TD 94/D71 - Income tax: property development: where the estimated profits method of recognising income from long term construction contracts (Income Tax Ruling 2450) is adopted, how is an estimated 'ultimate loss' arising under a contract to be recognised?

Australian Taxation Office

Taxation Determination **TD 94/D71**

Draft Taxation Determination

Income tax: property development: where the estimated profits method of recognising income from long term construction contracts (Income Tax Ruling 2450) is adopted, how is an estimated 'ultimate loss' arising under a contract to be recognised ?

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

2. Paragraph 26 of IT 2450 equates 'ultimate profit or loss' with 'notional taxable income' expected to arise under a particular contract and indicates that this notional taxable income is to be spread over the years taken to complete the contract.

3. Paragraphs 31-32 provide examples of methods acceptable to the Commissioner by which the notional taxable income may be spread across the years taken to complete the contract. These methods largely reflect those outlined in paragraph 10 of Australian Accounting Standard (AAS) 11. Importantly, all of the latter methods meet the requirement stated in paragraph 31 of the Ruling, concerning the recognition of 'notional taxable income in a manner that reflects progress of a contract.'

4. Paragraph 18 of AAS 11 provides that where a loss is probable from a contract, 'provision is to be made for the foreseeable loss on the contract regardless of the amount of work performed on the contract'. This approach is unacceptable for income tax purposes. It is inconsistent with the approaches outlined in the Ruling for the spreading of notional taxable income. Also, it does not fulfill the basic principle of income tax law that the liability to income tax is an annual event, and therefore only income and losses that have been derived or incurred in an income year are brought to account.

Example

A construction company is in the fourth year (19X4) of a five year contract. At 30 June X4, it is probable that the company will incur an ultimate loss of $1,000 from the contract. The contract at the end of the 19X4 income year is 80% complete with 20% having been performed during the 19X4 income year. For accounting purposes the company will follow AAS 11 paragraph 18 and recognise in 19X4 that amount of the ultimate loss not already reported in a previous year's statutory accounts. For income tax purposes however, the construction company will return in 19X4, a loss sufficient to recognise the company has completed 80% of the contract, i.e. the loss returned in 19X4 will be an amount which, together with the amounts returned in the previous three years, will equal a loss of $800 representing 80% of the ultimate loss under the contract and *thus reflecting progress on the contract. In 19X5 if the probable loss is realised, the company will return a loss of $200 representing the final 20% of the work on the contract.*

Commissioner of Taxation
30/6/94

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