# *TD 93/D255 - Income tax: property development: is a "management reserve" taken into account in calculating notional taxable income under the estimated profits basis of returning income from a long term construction contract?*



This document has been finalised by TD 94/65.

# Draft Taxation Determination

## Income tax: property development: is a "management reserve" taken into account in calculating notional taxable income under the estimated profits basis of returning income from a long term construction contract?

1. No. Only those costs that can be identified as being likely to be incurred over the period of the contract should be 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 should be well documented.

2. On the other hand a "management reserve" is a general reserve or provision which is usually made to cover all those expenses that are not currently capable of being individually identified but which, based on the taxpayer's experience, may be incurred during the period of the contract. A management reserve provides the taxpayer with a "comfort margin" when calculating its notional taxable income.

3. The correct method of returning notional taxable income each year requires the initial calculation of notional taxable income to be adjusted if and when the expenses intended to be covered by the "management reserve" become capable of individual identification. These expenses are then estimated using sound commercial or business principles.

4. Paragraph 28 of IT 2450 points out that notional taxable income does not remain the same over the life of the contract. It recognises that the initial calculation of notional taxable income may need to be reviewed as a result of unexpected increases in material and labour costs, industrial problems, delays, inclement weather, cave-ins, disputes over if and when payments should be made, etc.

5. Paragraph 29 of IT 2450 goes on to say that a company deriving income from a long term construction contract is not irrevocably bound to the figure for notional taxable income initially expected. Notional taxable income is something that can be adjusted from year to year, i.e. 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.

6. This draft Taxation Determination replaces Draft PDI 92/8, which has been withdrawn.

*Example:*

*A company enters into a ten year contract to install electrical equipment in aircraft and includes a "management reserve" equal to 10% of estimated costs when calculating its notional taxable income under the estimated profits basis. The management reserve is based on the assumption that there will be additional costs to the contract that cannot be identified at the moment. The reserve is based on previous experience and estimates.*

*The company is not allowed to take into account the management reserve in calculating notional taxable income. Costs intended to be covered by the reserve may be used to adjust notional taxable income when they are identified and accurately estimated.*

**Commissioner of Taxation**
30/09/93

FOI INDEX DETAIL: Reference No. Previously issued as Draft PDI 92/8

Related Determinations: TD 92/125; TD 92/131; TD 92/186

Related Rulings: IT 2450

Subject Ref: deductions; estimated profits method; long term construction contract; outstanding claims provisions; reserves

Legislative Ref: ITAA 51(1)

ATO Ref: PDI Cell/16A

ISSN 1038 - 8982