TR 2023/2 - 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

Status: **legally binding**

Taxation Ruling

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

Relying on this Ruling

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

If this Ruling applies to you, and you correctly rely on it, we will apply the law to you in the way set out in this Ruling. That is, you will not pay any more tax or penalties or interest in respect of the matters covered by this Ruling.

Table of Contents **Paragraph**

What this Ruling is about

1. This Ruling explains when certain labour costs related to constructing or creating capital assets (tangible or intangible) cannot be deducted under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) because of the capital exclusion in paragraph 8-1(2)(a) of the ITAA 1997.

2. All legislative references in this Ruling are to the ITAA 1997, unless otherwise indicated.

Ruling

When this Ruling applies

3. This Ruling applies to you if you incur labour costs that are:

- salary and wages[1] for employees who perform functions in relation to the construction or creation of capital assets, and other costs associated with the employment of that labour[2], or, or both
- other amounts for labour or principally for labour incurred in relation to the construction or creation of capital assets[3]

(together referred to as **capital asset labour costs**).

4. This Ruling concerns the application of paragraph 8-1(2)(a) to capital asset labour costs.

5. This Ruling does not apply to other labour costs and does not consider when capital asset labour costs you incur are:

- made deductible under other provisions (such as costs that are contributions made to a superannuation fund or retirement saving account that are deductible under section 290-60, or the labour costs of employing a tax manager to the extent those costs relate to managing the tax affairs of an entity constructing or creating capital assets and are deductible under section 25-5)
- specifically taken not to be an outgoing that is capital or of a capital nature under other provisions (such as costs incurred in connection with acquiring an item of trading stock under section 70-25), or
- otherwise taken into account in working out an amount of assessable income or allowable deduction (such as costs provided under a Division 230

[1] For the purposes of this Ruling, salary and wages includes items such as bonuses, gratuities, allowances and any other compensation or reward for personal services.
[2] Other costs associated with the employment of labour are amounts that are, in substance, paid because an entity's labour has been provided. This includes losses or outgoings incurred for long service leave, annual leave, sick leave and similar leave, and bonuses and allowances.
[3] For example, contract payments to a person or a labour hire firm for people who, in substance, perform work activities for an entity on the same basis as their employees do.

financial arrangement[4], or otherwise taken into account in working out the amount of a profit or loss that is included in assessable income or allowable as a deduction[5]).

6. For the purposes of this Ruling, capital assets are those assets (tangible and intangible) constructed or created which form part of the profit-yielding structure of a business entity, structure or organisation.[6]

7. Section 8-1 provides for general deductions from your assessable income. However, paragraph 8-1(2)(a) prohibits you from deducting an amount of expenditure under section 8-1 to the extent that your expenditure is capital or of a capital nature.

8. It is acknowledged that labour costs are generally revenue in nature and would form part of a business' working expense. This Ruling, however, addresses a particular category of labour costs – capital asset labour costs – and when they will be considered to be on capital account.

9. To the extent capital asset labour costs are incurred specifically for constructing or creating capital assets, their essential character[7] is considered to be capital or of a capital nature and therefore cannot be deducted in accordance with paragraph 8-1(2)(a).[8] This is not limited to those involved in the construction work itself, but can include the costs of labour for those who perform functions in relation to the construction or creation of capital assets.

10. It is a question of fact and degree whether costs are incurred specifically for constructing or creating a capital asset. Not all capital asset labour costs will be regarded as being specifically incurred for constructing or creating capital assets. The cost of workers or employees whose role has a remote connection with constructing or creating capital assets, or who have a broader role that involves incidental activities connected with constructing or creating capital assets, will generally not be regarded as being incurred specifically for constructing or creating capital assets and therefore will not be capital or of a capital nature.

11. Whether capital asset labour costs are incurred specifically for constructing or creating capital assets is ordinarily to be ascertained at the time the loss or outgoing is incurred, and so:

- costs in relation to an employee may be initially on capital account and later change to be on revenue account (and vice versa), and
- employees may be specifically employed for both constructing or creating capital assets and other duties, in which case apportionment of the losses or outgoings will need to be considered.

12. Apportionment is to be conducted on a fair and reasonable basis.[9]

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[4] This means labour costs you incur that are allowable as deductions to you under Division 230 or are taken into account in working out whether you make a gain that is included in your assessable income or a loss allowable to you as a deduction to you under that Division.

[5] For example, the profit or loss from that is derived from a revenue asset as defined in section 977-50.

[6] The business entity, structure or organisation set up or established for the earning of profit as per *Sun Newspapers Limited v Federal Commissioner of Taxation* [1938] HCA 73, per Dixon J. That is, capital assets that form part of the 'tree' and not the 'fruit' that results from the tree, as referenced in *Shepherd v Commissioner of Taxation (Cth)* [1965] HCA 70 and later in *Commissioner of Taxation v Myer Emporium Ltd* [1987] HCA 18.

[7] *Goodman Fielder Wattie Ltd v Commissioner of Taxation* [1991] FCA 264, per Hill J; *Lunney v Commissioner of Taxation* [1958] HCA 5, per Williams, Kitto and Taylor JJ.

[8] These costs may also not be deductible because of other provisions, such as the other limbs of section 8-1.

[9] *Ronpibon Tin NL v Commissioner of Taxation (Cth)* [1949] HCA 15.

Example 1 – general manager of Head Co salary

13. *Offshore Parent Co is the head of a global enterprise and, a number of years ago, had established Australian Head Co to run its Australian operations through a number of subsidiaries. Australian Head Co is the head company of a consolidated group for income tax purposes. It has recently established a wholly-owned Australian Sub Co for constructing a facility which is a capital asset.*

14. *Australian Head Co has a long-standing general manager. Under the employment contract, the general manager has responsibility for the day-to-day operations of all the Australian operations, as well as developing strategy and plans for future operations. The general manager is not required to time-write their work hours. However, for accounting purposes, a portion of their labour cost is capitalised as part of overhead allocations. During the construction of the facility by Australian Sub Co, the general manager spends approximately one day a week discussing aspects of the construction project with other managers and contractors involved, and preparing reports on the progress of the construction project for Offshore Parent Co.*

15. *The salary of the general manager of Australian Head Co will be immediately deductible under section 8-1 as they are not considered to be specifically employed for the construction or creation of a capital asset. Rather, they are specifically employed in the ordinary recurrent working operations of the business. There is nothing in the circumstances of their employment, including their roles, responsibilities, time recording or the accounting treatment that changes the essential character from being an ordinary working expense. The fact that some of their time is spent on activities related to the construction of the facility is an ordinary incident of the general manager role and does not change the essential character of, or call for apportionment of, their salary.*

16. *A similar outcome would arise for support functions, such as human resources or legal staff who are employed in the ongoing business of the Australian operations but devote an infrequent or incidental amount of their time to supporting the construction project.*

Example 2 – centralised project management team salary

17. *Following on from Example 1 of this Ruling, a centralised project management and procurement team (that includes a project general manager, project human resources manager and project finance manager) is established in Australian Sub Co. The team is specifically employed to manage the project and recruit personnel for the construction of the facility. They periodically report to the general manager on the performance of Australian Sub Co during the construction of the facility. During this period, the team's labour costs are capitalised in accordance with Australian Sub Co's accounting policies. Once the facility is installed and ready for use, some members of the team are retained to manage and work in the Australian Sub Co business that utilises that facility.*

18. *For the period when the centralised project management and procurement function team are specifically employed for constructing the new facility, the essential character of their salary is wholly capital or capital in nature and their salary will not be deductible due to the application of paragraph 8-1(2)(a). In this example, the accounting treatment is not a determinative factor when considering all the facts and circumstances relevant to making a determination.*

19. *Once the facility is installed and ready for use, the retained employees are then specifically employed in the recurrent ordinary business operations. The essential*

character of their salary will then be an ordinary working expense on revenue account and deductible under section 8-1.

Example 3 – contract labour costs

20. *Following on from Examples 1 and 2 of this Ruling, Australian Sub Co enters into a contract with a third-party labour hire firm for the provision of additional labour to assist Australian Sub Co staff to construct the facility. Once the facility is installed and ready for use, Australian Sub Co contracts with the third-party labour hire firm for the ongoing maintenance of the facility. Some of the same staff of the third-party labour hire firm stays on to undertake that maintenance.*

21. *The salary costs incurred by Australian Sub Co for the contractor costs for the additional labour hire workers are not deductible (due to the application of paragraph 8-1(2)(a)) because those workers are specifically engaged in the construction or creation of the facility. They have the essential character of being wholly capital or capital in nature.*

22. *The essential character of the contractor costs changes when the facility is installed and ready for use. Once the facility is installed and ready for use, the contractor costs are no longer specifically incurred to construct or create the facility, but rather they are for the staff to perform activities in the ordinary ongoing operations of the business, and the outgoings are therefore ordinary working expenses deductible under section 8-1.*

Example 4 – apportionment of labour costs

23. *Following on from Examples 1, 2 and 3 of this Ruling, Australian Head Co has another wholly-owned subsidiary called Australian Operations Co, which employs a team of electricians specifically to undertake maintenance and construct capital assets that will be owned by members of Australian Head Co's consolidated group. The salary costs of the electricians incurred by the tax consolidated group have the essential character of being in part capital or capital in nature, and to that extent are not deductible due to the application of paragraph 8-1(2)(a).*

24. *The electricians account for their time by completing time sheets on a daily basis. Those time sheets identify the subject entity, the type of activity (maintenance, repair or capital works) and the time spent on the activity. Records show approximately 50% of time is spent on maintenance and repair and the other 50% on capital works.*

25. *For group accounting purposes, salary costs of the electricians are expensed or capitalised in accordance with time sheets.*

26. *For income tax purposes the salary costs are to be apportioned on a fair and reasonable basis. Since the employees account for their time in a manner consistent with the specific purposes for which they are employed and which is also adopted for accounting purposes, it represents a fair and reasonable basis for apportionment for income tax purposes.*

Example 5 – apportionment of labour costs to the project

27. *Outback Gas Co is an Australian company which carries on a business of exploration, evaluation, development and production of petroleum resources in Australia. Outback Gas Co and its co-venturers approve the final investment decision for the New Frontier LNG Project (Project), which will involve the recovery of natural gas from the*

offshore New Frontier gas field to produce liquefied natural gas (LNG) for export to Asian markets. [10]

28. *The Project is expected to cost $30 billion and will produce sufficient gas for 2 LNG trains for 30 years, with potential for adding up to 2 additional trains if more resources are found.*

29. *Outback Gas Co refers to the construction stage of the Project as the 'execute' phase. Following completion of the construction stage of the Project, Outback Gas Co will redeploy its workforce into day-to-day, business-as-usual operations. Outback Gas Co refers to this post-construction stage as the 'operate' phase.*

30. *Outback Gas Co establishes the following teams, comprising its own employees and third-party contractors, to perform various functions:*

- *Upstream team – to deliver the tangible assets for the upstream sector of the Project, including the design, development and construction of a sub-surface production facility, offshore platform and processing facility and a gas pipeline.*
- *Downstream team – to deliver the tangible assets for the downstream sector of the Project, including onshore processing and conditioning plant, liquefaction facilities, LNG storage tanks and port facilities. This team is also responsible for maintaining and preserving handed-over assets, and for conducting operations readiness activities.*
- *Supporting team – to provide business functions to support the Upstream and Downstream teams to develop the Project. These activities include technical, commercial, finance, health and safety, legal, environmental, information technology, human resources, and management and administration services.*

31. *The combined costs associated with the Upstream, Downstream and Supporting teams are charged to specific project activity codes via a work breakdown structure, via cost centre allocations or through time-writing. Further, the combined costs are documented through a combination of project governance documents, charter of responsibilities, job descriptions, written reports and notes, emails, calendar and diary entries and time sheets, and this flows through into how expenditure is allocated for the purposes of the Australian Accounting Standards.*

32. *An analysis is undertaken of the combined costs and the activities performed by each team that allows Outback Gas Co to determine the teams or activities that relate to the delivery of the tangible assets of the Project (which are capital or capital in nature). As a number of staff members were specifically employed or engaged to wholly or partly perform functions in relation to the delivery of the tangible assets of the Project, Outback Gas Co determines that the essential character of their costs is at least partly capital in nature. As such an appropriate apportionment methodology is required that is fair and reasonable.*

33. *For staff members who conduct activities considered to be both capital and revenue in nature, Outback Gas Co conducts an analysis of the employee time-writing reports and other documentation in line with their business practices and how their*

[10] The principles applied in this example can be applied whenever staff are assigned to a specific project for the creation or construction of a capital asset, including an intangible asset. An example of this would include the development of software in which teams of (new or existing) employees and third-party contractors are specifically engaged to perform functions (wholly or partly) in relation to the creation of the intangible asset. See Taxation Ruling TR 2016/3 *Income tax: deductibility of expenditure on a commercial website* for further guidance on the deductibility of expenditure (including labour costs) on software more generally.

accounting systems function. This allows Outback Gas Co to determine on a fair and reasonable basis which proportion of the combined costs are capital or capital in nature.

34. *It would be fair and reasonable to determine the extent that the combined costs are capital or capital in nature by apportionment using the best information available to Outback Gas Co via its existing accounting or operational systems including work breakdown structure, time-writing, cost centre allocations, project governance documents, charter of responsibilities, job descriptions, written reports and notes, emails, calendar and diary entries and time sheets.*

Example 6 – project delays

35. *Diverse Mining Company (DMC) explores, develops and operates many mines throughout Australia, including the Really Big Mine. The management of DMC has approved the final investment decision to extend the Really Big Mine to recover the remaining proven reserves. DMC establishes a project management team within its mining division to construct and project manage the mine extension. The team includes engineering, operational mining and project management staff seconded from DMC's existing operations.*

36. *An industrial dispute results in a delay in the construction of the extension to the Really Big Mine. During this period, some of the secondees are redeployed to other operational mines while others remain on standby waiting for construction to commence. Project team labour costs cease to be capitalised for accounting purposes during this period.*

37. *Employees who are redeployed to operational mines are no longer considered to be specifically employed for the construction or creation of a capital asset (that is, the mine extension). During this time, these employees will be specifically employed in the recurrent operations of the business and their labour costs will be deductible under section 8-1.*

38. *Employees who remain on standby have had no change in their employment arrangements and while they may not be working on the construction or creation of a capital asset, they remain employed specifically for the construction or creation of a capital asset. Their labour costs have the essential character of being capital or capital in nature.*

Example 7 – infrequent and incidental duties

39. *Window Maker Company manufactures windows, employing 20 staff. One of the employees, the general manager, is also the company director and business owner. Due to the growth of the business, the manufacturing premises needs to be extended substantially. An outside contractor is hired to construct the extension to the existing structure.*

40. *To manage its costs, Window Maker Company undertakes the fit-out of the premises, using 3 of its staff full-time on the build for a period of 6 months. A fourth employee is, in addition to their other operational duties associated with the manufacturing of windows, appointed to look after the progress made by the 3 employees and is required to report back to the general manager. The fourth employee spends their time infrequently*[11] *in managing the 3 employees on the construction and most of their time overall is spent on looking after the manufacturing of windows, et cetera. There are no contemporaneous written records (that is, time sheets) of how this person allocates their time on their various duties, but they regularly advise the general manager verbally of their*

[11] This might also include activities that are sporadic, minor and incidental.

time allocation. Having regard to all the facts and circumstances (including statements obtained from the fourth employee and the general manager), the Window Maker Company determines that the time allocated by the fourth employee to overseeing construction activities is incidental compared to their normal duties.

41. *As the 3 employees on the construction are specifically engaged during this period to perform functions in relation to the delivery of tangible assets (the fit-out), the essential character of their labour costs for this period are capital or capital in nature. The labour costs of the fourth employee will be immediately deductible under section 8-1 as they are not specifically employed in the construction of capital assets and there is nothing in the facts and circumstances that changes the essential character from being an ordinary working expense.*

Date of effect

42. This Ruling applies to years of income commencing both before and after its date of issue. However, this 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 this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation
7 June 2023

Appendix 1 – Explanation

This Explanation is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

Principles of capital and revenue relevant to costs of labour

43. Paragraph 8-1(2)(a) prevents costs being deductible to the extent they are capital or capital in nature. In determining the deductibility under this paragraph, consideration must be given to the whole set of circumstances and the commercial context within which the expenditure is made.[12]

44. Determining the extent to which any type of expenditure is capital or capital in nature should not be done with reference to isolated quotes from decisions about particular types of expenditure in a given fact scenario that might be argued to support a particular proposition. Rather, in the words of French CJ, Kiefel and Bell JJ in *AusNet Transmission Group Pty Ltd v Federal Commissioner of Taxation* [2015] HCA 25 (*AusNet*) at [14], '[t]he evaluative judgment required to distinguish between expenditure on capital or revenue account is made under the guidance of approaches developed in decisions of this Court over many years'.

45. In other words, it is the totality of the decisions made by Courts over many years that must be used as guidance in order to determine whether capital asset labour costs are capital or capital in nature for income tax purposes. In undertaking this exercise, individual cases that may support one proposition or another might be relevant but are not determinative.

46. The generally-recognised starting point for considering whether expenditure is on capital or revenue account is the judgment of Dixon J in *Sun Newspapers Limited v Federal Commissioner of Taxation* [1938] HCA 73 (*Sun Newspapers*). Dixon J outlined the following 3 matters to be considered:

> … (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.

Character of the advantage sought

47. While each of Dixon J's criteria need to be considered, depending on the circumstances, not all of them will be of equal weight. The following passage from the High Court of Australia in *GP International Pipecoaters Pty Ltd v Commissioner of Taxation (Cth)* [1990] HCA 25 (*GP Pipecoaters*) makes this clear and was later cited in *AusNet* at [23]:

> The character of expenditure is ordinarily determined by reference to the nature of the asset acquired or the liability discharged by the making of the expenditure, for the character of the advantage sought by the making of the expenditure is the chief, if not the critical, factor in determining the character of what is paid …

48. Consistent with paragraph 9 of this Ruling, where capital asset labour costs are incurred specifically for constructing or creating a capital asset, the character of the costs

[12] *BP Australia Ltd v Commissioner of Taxation (Cth)* [1964] HCA 81; *AusNet Transmission Group Pty Ltd v Federal Commissioner of Taxation* [2015] HCA 25 at [74].

is to be ordinarily determined by reference to the nature of the asset acquired by the making of the expenditure on the labour and by the fact that the labour is specifically employed or contracted to construct or create that asset. This is because the character of the advantage sought by incurring the costs is the chief, if not critical, factor in determining their character.

49. The reference in *GP Pipecoaters* to an asset being acquired by the making of the expenditure is, in the case of capital asset labour costs, a reference to the capital asset that is being created or acquired.

50. Therefore, capital asset labour costs are a loss or outgoing of capital, or of a capital nature when they are incurred specifically for creating or constructing a capital asset.

51. This conclusion flows from the need to identify the character of the advantage sought with reference to what the expenditure actually achieves or is intended to achieve. This approach is consistent with Dixon J's approach in *Sun Newspapers*:

> The result or purpose of the expenditure may be to bring into existence or procure some asset or advantage of a lasting character which will enure for the benefit of the organization or system or "profit-earning subject". It will thus be distinguished from the expenditure which should be recouped by circulating capital or by working capital.

52. Windeyer J made similar observations in *BP Australia Ltd v Commissioner of Taxation (Cth)* [1964] HCA 81 (*BP Australia*):

> The character of a questioned item of expenditure must, I think, depend primarily upon its purpose. Regard ought therefore to be had to what it was sought to acquire and to the relation of that to the taxpayer's undertaking or business. These, rather than the form of the transaction or the mechanics of the acquisition, are what appear to me to be deciding factors. In other words, it was what the particular taxpayer got for his money, rather than how he got it, that is important. What he got may be contractual or proprietary rights, or some intangible advantage such as immunity from competition that can more readily be described than classified. Whatever it was, its acquisition must be considered in relation to the circumstances of the particular taxpayer's business.

53. More recently, the High Court in *Commissioner of Taxation v Sharpcan Pty Ltd* [2019] HCA 36 (*Sharpcan*) approached the task of ascertaining the essential character by reference not only to the purpose of the outgoing but also by reference to a 'counterfactual' or 'but for' test at [33]:

> … the determination of whether an outgoing is incurred on capital account or revenue account depends on the nature and purpose of the outgoing: specifically, whether the outgoing is calculated to effect the acquisition of an enduring advantage to the business. And the identification of what (if anything) is to be acquired by an outgoing ultimately requires a counterfactual, not an historical, analysis: specifically, a comparison of the expected structure of the business after the outgoing with the expected structure *but for* the outgoing, not with the structure *before* the outgoing.

54. Drawing conclusions about essential characterisation by reference to the observation that capital asset labour costs secure a recurrent service like any other provision of labour is a narrow view that results in a mischaracterisation. It is inconsistent with this passage from the decision of Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* [1946] HCA 34 (*Hallstroms*):

> … [the capital/revenue distinction depends on] what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.

55. In the more recent case of *Commissioner of Taxation v Star City Pty Limited* [2009] FCAFC 19, Jessup J at [263] made observations similar to those made by Dixon J in *Hallstroms* in relation to salary and wages in particular:

> Likewise, while wages are ordinarily a revenue expense, wages paid to employees engaged wholly upon the installation of new capital equipment should not be so regarded. Merely to look at the legal rights and obligations which existed as between the payer and the payee (ie the employer and the employee) would be of no assistance in the task of characterisation.

56. The mere fact that in a number of situations the costs incurred for labour are on revenue account does not change the conclusion that they may be, in other situations, on capital account. As the High Court of Australia stated in *AusNet* at [19] (footnotes omitted):

> The proposition is well established that expenditure of a kind ordinarily treated as being on revenue account in one set of circumstances may be treated as on capital account in another set of circumstances. An example is found in the decision of the Scottish Court of Session in *Law Shipping Co v Inland Revenue*. The expenditure of substantial sums on repairs to a ship which had been necessary at the time of its purchase was treated as capital. The need for repairs meant that the ship when purchased was a less valuable asset than if it had been in repair. Absent the need for repairs, the sellers could have demanded a higher price.

57. Consistent with this passage from Starke J in *Hallstroms*, the principles in paragraphs 7 to 12 of this Ruling are applicable for both tangible assets and intangible assets:

> The asset or advantage need not have a tangible existence: thus the acquisition of the goodwill of a business or of restrictive covenants not to compete in business and the promotion of Parliamentary bills and so forth may all involve expenditure of capital or of a capital nature …

58. While *Goodman Fielder Wattie Ltd v Commissioner of Taxation* [1991] FCA 264 (*Goodman Fielder*) is not authority for a proposition that wages and salary can be on capital account, the following passage from Hill J's judgment in that case is relevant for the purposes of the evaluative judgment that the decision in *AusNet* requires to be undertaken:

> Where a person is employed for the specific purpose of carrying out an affair of capital, the mere fact that that person is remunerated by a form of periodical outgoing would not make the salary or wages on revenue account. On the other hand, where an employee is employed and engaged in activities which are part of the recurring business of a company, the fact that he may, on a particular day, be engaged in an activity which viewed alone would be of a capital kind, does not operate to convert the periodical outgoing for salary and wages into an outgoing of a capital nature.

59. If it were not possible that capital asset labour costs could be on capital account (which is the alternative view that has been put to the Commissioner), Hill J's statements would be otiose.

When capital asset labour costs are likely to be on capital account

60. Not all capital asset labour costs will be considered capital or capital in nature. However, where labour is specifically employed or contracted for the construction or creation of a capital asset, it will be on capital account. This is to be distinguished from where employees are employed in the day-to-day and ongoing operations of a business and they engage in activities that are capital in nature (such that their labour costs could be categorised as capital asset labour costs for the purposes of this Ruling) but they engage in those activities infrequently or those activities are considered minor or incidental in the context of their overall activities, duties and functions. The essential character of the

capital asset labour costs of those employees is wholly revenue in nature and apportionment will not be relevant.[13]

61. The employment or other contractual arrangements and/or an understanding of the functions undertaken by the employees or contractors will generally demonstrate whether or not persons are specifically employed or engaged for constructing or creating a capital asset. Other circumstances that will assist in ascertaining this include:

- the nature and scope of the business
- the corporate structure used to organise, plan, manage and undertake capital activities or activities related to capital assets
- how the business plans and executes those activities
- the business practices concerning the use of internal labour and external contractors for those activities
- the terms of employment, job descriptions, key performance indicators of staff, the pattern of deployment and working profile and practices of internal labour in those activities, and
- the accounting, control and governance systems you use to record the costs and resources used in those activities.

62. The functions undertaken by the employee or contractor may be directly related to the construction or creation of the capital asset in the sense that the employee or contractor physically constructs or creates the asset. Equally those functions may support the direct functions (such as the project and human resource managers) or support the functions that are a necessary component of the construction or creation activity (such as the project finance manager, project legal counsel, and project materials procurement manager).

63. Whether or not a person is undertaking a function that is for the construction or creation of the asset will be a matter of fact and degree. Some activities are too remote to be considered necessary, essential or sufficiently connected to the construction or creation of a capital asset. For example, a security guard who is responsible for the security of a project site where capital assets are being created or constructed would be regarded as too remote from the activity creating the capital assets. This is because the security guard is engaged to protect the project site and the capital assets and that engagement is not considered to be necessary, essential or sufficiently connected to the construction or creation of the capital assets. Conversely, a human resources manager specifically engaged by an entity for the sole purpose of recruiting and managing workers that will be constructing a capital asset for the entity would be regarded as necessary, essential or sufficiently connected to the construction of the capital asset.

64. Whether a person is specifically employed in respect of the construction or creation of a capital asset will be determined at the time a relevant expense is incurred. Hence an employee cost or contracted labour cost can initially be on capital account and later be on revenue account when the employment or contracting changes (and vice versa).

When capital asset labour costs are likely to be on revenue account

65. On the other hand, the essential character of a cost may be revenue in nature, notwithstanding some part or amount of the cost is a capital asset labour cost (that is, the

[13] *Goodman Fielder*; *Associated Minerals Consolidated Ltd v The Commissioner of Taxation of the Commonwealth of Australia* [1994] FCA 28.

cost can be attributed to the relevant employee or worker performing some function in relation to constructing or creating a capital asset). This is more likely to be the case when the employee or contractor is employed specifically for undertaking functions and activities directed to the ordinary recurrent operations of the business, albeit a minor and incidental part of their time is spent on the construction or creation of a capital asset or they only spend time on such activities infrequently.

66. This means, for example, that an employee may spend time on the construction or creation of a capital asset (including an activity supporting that construction or creation), but the essential character of costs in relation to all of their time is considered an ordinary working expense. It is a question of fact and degree, but where the person is specifically employed in the recurrent business operations of the entity and any activity or function performed in relation to the creation or construction of capital assets of the entity is incidental or minor, the essential character of any capital asset labour costs are likely to be revenue in nature. The question of whether an activity or function in relation to the creation or construction of a capital asset is incidental or minor or infrequent is a relative assessment based on the overall activities or functions of the employee or worker concerned. For example, costs in respect of the following employees would be regarded as on revenue account even though an infrequent, minor or incidental amount of their time is devoted to the construction or creation of capital assets:

- a human resource manager responsible for all of the employees or personnel of an established and ongoing business, including employees or personnel constructing or creating a capital asset
- a finance manager responsible for all of the ongoing financial aspects of an established and ongoing business, including the finance aspects of constructing or creating a capital asset
- a general manager responsible for overseeing the ongoing operations of an established and ongoing business, and who spends some time overseeing the construction or creation of a capital asset, and
- a general counsel responsible for all general legal affairs of an established and ongoing business, including the legal aspects of constructing or creating a capital asset.

The manner in which it is to be used

67. In *Sun Newspapers*, Dixon J stated that the recurrence of expenditure ‘may play its part’ in determining both the character of the advantage sought, as well as the manner in which it is to be used, relied upon or enjoyed. Capital asset labour costs, as defined in this Ruling, will generally qualify as recurrent expenditure.

68. That said, while recurrence of expenditure ‘plays its part’ in the analysis, it is not determinative of the question as to whether that expenditure is of capital, or of a capital nature. This was made clear by Taylor J in *BP Australia* (references omitted):

> Emphasis was, of course, laid upon what was called the “recurring” nature of the expenditure but as was said in Sun Newspapers Ltd. and Associated Newspapers Ltd. v. Federal Commissioner of Taxation “Recurrence is not a test, it is no more than a consideration the weight of which depends upon the nature of the expenditure” (per *Dixon J.*, as he then was…

69. In considering this factor, it is important to bear in mind the driving force behind costs incurred for labour being paid periodically (fortnightly, etcetera). They are paid in this way because it is this form of payment that the entity providing the labour typically

demands, as well as what the employer is willing to provide and what the labour law[14] usually requires. As observed in *Sharpcan*[15], this is not to say it is not a 'once and for all' payment to secure a structural advantage. It does not change the character of the advantage sought. Rather, it highlights an exception to the ordinary case; an example of expenditure incurred recurrently that may nonetheless be made in order to secure an advantage that is of an enduring capital nature. It is for similar reasons that the payment for a capital asset in instalments does not put those payments on revenue account.[16]

Means adopted to obtain it

70. The final factor mentioned by Dixon J in *Sun Newspapers* is the means adopted to obtain it – that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.

71. In the case of capital asset labour costs as defined in this Ruling, the payments made are not merely to cover the use or enjoyment for the asset over a period commensurate with the payment. Rather, they are 'one-off' payments made to construct or create the asset and to secure the future use or enjoyment of that asset.

Apportionment

72. Section 8-1 prevents a deduction for an amount to the extent that it is capital or capital in nature. If the essential character of a loss or outgoing can be said to be in part on capital account, then the words 'to the extent that' require apportionment on a fair and reasonable basis.[17]

73. As noted by the Full Court of the High Court of Australia in *Ronpibon Tin NL v Commissioner of Taxation (Cth)* [1949] HCA 15 (*Ronpibon*):

> … [the general deduction provision] contemplates apportionment. The question what expenditure is incurred in gaining or producing income is reduced to a question of fact … One kind [of expenditure in this case] consists [of] undivided items of expenditure in respect of things or services of which distinct and severable parts are devoted to gaining or producing assessable income and distinct and severable parts to some other cause. In such cases it may be possible to divide the expenditure in accordance with the applications which have been made of the things or services.

74. The extract in paragraph 73 of this Ruling supports the view that section 8-1 contemplates apportionment and where expenditure is in respect of services (such as labour services) of which distinct or several parts are devoted, that may provide a basis for apportionment.

75. A view put to the Commissioner is that the following observation by Hill J in *Goodman Fielder* is authority for the proposition that salary and wages cannot be apportioned by reference to the number of hours an employee is engaged in a particular activity[18]:

> In between, there will be cases where it may be difficult to determine whether the expenditure should properly be regarded as on capital account or as on revenue account.

[14] Refer to section 323 of the *Fair Work Act 2009.*
[15] *Sharpcan* at [18].
[16] This was also supported in *Sharpcan* at [18].
[17] *Ronpibon Tin NL v Commissioner of Taxation (Cth)* [1949] HCA 15.
[18] See also *Associated Minerals Consolidated Ltd v The Commissioner of Taxation of the Commonwealth of Australia* [1994] FCA 28, per Lee J.

> Each case will depend upon its facts but the answer will not be derived merely by counting the number of hours in which the employee is engaged in activities which themselves may be said to involve matters of capital.

76. However, it is considered that Hill J's observation was made in the context of how to determine the essential character of labour costs and is not authority for what apportionment method would be considered fair and reasonable once it is determined that expenditure on labour is, to some extent (but not wholly) capital in nature. Nor is Hill J's observation authority for the proposition that labour costs are not, in any circumstances, apportionable.

77. Nonetheless, the Commissioner accepts that counting the number of hours an employee is engaged in activities may not always be a fair and reasonable method of apportionment. For example, this may be the case where a business does not require employees to record their time or does not otherwise account for labour costs on a time basis. However, in circumstances where a business maintains records of the time spent by employees on particular activities (some of which are of a capital nature), such records may provide a fair and reasonable basis for apportionment. A fair and reasonable basis requires all relevant circumstances to be considered, including what information is practically available.

78. For example, an analysis of an employee's job description or functions and expectations or historical knowledge about the proportion of time that the employee will devote to capital activities may provide a fair and reasonable basis for apportionment in the absence of information about the actual time spent by the employee on those activities. Other examples of records and information that may assist in apportioning labour costs include:

- emails
- calendar or diary entries, and
- any other written report, budget or planning document that includes a description and nature of activities undertaken by the employee.

79. However, it is not considered that a notional basis for apportioning labour costs is a reasonable basis, unless there is evidence to support that it is appropriate in the circumstances.

Relevance of accounting treatment

80. The accounting treatment is not a determinative factor of the character of expenditure incurred for income tax purposes. However, there is substantial case law indicating that the way the expenditure is classified and treated for accounting purposes and how the accounting systems record expenditure may be a useful indicator of the facts and circumstances surrounding the expenditure and can therefore assist in ascertaining its true nature when completing the full and complete assessment of all the relevant facts and circumstances.[19] Accounting treatment may also be a useful indication of a reasonable basis for apportionment of expenditure.

[19] See, for example, *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes* [1985] PNGLR 129; *RACV Insurance Pty Ltd v Commissioner of Taxation* [1975] VR 1; *Commercial Union Assurance Company of Australia Limited v Commissioner of Taxation* [1977] VicSC 202; *Commissioner of Taxation (Cth) v James Flood Pty Ltd* [1953] HCA 65.

81. There are 2 accounting standards that are relevant in this regard:

- Australian Accounting Standard AASB 116 *Property, Plant and Equipment* includes in the cost of an item of property, plant and equipment those costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.[20] The accounting standard includes (as an example of directly attributable costs) the costs of employee benefits arising directly from the construction of the item of property, plant and equipment.
- Australian Accounting Standard AASB 138 *Intangible Assets* includes in the cost of internally generated intangible assets all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in the manner intended by management. This standard also includes as an example of directly attributable costs, the costs of employee benefits arising from the generation of the intangible asset.[21]

82. The treatment of labour costs under these standards is one of the many relevant factors that need to be considered when conducting a complete analysis of all the facts and circumstances relevant to determination of whether these costs are not deductible under paragraph 8-1(2)(a).[22]

83. Given the proximity of how expenditure factually satisfies the accounting test of embodying future economic benefits and the matching of the expenditure to that character (that is, the cost base of the asset in accordance with AASB 116), and the treatment of that expenditure having a sufficient, material and discernibly rational link to an enduring benefit or to the profit-yielding structure, the Commissioner considers that there will be at times instances where the accounting treatment of capital asset labour costs is a relevant factual consideration when ascertaining the character of the expenditure.

84. In some cases, the accounting treatment of expenditure, which is partly, but not wholly, on capital account will provide a fair and reasonable basis for apportionment. However, the accounting treatment may not be the only fair and reasonable basis.

Tangible and intangible capital assets covered by this Ruling

85. For the avoidance of doubt, the reference to capital assets in this Ruling covers tangible as well as intangible capital assets (for example, labour costs that are directed to the construction of manufacturing plant as well as the creation of an operating procedures manual for that plant).

[20] Paragraph 16 of AASB 116.
[21] Paragraph 66 of AASB 138.
[22] *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes* [1985] PNGLR 129; *RACV Insurance Pty Ltd v Commissioner of Taxation* [1975] VR 1; *Commercial Union Assurance Company of Australia Limited v Commissioner of Taxation* [1977] VicSC 202.

Appendix 2 – Alternative view

This Appendix sets out an alternative view and explains why it is not supported by the Commissioner. It does not form part of the binding public ruling.

86. It has been put to the Commissioner that the costs of labour can never be an outgoing of capital or of a capital nature. This alternative view is inconsistent with income tax law and relevant cases decided on income tax law. This Appendix explains why this is the case.

Steele is authority for the deductibility of all costs of labour costs

87. The Commissioner is aware of an alternative view that labour costs covered by this Ruling will not be prevented from being deductible under paragraph 8-1(2)(a) because of the reasoning contained in *Steele v Deputy Commissioner of Taxation* [1999] HCA 7 (*Steele*). In that case, the High Court decided that the fact that borrowed funds may be used to purchase a capital asset does not of itself mean the interest outgoings are therefore on capital account (see *Steele* at [29–30]).

88. The alternative view is based on the following passage from *Steele* at [29] (footnotes omitted):

> … interest is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but, rather, the use of the borrowed money during the term of the loan. According to the criteria noted by Dixon J in *Sun Newspapers Ltd v Federal Commissioner of Taxation* it is therefore ordinarily a revenue item. This is not to deny the possibility that there may be particular circumstances where it is proper to regard the purpose of interest payments as something other than the raising or maintenance of the borrowing and thus, potentially, of a capital nature. However, in the usual case, of which the present is an example, where interest is a recurrent payment to secure the use for a limited term of loan funds, then it is proper to regard the interest as a revenue item, and its character is not altered by reason of the fact that the borrowed funds are used to purchase a capital asset.

89. It has been put to the Commissioner that labour costs can be analogised to interest expenses on the basis that the former amounts are incurred not for an enduring advantage, but rather for the use of the labour during the relevant period. As such, labour costs should be regarded as a revenue item and its character not altered by reason of the fact that the labour itself is being used to create a capital asset.

90. The Commissioner does not agree that labour costs are directly analogous to that effect. The Commissioner has previously made this point in paragraph 26 of Taxation Ruling TR 2004/4 *Income tax: deductions for interest incurred prior to the commencement of, or following the cessation of, relevant income earning activities* (referring to *Steele* – footnotes omitted):

> Even though generally interest cannot be capital (see paragraph 8), the proposition does not extend to other types of recurrent expenditure. For example, if Mrs Steele had reached the stage of actual motel construction, weekly payments to bricklayers would be capital, even though the recurrent interest expenditure in respect of the loan funds used to buy the land would not be so.

91. In disagreeing with this alternative view, the following observations are germane:

- *Steele* concerned interest expenses only and Gleeson CJ, Gaudron and Gummow JJ in the majority did not seek to analogise interest to salary and wages. Kirby J in dissent was the only member of the Court to mention wages where it was observed that '[w]ages may certainly be "of a capital nature" although liability to pay them is typically, if not invariably, recurrent.'[23]

- In any event, the passage from *AusNet* quoted in paragraph 44 of this Ruling is authority for the proposition that the totality of guidance from the Courts should be taken into account in forming a judgment as to whether a particular cost is capital, or of a capital nature, and is not to be substituted with mere reasoning by analogy.
- The conclusions drawn in *Steele* are therefore to be seen in that light; an application of the general principles discerned from case authority to distinguish capital from revenue outgoings in respect of the interest incurred by Mrs Steele. In the Commissioner's opinion, that same exercise, when applied to a different kind of outgoing (namely, the cost of labour) leads to a different conclusion. This inevitably also leads to the conclusion that interest and labour costs are not relevantly analogous.
- In *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes* [1985] PNGLR 129, an interest deductibility case whose conclusion the majority in *Steele* agreed with, the Court drew the same conclusion (emphasis added):

  > The interest paid was a payment made for the use of money borrowed to build the hotel, or money paid to service the loans used to build the hotel which is, of course, a capital asset. That is not saying that the interest paid is money paid out to build the hotel. **The interest paid is different in kind from money paid, for example, to the builder to build the hotel – which payment is essential to the erection of the capital asset. Unless the builder is paid he will not build the capital asset. On the other hand, the payment of interest is not, of itself, essential to the creation of the asset because if the company had sufficient funds it could build the hotel without borrowing.** I note too that the payment of interest does not enhance the value of the asset. The hotel, when erected, was worth $6,000,000 (or whatever); it was worth no more because it was built with borrowed funds.

- The principle that can be discerned from *Steele* is that interest is generally not capital, or of a capital nature, because it secures, not an enduring advantage, but rather the use of the borrowed money during the term of the loan. Capital asset labour costs for employees or contractors specifically engaged to construct or create a capital asset, on the other hand, do secure an enduring advantage – being the construction of creation of the capital asset.

[23] *Steele* at [76].

Status: **not legally binding**

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Previous draft:

TR 2019/D6

Related Rulings/Determinations:

TR 2004/4; TR 2006/10; TR 2016/3

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Other references:

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