



TR 2019/D6 - Income tax: application of paragraph 8-1(2)(a) of the Income Tax Assessment Act 1997 to labour costs related to the construction or creation of capital assets

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This document has been finalised by TR 2023/2.

 There is a Compendium for this document: **TR 2023/2EC** .



Draft 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

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❗ Relying on this draft Ruling

This publication is a draft for public comment. It represents the Commissioner's preliminary view on how a relevant provision could apply.

If this draft Ruling applies to you and you rely on it reasonably and in good faith, you will not have to pay any interest or penalties in respect of the matters covered, if this draft Ruling turns out to be incorrect and you underpay your tax as a result. However, you may still have to pay the correct amount of tax.

Summary – what this draft Ruling is about

1. This draft Ruling¹ 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*² because of the capital exclusion in paragraph 8-1(2)(a).

Ruling

Who is covered by this Ruling

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

- salary and wages³ for employees who perform functions in relation to the construction or creation of capital assets, and other costs associated with the employment of that labour⁴, and/or

¹ All further references to 'this Ruling' refer to the Ruling as it will read when finalised. Note that this Ruling will not take effect until finalised.

² All legislative references in this Ruling are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

³ Salary and wages, for the purposes of this Ruling, includes items such as bonuses, gratuities, allowances and any other compensation or reward for personal services.

⁴ 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

- other amounts for labour or principally for labour incurred in relation to the construction or creation of capital assets⁵

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

3. This Ruling does not apply to you to the extent that 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 financial arrangement⁶, 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 deduction⁷).

4. 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.⁸

or outgoings incurred for long service leave, annual leave, sick leave, and similar leave, and bonuses and allowances.

⁵ 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.

⁶ 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.

⁷ For example, the profit or loss from that is derived from a revenue asset as defined in section 977-50.

⁸ 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 (*Sun Newspapers*) 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.

Treatment of capital asset labour costs under section 8-1

5. 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.

6. To the extent capital asset labour costs are incurred specifically for constructing or creating capital assets their essential character⁹ is considered to be capital or of a capital nature and therefore cannot be deducted in accordance with paragraph 8-1(2)(a).¹⁰ 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.

7. 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.

8. 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 is called for.

9. Apportionment is to be conducted on a fair and reasonable basis.¹¹

Example 1 – general manager of Head Co salary

10. *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*

⁹ *Goodman Fielder Wattie Ltd v Commissioner of Taxation* [1991] FCA 264 (*Goodman Fielder*) per Hill J; *Lunney v Commissioner of Taxation* [1958] HCA 5 per Williams, Kitto, Taylor JJ.

¹⁰ These costs may also not be deductible because of other provisions, such as the other limbs of section 8-1.

¹¹ *Ronpibon Tin NL v Commissioner of Taxation (Cth)* [1949] HCA 15.

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.

11. *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. 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.*

12. *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 and time recording 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.*

Example 2 – centralised project management team salary

13. *Following on from Example 1, 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 are 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. 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.*

14. *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).*

15. *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

16. Following on from Examples 1 and 2, 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 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.

17. The salary costs incurred by Australian Sub Co for its existing employees and the contract costs for the additional labour hire workers are not deductible (due to the application of paragraph 8-1(2)(a)) because those employees and 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.

18. 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

19. Following on from Examples 1, 2 and 3, Australian Head Co has another wholly owned subsidiary called Australian Operations Co. Australian Operations Co 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.

20. 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.

21. For group accounting purposes, salary costs of the electricians is expensed or capitalised in accordance with time sheets.

22. 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). The salary costs are to be apportioned on a rational basis. Since the employees account for their time in a manner consistent with the income tax capital/revenue distinction and which is also adopted for accounting purposes, it represents a reasonable basis for apportionment for income tax purposes absent any other contrary indicator.

Example 5 – apportionment of labour costs (LNG Project)

23. 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.

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

25. Outback Gas Co refers to the construction stage of the Project as the 'execute' phase. Following completion of the construction stage of the Project (that is, the start-up date), Outback Gas Co redeploys its workforce into day-to-day, business as usual operations. Outback Gas Co refers to this post-construction stage as the 'operate' phase.

26. 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.

27. The combined costs associated with the Upstream team, Downstream team and Supporting team are charged to specific project activity codes via a work breakdown structure (WBS), 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/notes, emails, calendar/diary entries and time sheets, and this flows through into how expenditure is allocated for the purposes of the Australian Accounting Standards.

28. *An analysis is undertaken of the combined costs and the activities performed by each team via the WBS allocation that allows Outback Gas Co to determine the teams or activities that relate to the delivery of the tangible assets of the Project (that is, 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.*

29. *For those WBS allocations that contain staff members that conduct activities considered to be both capital and revenue in nature, Outback Gas Co conducts an analysis of the employee time-writing reports in line with their business practices and how their accounting systems function. This allows Outback Gas Co to determine on a fair and reasonable basis which proportion of the combined costs within that WBS allocation are capital or capital in nature.*

30. *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 WBS, time-writing, cost centre allocations, project governance documents, charter of responsibilities, job descriptions, written reports/notes, emails, calendar/diary entries and time sheets.*

Date of effect

31. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation**21 November 2019**

Appendix 1 – Explanation

❶ ***This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.***

Principles of capital and revenue relevant to costs of labour

32. 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 section, consideration must be given to the whole set of circumstances and the commercial context within which the expenditure is made.¹²

33. 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 French CJ, Kiefel and Bell JJ in *AusNet* at [14]:

The 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.

34. 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.

35. The generally recognised starting point for considering whether expenditure is on capital or revenue account is the judgment of Dixon J in *Sun Newspapers*. Dixon J outlined the following three 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

36. 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

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

GP International Pipecoaters Pty Ltd v Commissioner of Taxation (Cth) [1990] HCA 25 (*GP Pipecoaters*), makes this clear and was later cited in *AusNet*¹³:

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.

37. Consistent with paragraph 6 of this Ruling, where capital asset labour costs are incurred specifically for constructing or creating a capital asset, the character of the costs 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.

38. 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.

39. 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.

40. 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 organisation 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.

41. Windeyer J made similar observations in *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.

¹³ *AusNet* at [23] per French CJ, Kiefel and Bell JJ.

42. 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 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.

43. 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.

44. 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.

45. 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.

46. Consistent with this passage from Starke J in *Hallstroms*, the principles in paragraphs 5 to 9 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.

47. While *Goodman Fielder* is not authority for a proposition that wages and salary is on capital account, the following passage from Hill J's judgment (at page 44) 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.

48. 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

49. 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.

50. 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.

51. 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).

52. 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.

53. 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 likely to be on revenue account

54. 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 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/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 capital asset.

55. 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 is incidental or minor, the essential character of outgoings on labour costs (even to the extent they can be identified as capital asset labour costs) are likely to be revenue in nature. For example, costs in respect of the following employees would be regarded as on revenue account even though an infrequent 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

56. 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.

57. 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*:

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*... [(1938) 61 CLR 337] “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... [(1938) 61 CLR, at p 362]).

58. In considering this factor, it is important to bear in mind the driving force behind costs incurred for labour being paid periodically (fortnightly, etc). 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 law¹⁴ 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

59. 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.

60. 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

61. 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 Hill J in *Goodman Fielder* made the following observation in relation to the apportionment of salary and wages (at pages 44–45):

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

62. Whilst merely counting the number of hours an employee is engaged in activities is not the sole answer to apportionment, it may nonetheless be the method ultimately adopted. In other words, a fair and reasonable basis requires all relevant circumstances to be considered, but if, after having done so, time spent on capital

¹⁴ Refer 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.

activities fairly reflects the essential character of part of the relevant outgoing, it may be the most appropriate basis of apportionment. This does not discount other methods of apportionment which may be reasonable in the circumstances. For example, employee costs spent on supporting activities directly related to the construction or creation of capital assets may be able to be demonstrated to be a function of direct employee capital activities, and so their costs apportioned by reference to that ratio or relationship.

Relevance of accounting principles

63. The accounting principles are 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.¹⁸ Accounting treatment may also be a useful indication of a reasonable basis for apportionment of expenditure.

64. There are two accounting standards that are relevant in this regard:

- 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.¹⁹ 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.
- 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.²⁰

65. The treatment of labour costs under these standards is one of the many relevant factors that need to be considered when

¹⁸ See for example *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes* [1985] PNGLR 129 (*Travelodge*); *RACV Insurance Pty Ltd v Commissioner of Taxation* [1975] VR 1 (*RACV Insurance*); *Commercial Union Assurance Company of Australia Limited v Commissioner of Taxation* [1977] VicSC 202 (*Commercial Union*); *Commissioner of Taxation (Cth) v James Flood Pty Ltd* [1953] HCA 65.

¹⁹ Paragraph 16 of AASB 116 *Property, Plant and Equipment*.

²⁰ Paragraph 66 of AASB 138 *Intangible Property*.

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).²¹

66. 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.

Tangible and intangible capital assets covered by this Ruling

67. 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).

²¹ *Travelodge; RACV Insurance; Commercial Union.*

Appendix 2 – Alternative view

❶ *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.*

68. 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 the income tax law, and relevant cases decided on the income tax law. This Appendix explains why this is the case.

Alternative view – *Steele* is authority for the deductibility of all costs of labour costs

69. 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]).

70. 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.

71. 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.

72. 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.

73. 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 ‘Wages may certainly be “of a capital nature” although liability to pay them is typically, if not invariably, recurrent.’²²
- In any event, the passage from *AusNet* quoted in paragraph 33 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*, 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

²² *Steele* at [76].

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.

Appendix 3 – Your comments

74. You are invited to comment on this draft Ruling. Please forward your comments to the contact officer by the due date.

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

- provide responses to persons providing comments
- be published on ato.gov.au

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

Due date: 14 February 2020

Contact officer details have been removed following publication of the final ruling.

Appendix 4 – Detailed contents list

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

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

IT 2350; TD 93/126; TR 92/3;
TR 98/2; TR 2002/4; TR 2004/4;
TR 2006/10; TR 2016/3;
TR 2017/1; TR 2017/D1

Legislative references:

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- ITAA 1997 70-25
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- Fair Work Act 2009 323

Cases references:

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- BP Australia Ltd v Commissioner of Taxation (Cth) [1964] HCA 81; 112 CLR 386; 44 ATC 312; [1966] AC 224; 14 ATD 1
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- Goodman Fielder Wattie Ltd v Commissioner of Taxation [1991] FCA 264; (1991) 29 FCR 376; 91 ATC 4438; (1991) 22 ATR 26; 101 ALR 329
- GP International Pipecoaters Pty Ltd v Commissioner of Taxation (Cth) [1990] HCA 25; (1990) 170 CLR 124; 90 ATC 4413; (1990) 21 ATR 1
- Hallstroms Pty Ltd v Federal Commissioner of Taxation [1946] HCA 34; (1946) 72 CLR 634
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- Ronpibon Tin NL v Commissioner of Taxation (Cth) [1949] HCA 15; (1949) 78 CLR 47; [1949] ALR 785; (1949) 8 ATD 431
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- Steele v Deputy Commissioner of Taxation [1999] HCA 7; (1999) 197 CLR 459; 99 ATC 4242; 41 ATR 139
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Other references:

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-

ATO references

NO: 1-DTHZ73S

ISSN: 2205-6122

BSL: PGI

ATOlaw topic: Income tax ~~ Deductions ~~ General deductions –
section 8-1 ~~ Capital vs revenue expenditure

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