IT 2450 - Income tax : recognition of income from long term construction contracts

This document has been Withdrawn.
There is a Withdrawal notice for this document.

This ruling contains references to repealed provisions, some of which may have been rewritten. The ruling still has effect. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten. The legislative references at the end of the ruling indicate the repealed provisions and, where applicable, the rewritten provisions.

TAXATION RULING NO. IT 2450

INCOME TAX : RECOGNITION OF INCOME FROM LONG TERM CONSTRUCTION CONTRACTS

F.O.I. EMBARGO: May be released

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1211203	LONG TERM CONSTRUCTION CONTRACTS:-	
	ASSESSABLE INCOME	25
	ALLOWABLE DEDUCTIONS	51
	TRADING STOCK	28-31
	VALUE OF WORK IN PROGRESS	
	ESTIMATES OF INCOME	170(9)
	ADDITIONAL TAX	223
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OTHER RULINGS ON TOPIC CITCM 639

PREAMBLE Income tax returns of a number of companies engaged in long term construction projects have been subject to income tax audits in recent times. As a result of some of the audits a number of representations have been made to National Office by taxpayers engaged in long term construction projects and by industry groups. Central to the representations is the basis of returning income derived under long term construction projects. The representations allege inconsistent treatment by Branch offices, i.e. a method of returning income accepted in one Branch office has been specifically rejected in another. On the other hand, Branch offices have been concerned about the way income from long term construction contracts has been returned by a number of taxpayers in the industry and have sought direction in the matter.

2. The purpose of this Ruling is to restate the principles and practices which are to apply in bringing to account for income tax purposes income derived from long term construction contracts.

Present Instructions

3. Little has issued out of National Office by way of statement of principle on the basis of returning income from long term construction projects. Income Tax Order No. 128, dated 11 December 1915, simply stated:-

"In the matter of uncompleted contracts where progress payments are made, it has been decided to levy tax in the same manner as is adopted by the State Department in Victoria, i.e. on the actual estimated profits or income made in the specific year in which tax is based without regard to the amount of progress payments made.

In other cases where several contracts may be in varying stages of advancement, and progress payments are made in each, a fair estimate should be possible of the profits made at a definite date. Even if this estimate for the 12 months be a rough one, the balance of profit will come into the taxpayer's income in the year in which the contract is completed....."

4. Notwithstanding that Income Tax Order No. 128 applied to the Income Tax Assessment Acts prior to the Income Tax Assessment Act 1936 it is apparent that the latter Act proceeded on the basis that, in relation to contracts extending over more than one year of income, assessable income could include estimated amounts of profits and that estimated losses could be allowable as income tax deductions. This much appears from sub-section 170(9) which applies specifically to contracts extending beyond one year of income. Essentially, sub-section 170(9) is a repeat of section 37 of the Income Tax Assessment Act 1922-1934. The sub-section authorises 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 that estimated amounts of income upon which tax has been paid in relevant years fairly represent profits and/or losses attributable to the relevant years.

5. The acceptance that the Income Tax Assessment Act 1936 did not set out to fundamentally alter the basis of determining taxable income arising from contracts extending beyond one year of income is reflected in Canberra Income Tax Circular Memorandum No.639 (CM 639). Although CM 639 was issued in 1951 it expresses the approach that is still largely followed. CM 639 states three broad propositions:-

(a) In contracts which extend for more than one year of income it is not permissible to defer the bringing of profits or losses into account until the contract is completed.

(b) Strictly speaking, the income tax law requires all progress and final payments received in a year to be included in assessable income and income tax deductions allowed for losses and outgoings to the extent permitted by the income tax law.

(c) Notwithstanding (b) any method of accounting which has the effect of allocating, on a reasonable basis, the ultimate profit or loss on a contract over the years taken to complete the contract will be acceptable.

6. It is suggested from time to time that the approach outlined in paragraph 5(c) should be discontinued on the basis that it is not strictly in accordance with the requirements of the Income Tax Assessment Act. This is not a matter which has been the subject of judicial consideration in Australia. The High Court of New Zealand had occasion to consider the basis of assessing profits from a contract extending over a number of years in H.W. Coyle Limited v. Commissioner of Inland Revenue (N.Z.), 80 ATC 6012; 11 ATR 122.

7. The wording of the statute considered in that case, viz. the Land and Income Tax Act 1954 (N.Z.), differs somewhat from that in the Assessment Act. However, its effect is much the same. Section 88 of the N.Z. Act includes in assessable income all profits or gains derived from any business while sections 110-112 set down what deductions are allowable in calculating assessable income, i.e. in calculating the assessable profits or gains. For present purposes the provisions of the N.Z. Act are not materially different from those in the Assessment Act.

8. The taxpayer in that case was a member of a partnership which tendered for the roof and wall cladding work on a power station. The work was carried out between 1971 and 1975. The contract provided that progress payments on account would be made on the certificate in writing of the engineer. It further provided that the final balance of the moneys payable, less 5%, would be paid after the engineer had certified, under his hand, that the work had been finally and satisfactorily completed. No partnership returns were lodged until the 1975 year, the partnership taking the view that no profit arose under the contract until the work was completed. The Inland Revenue Commissioner, however, assessed income from the contract year by year on a percentage of completion basis being profit based on progress payments received less retentions and deductions for incurred expenditures each year.

9. Pertinent findings of the Court were:-

(a) Although there are alternative methods of accounting, each of which is based on proper accounting principles and results in profit being declared in different years, but where the total profit of a long term contract will be the same, nevertheless that cannot be the situation in determining what is assessable income.

(b) Each case must depend upon the terms of the contract and the provisions for payment in order to ascertain whether a profit (i.e. assessable income) has been derived at any particular stage.

(c) A threatened claim for damages for breach of contract could not be expenditure or loss incurred until it is actually paid or the contractor found liable to make such payment. No provision in this regard may be made in assessing the profit for income tax purposes unless the cost of repair has been agreed to be paid, or been

paid, or been ordered to be paid under the contract in the year in question.

(d) Just as in the case of the provision for claims for bad workmanship or breach of contract, it is not necessary for stock on hand and materials on site to be included in profit.

(e) The contract provides the circumstances in which progress payments are to be made. If they are due then the profit in respect of the events has been derived.

(f) Moneys which are entitled to be retained by the customer (5% of progress payments) are not derived or earned and should not be included in assessable income until they are payable.

10. Coyle's Case notwithstanding, against the background that the Income Tax Assessment Act 1936 proceeds on the basis that the assessable income of taxpayers engaged in long term construction projects may reflect estimated amounts of profits and losses and that the Act has been administered in this way since its inception, it is not proposed to say that the approach in paragraph 5(c) is no longer to be followed. What must be said, however, is that if this approach based on estimated amounts is to be accepted attitudes of fairness and reasonableness must be adopted by both the Australian Taxation Office and taxpayers.

RULING The Nature of a Long Term Construction Contract

11. Long term construction contracts are contracts relating to construction work where construction extends beyond a year of income. This is in accord with the definition of "construction contract" in the Statement of Accounting Standards - Accounting for Construction Contracts - AAS 11 - issued by the accounting profession. The word "construction" is used in its normal accepted sense. Income from long term construction contracts would include: income from construction of buildings, bridges, dams, pipelines, tunnels and other civil engineering projects; income from related activities such as demolition, dredging, heavy earth moving projects, etc.; and income from the construction of major plant items including ships and transport vessels. It would also include income from similar contracts in associated fields, e.g. air conditioning contracts, major electrical wiring or rewiring contracts, major refurbishment of hotels, stores, etc., major construction management contracts, etc..

12. A long term construction contract does not include a contract for the sale and supply over time of what may ordinarily be regarded as the sale of trading stock, e.g. 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. 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 & Sons Pty. Ltd. v. F.C. of T., 71 ATC 4157; 2 ATR 4970.

Consistency of Method

13. Whichever of the acceptable methods of determining taxable income from long term construction contracts is adopted by a taxpayer it is to be applied consistently to all years during which the particular contract runs and to all similar contracts entered into by the taxpayer. Taxpayers who are companies in the one group should adopt the same method of determining taxable income.

14. The requirement in the preceding paragraph is to apply in respect of all long term construction contracts entered into after 1 July 1987. Because the requirement has not been made explicitly clear in the past some taxpayers have been determining taxable income from existing contracts on differing acceptable methods - this practice may continue until those contracts are complete.

Basic Approach

15. As stated in CM 639 the basic approach is that 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. The approach seeks to treat taxpayers engaged in the long term construction industry in the same manner as any other taxpayer in business.

16. Since the issue of CM 639 there have been a number of cases decided by courts and tribunals dealing with the question of when business income is derived. The reasoning of the High Court in Henderson v. FCT, 70 ATC 4016; 1 ATR 596 makes it abundantly clear that 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 entitled to be billed to customers in a year for work carried out and certified as acceptable for payment by the appropriate architect, engineer, surveyor or other person authorised in the contract for that purpose. It is not accepted that a taxpayer can defer assessment of contract income simply by deliberately 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 close of the year. Nor is it accepted that the assessment of contract income can be deferred by deliberately refraining from or postponing the obtaining of certification from the relevant architect, engineer, etc..

17. Normally, progress payments under a long term construction contract are made at specified times or stages of construction. It is not unusual, however, for an up front payment of part of the contract price to be made to a contractor at the time of, or prior to, beginning work. The reason for the up front payment is that a typical project will often require extensive outlay by the contractor in the acquisition of plant and equipment. An up

front payment of part of the contract price enables the contractor to acquire plant and equipment without the need to borrow. As an alternative to up front payments of contract price the parties may agree for progress payments to be made in advance from the beginning of the work.

18. For taxpayers who use the basic approach in determining taxable income up front payments of contract price or advance progress payments are assessable income in the same way as progress and final payments. The particular question with them is whether they can be said to be derived at the point of receipt or whether they should be regarded as unearned income in terms of the decision in Arthur Murray (N.S.W.) Pty. Ltd. v. F.C of T., (1965) 114 CLR 314; 14 ATD 98 and brought to account as and when work progresses.

19. In many cases there will not be any problem - the payment and the period to which it relates will occur within the year of income. Situations may arise, however, where a long term construction contract begins towards the end of an income year and an up front payment or advance progress payment may not be offset by any allowable income tax deductions. In these circumstances it would be a distortion of the true situation to say that the up front payment or advance progress payment represented assessable income earned by the company in the year of receipt. As a general rule up front payments or advance progress payments should be brought to account as assessable income over the period from their receipt until the next progress payment is due. However, there may be situations where the circumstances surrounding an up front payment may warrant it being brought to account 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.

20. Some long term construction contracts have retention clauses, e.g. there will be provision in the contract for the customer to retain a certain percentage of the contract price until the maintenance period specified in the contract has elapsed. For taxpayers who use the basic approach in determining taxable income the amounts so retained should not be included in assessable income until the taxpayer either receives them or is entitled to receive them from the customer. On the other hand, if the taxpayer, being a contractor, similarly retains amounts from sub-contractors, the amounts so retained would not be deductible until such time as they are due to the sub-contractors.

21. In some cases it seems that retention moneys are paid over by the customer to the contractor before they are actually due on condition that the contractor remedies any defects before the building, for example, is handed over or accepted by the owner. Retention moneys paid in these circumstances would generally represent assessable income in the year of receipt. However, where retention moneys are received on the basis that they will be retained in a separate account and will not be available for disbursement or general use by the contractor until the relevant

works are completed to the client's satisfaction, the moneys will not be assessable income until the contractor is entitled to withdraw or apply them.

22. In other cases it appears that contractors, in lieu of customers retaining amounts from progress or final payments, obtain bank guarantees in which the customers are guaranteed payment by the bank if the contractors become liable under the terms of warranties during the retention period. In these circumstances the inclusion in assessable income of amounts due to the contractors should not be reduced by the amounts guaranteed. 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.

23. Although the basic approach seeks to assimilate the determination of taxable income from long term construction contracts to the determination of taxable income of businesses generally, work-in-progress is not considered to represent trading stock. It is difficult to say that work-in-progress is on hand in the sense contemplated by sections 28-31. Property in it would normally belong to the client or customer with the contractor having rights to sue for work done.

24. Industry bodies have pressed upon this Office that the determination of taxable income arising from long term construction contracts should follow the approach of accepted accounting standards in the respect that income tax deductions should be allowed for expected claims or costs and estimated losses. The suggestion cannot be accepted for taxpayers who use the basic approach. It is now well established that accounting standards and practices cannot supplant the terms of the income tax law which must be considered in determining whether income tax deductions are allowable. It is equally well established that the income tax law does not permit income tax deductions for claims for costs or losses which may be expected to arise in performance of long term construction contracts. It is only losses and outgoings which are incurred during a year of income which may be allowed as income tax deductions.

Estimated Profits Basis

25. 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 and is in accordance with accepted accountancy practices.

26. It is important in this context to understand what is meant by the expression "ultimate profit or loss". In one sense profit or loss is simply the result of the comparison between receipts and expenditure. In another sense profit or loss is a figure determined by the application of accountancy principles. The expression is not used in either of these senses. Rather it 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 the income tax law on the assumption that the losses and outgoings would actually be incurred over the period of the contract. 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 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.

27. Because the estimated profits basis focuses on the end result of a long term construction contract the question of when income tax liability attaches to up front payments, advance progress payments and amounts withheld under retention clauses does not arise. On the other hand, in the calculation of the end result of a long term construction contract it is permissible to take into account a reasonable amount for probable costs in remedying defects etc. during the maintenance period. It is more than likely that contractors will know from experience the extent to which additional costs are incurred during the maintenance period and this will be a guide in fixing a reasonable amount to be taken into account in determining the end result.

28. 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 unlikely to remain unchanged. The end result may differ markedly from initial expectations as a result of increases in material and labour costs, industrial problems, delays, inclement weather, cave-ins, disputes over if and when payments should be made, etc..

29. 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, 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. To take a simple illustration:-

	Year 1	Year 2	Year 3
Estimated Notional Taxable Income	$500	$400	$300
Percentage of Contract Completed	20%	60%	100%
Assessable Income	100	140 (240-100)	60 (300-240)

30. If, using the figures in the above example, the notional taxable income had fallen to $200 in year 3, it is apparent that the amounts included in assessable income in years 1 & 2 would have exceeded the total profit. The operation of sub-section 170(9) would enable the over-assessment to be rectified. 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. The reason for this is that, at the time the assessment for year 1 was made, it was correctly made. The only provision which would authorise amendment is sub-section 170(9) and that does not operate until the contract is complete. In many cases the impact of the inability to amend assessments prior to the expiration of a contract may not be significant. A contractor engaged in more than one contract will be able to set off losses against other profits.

31. 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 progress of a contract. The particular method used will depend upon the nature of a contract. In a cost plus contract, i.e. a contract where the contractor is to be paid for agreed cost plus a percentage or fixed fee, 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.

32. 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. Accounting Standard AAS 11 referred to in paragraph 11 suggests the following methods by which this may be achieved:-

(a) physical estimates or surveys by engineers and architects of the work performed to date;

(b) the cost basis - calculating the proportion that costs incurred in each year bear to the estimated total costs of the contract;

(c) the billings basis - calculating the proportion that billings or entitlement to billings in each year bears to total billings.

Each of the above methods is acceptable to this Office. Any other method which achieves the same broad result would also be acceptable. Whatever method is used, it must be applied consistently, cf. paragraph 13 above.

33. One of the suggestions put forward was that there should be a threshold stage of completion of a long term construction contract before which it would be inappropriate to recognise any notional taxable income as liable to tax. Figures ranging from 10% to 60% have been suggested. However, as each case must necessarily depend on its own facts, particularly the terms of the contract and its duration, it is just not practicable to attempt to specify any threshold that could have universal application. 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 a year of income 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 brought to account. At the same time it is also recognised that, in the very early stages of a long term construction contract, it may not be apparent that any profits have been derived. Even so, it is not accepted that, as a general proposition, there should be a threshold stage before which assessable income would be derived under long term construction contracts.

Completed Contracts Basis

34. In CM 639 it is stated that the completed contracts basis is not an acceptable method for determining taxable income from long term construction contracts. This is still the case. The reason that it is not acceptable is, as is stated earlier, that 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. Sub-section 170(9) 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.

Sub-section 170(9)

35. The effect of sub-section 170(9) is referred to in paragraph 4. It is not necessary to quote the section in full. It is capable of determining taxable income from long term construction contracts to ensure that a taxpayer's income tax liability is limited to the ultimate taxable income derived from the contract.

36. Whether or not assessments should be amended in terms of sub-section 170(9) will depend upon the circumstances of the case. They will require amendment where the ultimate taxable income is either more than or less than the total of amounts of notional taxable income included over the years taken to complete the contract. For this purpose taxpayers engaged in long term construction projects should provide a statement in the return of income of the year of completion of a contract reconciling the ultimate taxable income with the amounts of notional taxable income included in assessable income over the years taken to complete the contract. Ordinarily the date of completion of a contract may be taken as the date upon which a completion certificate is issued.

37. 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 would be necessary. In many cases variations of this nature in one contract will be offset by variations in other contracts. In other cases taxpayers may require amended assessments, e.g. a proper allocation of profit to earlier years to absorb otherwise undeducted section 80 losses. In these cases assessments should be amended.

Requests for Information

38. Auditors in one Branch office have stated that they were experiencing difficulty with some large contractors in establishing the basis upon which estimated profits were ascertained for use by the contractors in determining year by year assessable income. Requests for information on the matter were met with responses that the contracts are complete and the information is no longer available.

39. It is difficult to accept responses of this nature in the light of the requirements of the Income Tax Assessment Act relating to the keeping of business records and of the fact that large contractors would have audited accounts and would, or ought to be, accounting in accordance with Accounting Standard AAS 11. The standard requires generally that the profit to be recognised should be determined each year in proportion to the progress on a contract by the percentage of completion method - subject to the conditions in paragraphs 33 and 34 of AAS 11. Requests for information of the kind sought by the auditors is a legitimate exercise of the powers given by sections 263 and 264. It is in the interest of all concerned that the information be provided without resort to legal action.

Additional Tax : Current Audits

40. Audits or investigations of taxpayers involved in long term construction contracts which have been held over as requested in National Office Memorandum 21 86/2845-9 of 22 August 1986 may now proceed to completion.

41. Care will be needed in determining whether additional tax imposed by section 223 will apply. It must be remembered that, at least since the issue of CM 639, this office has been on record as accepting for income tax purposes methods of accounting which had the effect of allocating, on a reasonable basis, the ultimate profit or loss on a contract over the years taken to complete it. There have not been any guidelines as to what amounts to a reasonable basis. At a minimum, if accepted accounting principles have been applied (apart from the completed contracts basis) the basis is reasonable. In the circumstances there can be no justification for changing the basis upon which taxpayers have disclosed income from long term construction contracts in returns lodged to date because the basis varies from bases acceptable under this Ruling. It follows that adjustments to assessments should not be made in these circumstances and the question of additional tax does not arise. Returns lodged subsequent to the issue of this Ruling should, of course, be in accordance with the principles herein.

42. Where a taxpayer has returned income from a long term construction contract on the basis of notional taxable income and the ultimate taxable income on the contract exceeds to a significant extent the total of the notional taxable income included in assessable income for the years of the contract, a liability to section 223 additional tax may arise. The extent

to which the additional tax is to be remitted should be determined in accordance with IT 2206. However, additional factors that may be taken into account could include windfall gains, extraordinary saving in expenditures during the later period of the contract, litigated or arbitrated claims between contractors and clients, etc..

43. Although this Office does not accept the completed contracts basis as an acceptable method of determining taxable income from long term construction contracts, this Ruling is not to be taken as authority for re-opening assessments issued prior to this Ruling where that basis has been used, the contracts have been completed and total income from the contracts returned. The only justification for reopening such assessments would be to impose additional tax on income allocated to earlier years of the contracts. That is not contemplated by this office. Taxpayers who have used the completed contracts method should be informed that it is not acceptable and that existing contracts are to be dealt with according to this Ruling. Returns using this method and lodged after the date of this Ruling will be liable to adjustment and additional tax.

Small Businesses

44. There are many small businesses associated with the industry, e.g. minor sub-contractors, "spec" home builders, etc., who return income on the basis of receivables, expenditure incurred, work-in-progress and any trading stock on hand. Although some of their jobs or operations may overlap 2 income years there is no necessity to disturb their existing basis of returning income.

COMMISSIONER OF TAXATION
1 October 1987