

36. A taxpayer deriving income from long term construction projects is not irrevocably bound to the figure for profit or loss initially expected. It is something which can be adjusted from year to year, that is, in each year of the contract the amount of notional taxable income may be determined according to expectations existing at the close of each year.

Example 2

37. *If, using the figures in the below table, the notional taxable income had fallen to $200 in year 3, the amounts included in assessable income in years 1 and 2 (being $240 total) would have exceeded the total profit. The operation of subsection 170(9) of the Income Tax Assessment Act 1936 (ITAA 1936) enables the over-assessment to be rectified.*

	Year 1	Year 2	Year 3
(a) Estimated notional taxable income	$500	$400	$300
(b) Percentage of contract completed	20%	60%	100%
(c) Notional income to be returned = (a) × (b)	$100	$240	$300
(d) Less income already returned	$0	$100	$240
Assessable income	**$100**	**$140**	**$60**

38. *If, on the other hand, it appeared in year 2 that the contract would result in a loss, it would not be possible at that time to amend the assessment for year 1 to exclude the profit assessed in that year. At the time the assessment for year 1 was made, it was correctly made. The only provision which would authorise amendment is subsection 170(9) of the ITAA 1936, which does not operate until the contract is complete.*

Subsection 170(9)

39. Where the estimated profits basis is used, subsection 170(9) of the ITAA 1936 extends the period of time to amend an assessment where the ultimate taxable income from the contract differs from the previously anticipated amount that was used to calculate assessable income. The provision allows amendment of assessments to ensure that:

- income tax liability arising from contracts extending beyond one year of income is restricted to the ultimate profit or loss on the contracts, and
- estimated amounts of income upon which tax has been paid in relevant years accurately represent profits and/or losses attributable to the relevant years.

40. The provision contemplates the inclusion of an estimated amount of income derived by the taxpayer in the relevant year from an operation; the profit or loss in which was not ascertainable at the end of the year because the operation extended over more than one year.[15]

41. This provision ensures that a taxpayer's income tax liability is limited to the ultimate taxable income derived from the contract.

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[15] *Grollo Nominees Pty Ltd* op. cit. (1997) 97 ATC 4585 at 4615; (1997) 36 ATR 424 at 459.

Unacceptable methods

42. Neither the completed contracts basis (which returns profits and losses on completion of a contract) nor the 'emerging profits basis'[16] is an acceptable method for determining taxable income from long term construction contracts. Liability to income tax has to be determined annually. In the case of long term construction projects it is the position at the end of each year that has to be taken into account. Subsection 170(9) of the ITAA 1936 is the mechanism provided in the income tax law to ensure that, in the end result, there is not an over assessment of income tax liability.

43. A variation of these methods, which claims deductions for expenditure incurred in the year in which it is incurred, but does not include amounts derived under the contract in assessable income until the year in which the contract is completed or substantially completed, is similarly unacceptable.

Date of effect

44. When the final Ruling is issued it is proposed to apply from 1 January 2018. However, the Ruling 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 the Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
18 October 2017

[16] *Grollo Nominees Pty Ltd* ibid. (1997) 97 ATC 4585 at 4604 and 4608; (1997) 36 ATR 424 at 446 and 451.

Appendix 1 – Compliance approach

❶ ***This Appendix sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow the advice in this appendix in good faith and consistently with the ruling section, the Commissioner will administer the law in accordance with this approach.***

Amending assessments under subsection 170(9)

45. Whether or not assessments should be amended in terms of subsection 170(9) of the ITAA 1936 will depend upon the circumstances of the case. In requesting an amended assessment, taxpayers engaged in long term construction projects should provide a statement reconciling the ultimate taxable income with the amounts of notional taxable income included in assessable income over the years taken to complete the contract.

46. In some cases, notwithstanding that the ultimate taxable income may equal the total of the amounts of notional taxable income; it may appear that the yearly allocation was not correct. Where the rates of tax payable over the period have not altered it is unlikely that amendment to the assessments concerned is necessary. In many cases variations of this nature in one contract will be offset by variations in other contracts. In other cases taxpayers may request amended assessments, for example, a proper allocation of profit to earlier years to absorb otherwise undeducted losses. In these cases assessments should be amended.

Estimated Profits Basis interacting with other provisions

47. The term 'ultimate profit or loss', as explained in paragraphs 18 and 19, refers to the overall taxable income expected to arise from a particular contract. It requires the total receipts expected to be received under the contract to be regarded as income assessable under section 6-5 of the ITAA 1997 ('ordinary income') and deductions allowed for expected losses and outgoings to the extent permitted by law (assuming the losses and outgoings would actually be incurred).

48. Section 6-5 speaks of income according to ordinary concepts; it replaces the former subsection 25(1) of the ITAA 1936 which spoke of gross income derived. The Estimated Profits Basis effectively allows for the notional taxable income to be treated as ordinary income. This is an administrative concession allowing deductions to be factored in earlier than they otherwise would have been.[17]

49. Taxpayers who use the Estimated Profits Basis should use their notional taxable income when determining their eligibility for the purposes of other tests in the tax laws.

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[17] This maintains the view previously expressed in Taxation Ruling IT 2450 *Income tax: recognition of income from long term construction contracts*.

Appendix 2 – Your comments

50. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

51. A compendium of comments is prepared for the consideration of the relevant Public Advice and Guidance Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments, and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: **1 December 2017**

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Appendix 3 – Detailed contents list

52. The following is a detailed contents list for this Ruling:

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References

Previous draft:

Not previously issued as a draft

Previous Rulings/Determinations:

IT 2450; TD 92/131; TD 92/186; TD 94/39; TD 94/65; TD 94/87

Legislative references:

- ITAA 1936
- ITAA 1936 25(1)
- ITAA 1936 170(9)
- ITAA 1997
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 Subdiv 70-C

Cases relied on:

- Arthur Murray (NSW) Pty Ltd v. Federal Commissioner of Taxation (1965) 114 CLR 314; (1965) 39 ALJR 262; (1965) 14 ATD 98; [1965] HCA 58
- Grollo Nominees Pty Ltd v. Commissioner of Taxation (1997) 73 FCR 452; (1997) 36 ATR 424; (1997) 147 ALR 330; 97 ATC 4585
- Henderson v. Federal Commissioner of Taxation (1969) 119 CLR 612; (1969) 43 ALJR 172; (1969) 15 ATD 298; 69 ATC 4049; (1969) 1 ATR 133; [1970] HCA 62
- H.W. Coyle Limited v. Commissioner of Inland Revenue (N.Z.) 80 ATC 6012; 11 ATR 122
- J Rowe & Son Pty Ltd v. Federal Commission of Taxation [1971] HCA 80; (1970) 124 CLR 421; (1970) 45 ALJR 21; (1970) 2 ATR 121; 71 ATC 4001

Other references:

- AASB 15 Revenue from Contracts with Customers

ATO references

NO:	1-BD70DD7
ISSN:	2205-6122
BSL:	TCN
ATOlaw topic:	Income tax ~~ Assessable income ~~ Timing and derivation Income tax ~~ Deductions ~~ Meaning of incurred and timing issues

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