Tax Treatment of Construction Contracts

WEBINAR

Wednesday, 15 November 2023

1.00pm to 2.00pm AEDT

CLE/CPD ACCREDITATION

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PREPARED & PRESENTED BY

William Calokerinos, Barrister, Two Wentworth Chambers

Lisa To, Partner, Bartier Perry - Chair

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Profiles

Lisa To, Partner, Bartier Perry

Perry Lawyers and has over 15 years' experience specialising in federal and state taxation, superannuation, trusts, estate planning and business succession planning. She is a SMSF Specialist Advisor T with the SMSF Association and a Chartered Taxation Advisor T (CTA) with the Taxation Institute of Australia. Lisa holds a double degree in law and accounting and Masters of Tax from the University of Sydney. Lisa sits on the NSW Law Society and Revenue NSW liaison committee and is actively involved with SMSF, tax education and promoting women leadership. She has significant experience in property development and business transactions involving SMSFs, trust structures and borrowing arrangements. Lisa manages all stages of tax and SMSF disputes, reviews, audits, objections, SMSF specific advice and private ruling applications with the ATO including seeking Commissioner discretion.

William Calokerinos, Barrister, Two Wentworth Chambers

Mr Calokerinos is an experienced and trusted Australian Barrister. Mr Calokerinos has practised from the same Chambers since being admitted in April 2010. Mr Calokerinos is a floor member and owns Chambers in Two Wentworth Chambers. Mr Calokerinos is also presently; a part-time academic at the UTS law school, Sydney, teaching Construction Law in the LLB Program and a presenter, teacher, exam writer and marker with the CTA programs for the Tax Institute. Mr Calokerinos prides himself on his attention to detail with all his professional work. In his early career, Mr Calokerinos spent around six years working in management and director reporting roles as a senior management accountant in the telecommunication industry (Vodafone and Macquarie Telecom) prior to his experience working in Big Four in tax consulting. As a Barrister, Mr Calokerinos has significant expertise in tax law, commercial matters, criminal law, insolvency, planning and environmental law, building, construction, and infrastructure litigation. Mr Calokerinos practices in both the civil and criminal jurisdiction. William's litigation experience includes appellant jurisdiction, corporate insolvency, bankruptcy, criminal law, white collar crime, tax crime, corporations and significant property, equity, and trust litigation. Mr Calokerinos is constantly maintaining his tax knowledge and he is a current CTA (Chartered Tax Adviser) member with the Tax Institute of Australia and full member and Chartered Accountant (CA) with CAANZ. Mr Calokerinos holds a Master of Laws (Uni Syd), a Bachelor of Laws (with Honours) (UTS) and a Bachelor of Commerce (UWoll). Mr Calokerinos is a member of: NSW Bar Association, Victorian Bar Association, Tax Bar Association, Criminal Bar Association and Australian Bar Association; Chartered Accountant member of CA ANZ; Master Builders Association member and Councillor. - also Completed CERT IV in building and Diploma of Building; Legal Aid NSW Serious Crime and Indictable Panel and the Society of Construction Law Australia (Barrister, Member).

Program

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Wednesday, 15 November 2023

WEBINAR

1.00pm	***Opening Comments by the Chair*** Lisa To, Partner, Bartier Perry
1.00pm to 2.00pm	***Tax Treatment of Construction Contracts*** William Calokerinos, Barrister, Two Wentworth Chambers
2.00pm	***Final Q&A and Closing Comments by the Chair*** Lisa To, Partner, Bartier Perry

2023 – Potential Tax Treatments arising from Construction Contracts

PRESENTATION at LEGALWISE SEMINARS –
15 NOVEMBER 2023

William Calokerinos, Barrister – TWO WENTWORTH CHAMBERS
2/180 PHILLIP STREET, SYDNEY NSW 2000

Contents

Synopsis

1. This paper critically considers the taxation issues arising from the Building Contracts, such as **AS 4902 - a Design and Construct Contract**.[1]

2. The points below are generic in nature and analyse possible issues that may arise due to specific **application** of a construction contract and arise due to the **implementation** of a building construction contract (the finished project).

3. The paper proposes practical strategies when considering seminal taxation law issues such as (inter alia):

    a. the application of income tax considerations for long term construction contracts;

    b. The GST issues for construction contracts;

    c. Stamp Duty;

    d. Land Tax;

    e. The various implication due to a completed building projects.

4. The main legislative instruments that regulate Australian income taxation laws are below:

    - *Acts Interpretation Act 1901* (Cth)
    - *Administrative Decisions (Judicial Review) Act* 1977 (Cth)
    - Commonwealth of Australia Constitution Act, s 51(ii), s 53, s 55, s 90, s 114
    - *Freedom of Information Act* 1982 (Cth)
    - *Fringe Benefits Tax Assessment Act* 1986 (Cth)
    - ***Income Tax Assessment Act* 1936 (Cth)**
    - ***Income Tax Assessment Act* 1997 (Cth)**
    - *International Tax Agreements* Act 1953 (Cth)
    - ***Taxation Administration Act* 1953 (Cth)**

[1] Please note, Clause AS 4902 cannot be reproduced for Copyright reasons.

- *Administrative Decisions (Judicial Review) Act* 1977 (Cth)
- *Taxation Administration Regulations* 1976 (Cth)

5. The GST law stated is the following:

   f. *A New Tax System (Goods and Services Tax) Act* 1999 (Cth) ("**GST Act**")
   g. *A New Tax System (Goods and Services Tax) Regulations* 1999 (Cth) ("**GST Regulations**")
   h. *Taxation Administration Act* 1953 (Cth).
   i. *Acts Interpretation Act 1901 (Cth).*

   ("**the relevant GST law**")

About the Speaker:

- **William P Calokerinos** is a barrister at the NSW Bar practising from Two Wentworth Chambers. For more information about Mr Calokerinos and his practice areas, please refer to two websites below:

  NSW Bar Association Website:
  http://find-a-barrister.nswbar.asn.au/profile/william-calokerinos-8280

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  - William is a member of the following professional bodies:
    Member, New South Wales Bar Association.
  - Member, Victorian Bar Association.
  - Member, Australian Bar Association.
  - Member, Tax Bar Association (Victoria).
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  - Member, a Chartered Accountant (**CA**) and fully qualified member of CA ANZ.
  - Member, Chartered Tax Adviser (**CTA**) with the Tax Institute.
  - Member, Australian Society of Construction Law.
  - Member, the Master Builders Association (NSW) with a Cert IV in Building and Diploma of Building.
  - Member, The Hellenic Australian Lawyers Association (HAL).

Disclaimer

The information contained on this paper is general in nature and does not consider your personal situation. You should consider whether the information is appropriate to your needs, and where appropriate, seek professional advice from a qualified lawyer. The Jurisdiction that has been considered is the state of New South Wales only.

Taxation, legal and other matters referred to in this paper are of a general nature only and should not be relied upon in place of appropriate professional legal advice.

The laws cited within this paper may change from time to time.

Part A – Overview of Important Building Construction Contract - Seminal Concepts

1. This paper and presentation are both not intended to go into the heavy technical detail, but rather, outline key issues and both the oral presentation and the technical paper complement each other.

2. This paper is intended to be a practical tool that Principals, projects managers (Superintendents), and contractors may consider applies to their construction contracts. It is important to get specific legal advice prior to relying on anything within this Paper.

The Intersection of Laws

3. The paper emphasises that there are various areas of law that intersect with construction law - there is an obvious reason.

Safety!

But what about changes in law?

4. What happens if there is a change in law and how does that affect construction contracts?

    a. There are often included a **changes in law** provision within the construction contract.

        i. Sometimes the **Contractor** takes the risk for a Change in Law at any time throughout the project.

        ii. Sometimes the **Contractor** takes the risk for a **certain amount of time**.

    b. If a change in the law impacts the Contractor or Principal, they are often given **extra time** or **additional compensation** to allow for this change in law (depending on the contract).

5. So, what should a prudent lawyer do (inter alia)?

    a. Identifying all relevant legislation and regulations, including **taxation laws**;

    b. Identifying the relevant case law;

    c. Identifying the general requirement to comply with laws such laws, including industrial relations, safety, contractual payment requirements and taxation requirements.[2]

6. How does the changes in law affect the major elements of a building contact? Consider the key elements of a building contract.

Key Building Construction Concepts

7. **Contract Sum:** means the price payable for the delivery of the scope of works

[2] See clause 11.1 from AS 4902.

Components of the Contract Sum include:

Preliminaries

i. on-site and off-site overheads e.g., insurance

Direct costs

ii. labour, materials, plant, subcontractors

Margins

iii. profit margin for the contractors

8. **Adjustments to Contract Sum**:

How are Contract Sums adjusted?

i. Variations
ii. Provisional sums
iii. Delay costs
iv. Escalation
v. Bonuses
vi. Set-offs (damages, liquidated damages etc)
vii. Termination for convenience payments.

9. **Types of Payment Structures:**

Payment structure influenced by:

i. Contract form
ii. Parties involved
iii. Risk
iv. Forex - Foreign exchange risk ("Forex") – when the project involves foreign contractors.

Structure types include:

i. Lump sum
ii. Schedule of Rates

iii. Cost Plus
iv. Pain share/ gain share -
    1. Used in particular, for alliance-style agreements
    2. Allows the Contractor to receive an incentive or received reduced payment based on performance.

    3. These contracts usually set out KPI's (key performance indicators) which the Contractor must meet.

    4. The pain share / gain share mechanisms can be based on:
        a. Cost performance
        b. Time performance
        c. Quality performance
        d. Safety performance etc.

10. **Consider: Security of Payment Act (SOPA) NSW:**

i. See the legislation: *Building and Construction Industry Security of Payment Act* 1999 (NSW) and Regulations: Building and Construction Industry Security of Payment Regulation 2020 (NSW).

ii. see the website: Adjudicate Today - https://www.adjudicate.com.au/2019-nsw-amendment

iii. Important changes to the NSW Building and Construction Industry Security of Payment Act and Regulation commenced on 21 October 2019. The amendments apply ONLY to contracts made either in writing or orally on or after 21 October 2019.

iv. Key features
    1. Interim determination/not final relief ("…pay now argue later")
    2. Contractual rights still preserved
    3. Short and strict timeframe

v. "Pay when paid" provisions are void

vi. **SOPA: No contracting out (section 34)**

34 No contracting out

(1) The provisions of this Act have effect despite any provision to the contrary in any contract.

(2) A provision of any agreement (whether in writing or not)—

(a) under which the operation of this Act is, or is purported to be, excluded, modified or restricted (or that has the effect of excluding, modifying or restricting the operation of this Act), or

(b) that may reasonably be construed as an attempt to deter aperson from taking action under this Act,
is void.

vii. **SOPA – Pay when paid**

12 Effect of "pay when paid" provisions

(1) A pay when paid provision of a construction contract has no effect in relation to any payment for construction work carried out or undertaken to be carried out (or for related goods and services supplied or undertaken to be supplied) under the contract.

(2) In this section—

money owing, in relation to a construction contract, means money owing for construction work carried out or undertaken to be carried out (or for related goods and services supplied or undertaken to be supplied) under the contract.

pay when paid provision of a construction contract means a provision of the contract—

(a) that makes the liability of one party (the ***first party***) to pay money owing to another party (the ***second party***) contingent on payment to the first party by a further party (the ***third party***) of the whole or any part of that money, or

(b) that makes the due date for payment of money owing by the first party to the second party dependent on the date on which payment of the whole or any part of that money is made to the first party by the third party, or

(c) that otherwise makes the liability to pay money owing, or the due date for payment of money owing, contingent or dependent on the operation of another contract

viii. Simple - SOPA Process - When Claim accepted.

(1) Payment Claim:

a. Contractor submits payment claim to Superintendent
b. Usually submitted on and from the last day of the month (depending on jurisdiction)

(2) Payment Schedule:

a. Superintendent responds to payment claim with payment schedule
b. within ~ 10 business days (depending on jurisdiction)

(3) Payment:

a. Principal pays amount set out in Payment Schedule
b. [NSW] Within 15 business days (head contract)/20 business days (subcontract – non-residential)/10 business days (subcontract – residential) from payment claim
c. Other states and other jurisdictions vary.

Part B – Income Tax Consequences

The income taxation of a construction project is complex. Various taxation regimes may apply to levy tax.

For example, the transfer of land may be taxable:

1. as a disposal of trading stock of a property development business;[3]
2. as a profit-making scheme;[4] or
3. as a taxable gain on the disposal of a CGT asset.[5]

Income Tax application will also depends on the Client's Circumstances.

Income Tax Issue Checklist

Consider the following matters:

- The fact that land may be **trading stock** for tax purposes - trading stock is considered to be objects acquired for the purpose of manufacture, sale or exchange in the ordinary course of business.[6]

- **Profit making schemes** - the ordinary income of a business operation or commercial transaction includes the 'profit' on certain isolated transactions entered into with the purpose of making a profit.

- **Capital gains tax implications** - A capital gain or loss may arise upon the occurrence of a CGT event (e.g. a transfer)[7] in respect of a CGT asset (e.g. land),[8] unless an exemption applies, rollover relief defers the capital gain or a provision denies the loss.

  A capital gain arises where the proceeds from the CGT event exceed the adjusted acquisition costs of the CGT asset.[9] A capital loss arises where the proceeds from

[3] Div. 70 ITAA 1997.
[4] Sec. 6-5 ITAA 1997.
[5] Pt 3.1 and 3.3 ITAA 1997.
[6] *FCT v St Hubert's Island P/L* 78 ATC 4104; (1978) 8 ATR 452.
[7] Sec. 104-10 ITAA 1997 - Disposal of a CGT Asset: CGT event A1.
[8] Sec. 108-5 ITAA 1997.
[9] Sec. 102-5 ITAA 1997.

the CGT event are less than the adjusted acquisition costs of the CGT event.[10]

Capital gains on assets acquired before 20 September 1985 are disregarded.[11]

A net capital gain is included in the assessable income of the taxpayer.[12]

- Differences in expense treatment for **development costs**.

- **Mere realisation of an asset** - where the trading stock, profit making scheme or capital gains tax regimes do not apply (e.g. pre-CGT assets), the proceeds of the project are not taxed.

  Post-CGT buildings and intangible improvements to pre-CGT Assets are separate post-CGT Assets.

  These improvements are subject to the CGT regime, requiring capital proceeds to be apportioned. A post-CGT building or structure is a separate asset to the pre-CGT land.[62]

- Selecting the **landowner structure** for a property project is not always possible.[13]

- Legitimate tax planning uses tax policy distinctions/disconformities to reduce the overall effective tax rate.

- Choosing the optimal business structure is an art rather than a scientific application of principles. The choice of structure will vary depending upon (amongst other matters) the insolvency protection, liquidity and financing requirements and priorities of each participant.

  - Consider a company structure

  - Consider a trust structure

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[10] Sec. 102-10 ITAA 1997.
[11] Sec. 104-10(5) ITAA 1997 - Disposal of a CGT Asset: CGT event A1; *Determination* TD 7.
[12] Sec. 102-5 ITAA 1997.
[13] e.g. the land was acquired under a will or by a particular entity for commercial and other reasons without regard to the taxation and commercial issues for future development.

- Consider an 'unincorporated joint venture'

- Care needs to be exercised when the structuring of a property development is intended to be on capital account, because changes to the taxpayer structure (e.g. a change of shareholding or a change of purposes in a Constitution) may transform a capital account development into a property development business.

- The practice of establishing separate development entities to argue that each entity does not have a history of property development may be of little effect: *FCT v Whitfords Beach Co P/L*[14]

Income Tax Treatment - Long Term Construction Contract - TR 2018/3

1. A long-term construction contract refers to a contract under which construction work extends beyond one year of income, but it can also refer to a contract which runs for less than 12 months but straddles two income years.

2. The word "construction" takes its ordinary meaning but can also apply to the construction of major plant items. This can include (but is not limited to) boats, other transport vessels and large machinery. It can also include service contracts like air conditioning, electrical and refurbishment contracts for sites like hotels or shops.

3. The Australian Tax Office (ATO) had increasingly become concerned with methods which deferred the taxing point of income and/or profits under these long-term contracts. As business owners were increasingly trying to defer the income to be taxed until a later year.

4. In **Taxation Ruling TR 2018/3** the ATO affirms the view they have practiced in the past, that the completed contracts method remains unacceptable. This method deferred the taxing point of the income or profit until the completion of the contract, whilst some businesses had also claimed expenses during the period before the completion.

5. **TR 2018/3** also states the ATO's suggested methods are:

    a. The **"Basic Approach"** – where all progress and final payments received in a year are included in assessable income and deductions are allowed to the extent permitted by law, when they are incurred.

[14] *FCT v Whitfords Beach P/L* [1982] HCA 8.

b. The **"Estimated Profits Approach"** – any method of accounting for the ultimate profit, which allocates the profit on a fair and reasonable basis over the contract period, will be acceptable.

6. **Basic Approach**:

    a. Progress and final payments – include amounts received and amounts billed or billable under the contract. A taxpayer cannot defer assessment of contract income by refraining from, or postponing billing.

    b. Up-front payments – are assessable income. There may be situations where this payment may be assessable over a longer period. For example if the payment was to enable the purchase of equipment.

    c. Retention clauses – amounts retained under a retention clause are not assessable until received or are entitled to be received.

    d. Work in progress – is generally not assessable as the property would belong to the client, as the contractor has rights to sue for the work done.

    e. Expected costs – are generally not deductible. Only costs and expenses incurred are allowable deductions.

7. **Estimated Profits Basis**:

    a. Accounting standard – **AASB 15** – revenue from contracts with customers is like the estimated profits basis. However, adjustments must be made for income tax purposes.

    b. Costs considered – only costs that are incurred or are likely to be incurred over the contract period are deductible, based on the taxpayer's experience in the construction industry e.g., materials and labour. Costs that are not deductible or are not deductible until incurred include:

        i. A management reserves
        ii. Additional costs due to wet weather
        iii. Industrial disputes

    c. Methods of allocating notional taxable income – seek to recognise notional taxable income in a manner that reflects the progress of a contract.

8. Both these methods are based on the basic principle of income tax law, that liability to income tax is an annual event and so an appropriate amount of the profit must be returned as taxable income each year of the project. The ATO have made it quite clear the deferring of

taxable income until the end of the contract will not be tolerated.

9. **See TR 2018/3 - attached – to this paper.**

Part C - GST Consequences

1. Under the GST Act, it is the vendor (as the supplier) who incurs the liability to pay the GST. The vendor has no statutory right to pass on any part of its GST liability to the purchaser, although the presumption is that the supplier will generally pass on the GST to the recipient as part of their contractual relationship. Accordingly, how GST is dealt with in the contractual relationship between vendor and purchaser is critical.

2. Disputes on which party to the contract is to bear the cost of GST does arise and in two contexts, each of the parties to contract have different considerations, different motivations due to differing drivers to cause dispute.

   There are several reasons for this:

   Firstly, transactions involving purchasers who are registered for GST and can claim input tax credits with respect to the transaction.

   In these types of transactions, the GST is not intended to be a cost to either party because the purchaser is entitled to an input tax credit equal to the GST payable by the vendor.

   Though, if the contract does not provide for the GST to be added to the Price, the vendor will still be liable to pay GST and will be out of pocket 1/11th of the Price. Further, the purchaser will receive a windfall gain of 1/11th of the Price. This is illustrated by the following examples:

   - **Example 1 – GST gross up:**

     A sells land to B for a stated price of $2,000,000 plus GST. At settlement a total price of $2,200,000 is paid and A pays GST of

$200,000 (1/11th) and B claims an input tax credit of $200,000.

The net price paid by B is $2,000,000.

- **Example 2 - No GST-gross up**

  A sells land to B for a stated price of $2,000,000 and the contract is silent on GST – thereby being GST inclusive. At settlement, a total price of $2,000,000 is paid and A pays GST of $181,818 and B claims an input tax credit of $181,818. The net price paid by B is $1,818,182, thereby giving B a windfall gain and leaving A out of pocket.

3. The main driver for contractual disputes is clear – if the purchaser can establish that the price was inclusive of GST, it can claim an input tax credit whilst being under no obligation to pay a dollar more to the vendor. Another driver is the NSW stamp duty, which is payable on the GST-inclusive price. As you can observe from Example 2 above, B would pay stamp duty on $2,000,000 rather than $2,200,000 – leading to a reduced stamp duty bill!

Secondly, transactions involving purchasers who are not registered for GST or purchasers who are registered for GST but cannot claim input tax credits. In these transactions, the liability for GST will be a cost to either the vendor or purchaser, depending upon the terms of the contract. This is illustrated by the following two examples:

- **Example 3 – GST gross up**

  A sells land to B for a stated price of $2,000,000 plus GST. At settlement a total price of $2,200,000 is paid and A pays GST of $200,000 (1/11th). The net price paid by B is $2,200,000.

- **Example 4 – No GST-gross up**:

  A sells land to B for a stated price of $2,000,000 and the contract is silent on GST – thereby being GST inclusive. At settlement, a total price of $2,000,000 is paid and A pays GST of $181,818. The net price paid by B is $2,000,000, leaving A out of pocket by $181,818.

4. As can be seen above, the main driver for GST disputes comes from the vendor, who can recover an additional amount from the purchaser if it can establish that the price was exclusive of GST. This would pass the GST cost to the purchaser, who would also then be subject to an increased liability for stamp duty.

5. There are numerous case law involving GST disputes about interpretation of contracts and what was the true contracting intention of the parties to contract. Disputes arise over who effectively bears the liability for GST under a contract and the relevant case law is discussed below.

6. In *A & A Property Developers Pty Ltd v MCCA Asset Management Ltd* [2016] VSC 653 the Supreme Court of Victoria found that GST was not to be added to the purchase price payable under a contract of sale. The decision is a further example of the difficulties that can arise when documenting the contractual position with regards to GST and the sale of real property.

    a. In this case the parties entered into the standard form LIV contract of sale which provides for a "tick the box" process with regards to GST. The particulars of sale state that "The price includes GST (if any) unless the words "plus GST" appear in this box". Clause 13.1 of the General Conditions provided that "*The purchaser does not have to pay the vendor any GST payable by the vendor in respect of a taxable supply made under this contract in addition to the price unless the particulars of sale specify that the price is 'plus GST'*."

    b. The difficulty in this case appears to have arisen because of the way the particulars of sale were completed. The price was $2,900,000 with a deposit of $290,000 but the word "GST" was included in the box dealing with GST, not the words "plus GST".

    c. Ginnane J opined the following by way of analysis of the GST dispute:

25 I accept the defendants' construction of the relevant provisions of the contract. A court should not add words into a written instrument unless it is clear that words have been omitted and what those omitted words were. Here the presence of the letters 'GST' is capable of a number of interpretations. One is that proposed by the plaintiff. Another, is that some thought was given as to who should be liable to pay any GST that was payable, but a decision was not reached. A third interpretation is that the letters 'GST' were inserted erroneously and were intended to be deleted, but that the deletion was overlooked.

26 The plain meaning of the contract is that the obligation to pay the GST lay with the vendor. To repeat the clear words of General Condition 13.1:

The purchaser does not have to pay the vendor any GST payable by the vendor in respect of a taxable supply made under this contract in addition to the price unless the particulars of sale specify that the price is 'plus GST'.

27 The reasoning in Duoedge Pty Ltd v Leong, contained in the passage previously quoted, is applicable even though the details of the particulars of sale in the two contracts differ.

28 The contract of sale appears to have been, in part, in the form of contract published by the Law Institute of Victoria and the Real Estate Institute of Victoria Ltd. The general conditions are in the form contained in the Estate Agents (Contracts) Regulations 2008. The contract provides a mechanism to oblige the purchaser to pay the vendor GST on the purchase price, but it was not used in this instance.

29 In construing a contract, the court can correct obvious errors in the contract's language and grammar. Such correction is usually limited to obvious mistakes in the expression of the contract, including spelling and grammar, mistakes in names, omissions or obvious words or the obvious use of the wrong word. The intention of the parties is to be determined objectively from the contract in admissible intrinsic evidence. In Fitzgerald v Masters Dixon CJ and Fullagar J stated:

Words may generally be supplied, omitted or corrected, in an instrument, where it is clearly necessary in order to avoid absurdity or inconsistency.

30 I do not consider that this case attracts the principle discussed in Fitzgerald v Masters. There is no absurd result or inconsistency in the construction of the contract that I have adopted.

31 The plaintiff did not seek an order for rectification of the contract and, in any event, the evidence suggests that the parties did not have a common intention about the their agreement concerning the liability to pay GST.

32 A further rule of construction is that when a clause in a contract contains a blank space, which was intended to be filled in, that part of the contract will usually be held void for uncertainty, unless the parties' unexpressed intention can be discerned from the context and background or one party was authorised to fill in the blanks'.[11] In some cases, a blank in a document may be dealt with simply by ignoring it, and reading the contract as if it was not there.[12]

33 I do not consider that this case falls within those principles.

34 In my opinion, the contract provided a clear mechanism for the parties to give effect to an agreement that the purchaser must pay GST on the purchase price, but it was not employed in this instance. The inclusion of the letters 'GST' in the box did not shift the burden of the payment of GST to the purchaser.

35 The words of commercial contracts are to be interpreted in accordance with their commercial purpose. While words should ordinarily be given some role to play in the operation of the contract, sometimes words are included or are left in the contract in error.

> *36 There was no ambiguity in this contract justifying reference to surrounding circumstances.*

d. The Court accepted the defendant's construction of the contract – that the language of clause 13.1 was clear and the purchaser was not required to pay GST unless the Particulars of Sale specified that the price was "plus GST". The Court found that it should not add words into a written instrument unless it was clear that the words had been omitted and what those omitted words were. The Court observed that the presence of the letters "GST" was capable of a number of interpretations.

e. The Court observed that the plain meaning of the contract was that the obligation to pay GST lay with the vendor and that the contract provided a clear mechanism for the parties to give effect to an agreement that the purchaser must pay GST on the purchase price – but that it was not employed in this instance.

f. The Court also observed that the plaintiff did not seek an order for rectification of the contract – and in any event, the evidence suggested that the parties did not have a common intention about their agreement concerning the liability to pay GST.

7. This decision can be compared with the decision of the New South Wales Supreme Court in *SSE Corp Pty Ltd v Toongabbie Investments Pty Ltd* as Trustee for the *Toongabbie Investments Unit Trust* [2016] NSWSC 1235 where the plaintiff unsuccessfully applied for rectification of two contracts of sale by inserting the words "plus GST" after the purchase price.

8. In *SSE Corp Pty Ltd v Toongabbie Investments Pty Ltd* as Trustee for the *Toongabbie Investments Unit Trust* [2016] NSWSC 1235, the plaintiff unsuccessfully applied for rectification of two contracts of sale by inserting the words "*plus GST*" after the purchase price.

   a. In this case the plaintiff contended that by mistake the words "*plus GST*" had not been added to the statement of the price in each of the contracts before the contracts were exchanged.

b. Robb J opined the following by way of analysis of the GST dispute:

Legal principles

23. It will be convenient at this stage to set out the legal principles that apply to the issue of whether on the evidence that is before the court, SSE is entitled to the orders for rectification of the two contracts that it seeks in its summons. There was no real issue between the parties concerning the content of those principles.

24. The principles that govern the application of the equitable doctrine of rectification have been considered at length in a number of recent decisions of the Court of Appeal. It will be sufficient for the purposes of the present case to note, with respect, the following statement of those principles by Gleeson JA (with whom Meagher JA and Sackville AJA agreed) in Mayo v W & K Holdings (NSW) Pty Ltd (in liq) (No 2)[2015] NSWCA 119:

> *[55] ...The authorities were considered by the court in Franklins Pty Ltd v Metcash Trading Ltd [2009] NSWCA 407; 76 NSWLR 603(Franklins v Metcash) and in Ryledar (see also Newey v Westpac Banking Corporation [2014] NSWCA 319). It is sufficient to refer to the following principles.*
> *[56] First, a written document that has been executed is presumed to be the true record of the parties' agreement: Equuscorp Pty Lt v Glengallan Investments Pty Ltd [2004] HCA 55; 218 CLR 471 at [33]. However if there is clear evidence of a mistake in the recording of their agreement the equitable remedy of rectification is available to reform the parties' document, but not to reform the parties' bargain: Maralinga Pty Ltd v Major Enterprises Pty Ltd [1973] HCA 23; 128 CLR 336 (Maralinga) at 350 (Mason J); J W Carter, Contract Law in Australia, (6th ed 2013, LexisNexis Butterworths) at [21-02].*
> *[57] Secondly, the rationale of rectification of a written*

document in equity is that it is unconscientious for a party to the contract to seek to apply the contract inconsistently with what that party knows to be the common intention of the parties at the time the written contract was entered into: Ryledar at [315] (Campbell JA; Mason P agreeing).

[58] Thirdly, the "intention" that is relevant to rectification of the contract is the subjective intention of the parties, sometimes called the actual intention: Ryledar at [267]. Before rectification of the contract is granted, the actual intention needs to exist in circumstances where it can be seen that there is a common intention of all those entering into the contract: Ryledar at [279].

[59] In Ryledar at [281], Campbell JA emphasised that when that intention relates to the terms upon which the parties will contract with each other, it is still necessary for them to know enough of each other's intentions for it to be said that there is a common intention. His Honour explained that the parties might come to know each other's intentions where those intentions are directly stated, or through the various other means by which one person's intentions can become known to another person. Those means sometimes involve a process of conscious and deliberate inference and could also involve simply perceiving a gestalt in a series of events. His Honour also noted that negotiation of any contract takes place in a context in which various facts are known or assumed by the negotiating parties. Thus, for example, if a contract is negotiated in a context where there are well understood business practices and conventions, and nothing is said about those practices and conventions not applying, it can be legitimate to conclude that both parties to the contract intended to act in accordance with those practices and conventions, even if they did not expressly communicate to each other that they intended to act in accordance with those practices and conventions.

25. It is also necessary to consider the following observation made by McClelland J (as his Honour then was), when in Johnson Matthey v

AC Rochester Overseas Corp (1990) 23 NSWLR 190, his Honour said, at 195, that the entitlement to rectification of a written contract requires "clear and convincing proof of a common intention of the parties not reflected in the written document". The reference by Gleeson JA to "clear evidence" in par [56] in Mayo is to the same effect.

26. I have not lost sight of the fact that SSE submitted in the alternative, to its claim that the parties exchanged contracts for the sale of the two properties under a common mistake as to its terms, that there was a unilateral mistake under which SSE was mistaken, but Toongabbie Investments was aware that SSE was acting under a material mistake. I do not propose to consider the principles that may apply where a unilateral mistake of this nature is established in fact, as I do not think it is arguable on the evidence that Toongabbie Investments was actually aware that SSE was acting under a material mistake when it exchange the contracts.

27. SSE strongly put a submission contrary to the conclusion that I have expressed in the preceding paragraph, based on an email exchange that took place between Ms Azar and Mr Elachi on 19 August 2015. I will explain below in chronological context why I have not accepted that submission.

c. The Court undertook a detailed review of the evidence and concluded that the parties did not make a common mistake in the recording of the agreement, and that the purchaser entered into the contracts with a definite and clear understanding that the prices were to be inclusive of GST, whatever the subjective understanding of the vendor may have been. The principals of the purchaser were not aware, when the contracts were exchanged, that the contracts did not reflect the vendor's understanding of the prices to be paid – so this was not a case where the vendor entered into the contracts under a unilateral mistake that was known to the purchaser.

d. This decision can be compared with the decision of the New South Wales Supreme Court in *AFC Holdings Pty Ltd v Shiprock Holdings Pty Ltd* [2010]

NSWSC 985, which involved the use of put and call options in a Deed arrangement.

9. In an earlier matter, in the case of *AFC Holdings Pty Ltd v Shiprock Holdings Pty Ltd* [2010] NSWSC 985, the NSW Supreme Court of NSW considered the matter of the vendor/defendant entered into an option deed by which an option was granted to the purchaser/plaintiff to purchase the vendor's properties.

10. The price stated in the option deed was $4m and clause 5 of the deed stated that "*if the Grantor incurs a liability to pay GST in connection with this Deed, the Grantee must pay to the Grantor on demand in addition to the Option Fee and any Extension Fee(s) the amount of the GST*".

    a. The purchaser exercised the option and a contract of sale was entered into, in the standard form of the NSW Law Society – 2005 edition. Towards the bottom of the first page of the contract, under the heading "Tax information", against the statement "GST: taxable supply" the box "yes in full" was marked with a cross. Special condition 4 provided that "The sale is a taxable supply and the purchaser will pay to the vendor on completion the amount of Goods and Services Tax for which the vendor is liable".

    b. The purchaser contended that special condition 4 simply recorded that the amount payable by the purchaser included an amount payable by the defendant in respect of GST.

    c. The vendor contended that the effect of the clause was that the purchaser was required to pay an additional amount on the account of GST. The Court preferred the vendor's construction. In doing so, the Court observed that the difficulty with the purchaser's construction was that the clause would have no practical effect – why would the parties have included special condition 4 if it were simply stating the obvious.

Strategies to Mitigate GST Disputes

11. The imposition of GST on real property transactions continues to test owners and developers and their legal advisers and attract the examination of the ATO and State

and Territory Revenue Offices (SROs).

There are several reasons for this:

i. there is a general belief that whatever the recipient of the supply can claim back GST the supplier charges as an input tax credit;

ii. there is a general belief that the margin scheme is always an option for residential developers;

iii. transactions are high value and can be fully taxable, partly taxable, taxable under the margin scheme, GST-free, input taxed or out-of scope (non-taxable and not subject to GST law application);

iv. the GST treatment can impact the contract price;

v. property developers are often inexperienced;

vi. property developments are often underpinned by complex arrangements; and

vii. property developments usually involve the claiming of substantial input tax credits upfront, thereby placing the developer on the ATO's radar.

12. There are other, equally valid reasons, for ensuring compliance with the GST Act, namely; to make savings and also increase profitability of the enterprise when the opportunity arises; and to avoid costly party to party disputes in litigation.

13. If there was a difference of view between the parties as to how the GST law may apply, the contract could provide a mechanism for resolving the difference of view (for example, by obtaining a binding ruling from the Commissioner).

14. Where litigation does not involve the Commissioner as a party, there is a danger that the potential GST issues may not be completely understood and the litigation may, therefore, not provide a satisfactory outcome. The problems where the

Commissioner is not a party to litigation has also raised problems where ordinary income tax or CGT issues are involved (see Appendix One for these issues).

15. It is clear as a matter of principle that a decision of a court case, in which the Commissioner is not a party, involves the determination to the effect of a taxation provision that does not bind the Commissioner: See for example the case of *Groves v FCT [2011] FCA 222.*

16. Practitioners to limit any risks of tax litigation may apply a GST checklist to limit the risk of dispute. Below is one such checklist.

17. Taking a little time with a GST checklist is a handy tip. Try to implement the checklist in your advisory dealings. Preferably, before a property contract is signed, a checklist will assist the solicitor to keep themselves and their property developer client out of trouble.

GST Checklist

The following is a suggested GST checklist:

- ☐ Confirm the description and proposed GST treatment of the target property
- ☐ Check the identity and GST status of the vendor/supplier and purchaser/recipient on ABN lookup - use the website http://abr.business.gov.au/
- ☐ Compare the supplier’s identity with the named proprietor on title.
- ☐ Consider what happens if the Commissioner challenges the treatment to be adopted by the parties or if something else goes wrong – such as the purchaser is not in fact registered for GST.
- ☐ If cancellation of GST Registration is an option, will that cancellation result in an increasing adjustment?
- ☐ Confirm that the purchaser of a going concern is correctly identified and registered for GST and that the requisite agreement has been made and documented.
- ☐ Confirm that the “going concern” is “going” at settlement and that all things necessary for the purchaser to continue to carry on that enterprise have been supplied?

- ☐ Discuss the opportunities and risks with the vendor/purchaser
- ☐ Consider funding a private ruling application – get advice from lawyer if required.
- ☐ If purchasing a property as a going concern or farm land, can the margin scheme be used later and, if so, how will the margin be calculated?
- ☐ Is there a risk to the purchaser of an increasing adjustment under Div 135 of the GST Act?
- ☐ If conducting a residential development correctly determine the developer's registration date (commencement of enterprise), input tax credit on purchases and any subsequent change of use adjustments
- ☐ Understand the significant difference between dual concurrent use (property leased and, on the market) and taking a property off the market (sole use as leased premises) – see (GSTR 2009/4).
- ☐ If the acquisition is a fully taxable supply, consider getting the GST paid into trust, to be released once the purchaser gets the GST refund from the ATO
- ☐ With contentious purchases, consider obtaining the contractual right to have involvement in any dispute with the Commissioner.
- ☐ Consider putting the developer on a monthly reporting cycle during the development phase – after 12 months the developer may be able to change to quarterly
- ☐ Lodge credit BAS as early as possible – even before the end of the month to receive the refund.

Application of the Checklist

EXAMPLE 1

Treeview Pty Limited (**Treeview**) owns a two-storey property in rural NSW and in the outskirts of the country CBD. Treeview is registered for GST. It reports its GST position to the ATO annually and sells the property with vacant possession to Mac Developments Pty Limited (**Mac**) for $6 million plus GST and gives the purchaser what appears to be a valid tax invoice. It takes Mac six months to recovers its $600,000 GST. The reason for the delay is that the ground floor of the building was commercial and first floor was a residential apartment. The GST had to be recovered in part from the ATO and in part from the vendor.

Apply the checklist above to the factual scenario to identify issues, aid compliance and securing the savings and the avoidance of the disputes with parties and the ATO.

Secondly, in this scenario, assume that Treeview, with early planning, the purchaser (Mac) could have invited the vendor to cancel its registration and make the supply without GST.

If the cancellation had been available to the vendor (without any increasing adjustment), the purchaser would have been able to purchase the entire property without GST and use the margin scheme on resale. What would have been the savings in GST?

EXAMPLE 2

XYZ Family Trust (Trust) has owned a large property in a Perth suburb since the 1970s. The land is presently very valuable. The Trust has never been registered for GST or required to be registered for GST due to it never charging market rent to its associated family business company XYZ Bricks Pty Limited (Bricks). Bricks moved to new premises several years ago, leaving the suburban property vacant. The Trust is enjoying the appreciation in value, but is struggling with the ongoing costs of holding the property.

A property developer, Big Gain Pty Limited (Big Gain), approaches the trustee with an offer to purchase the land for $10 million plus GST.

The trustee approaches his tax against for GST advice. The tax agent provides the following advice:

- The land has been used commercially
- Failing to account for GST could be a $1 million mistake
- Applying for a private ruling or seeking Counsel's opinion will cost money
- The Trust has never been registered for GST

- Registering for GST will allowing the Trust to give Big Gain a tax invoice of $11 million, including the GST of $1.0 million.
- Big Gain will presumably (although the agent is not advising this entity) recover the GST form the ATO as an input tax credit, thereby achieving a revenue neutral outcome; and
- Reporting and paying the GST to the ATO is a risk neutral position for the Trust to adopt and the Trust is happy to achieve a low risk revenue neutral outcome.

You are advising Big Gain. You are briefed that to consider and advise on the following issues:

- Consider section 188-25(a) of the GST Act and calculate Trust's prospective GST turnover at the time of the signing the contract of sale – is the turnover below or above $75,000?

- Consider the following - does the land qualify as a capital asset?

- What would the Commissioner say about this hypothetical transction? (see the ATO's GST Advice GSTA TPP 070 - *Goods and services tax: Is a party to a contract for the sale of a commercial property who deregisters for GST before settlement required to pay GST?*).

  If the Commissioner is satisfied that Trust's projected turnover is below the threshold, the Commissioner would cancel the registration.

What is the relevance of Trust's GST Registration for Big Gain?

- The outcome of the matter would give the purchaser (Big Gain) a significant advantage in terms of access to the margin scheme upon the sale of the town houses and the entitlement to use the full purchase price to calculate the margin, instead of some other amount.

    - See GSTR 2000/28 - Goods and services tax: attributing GST payable or an input tax credit arising from a sale of land under a standard land contract.

- What are the possible adjustment on cancellation of Trust's GST registration under section 138-5 of the GST Act?

- Big Gain may wish to fund a joint application for a private ruling to confirm that Trust can either not register for GST or cancel its registration and treat the sale of the property as a non-taxable supply.

- Big Gain cannot use the margin scheme if, when the company first purchased the property from Trust, the sale to Big Gain was fully taxable and the margin scheme was not used. Accordingly, if such ruling is obtained, Big Gain can use the margin scheme when it sells developed properties, thereby saving around $900k ($10 million / 11).

Stamp Duty – State Tax (NSW)

- In NSW, one of the more significant transaction costs associated with purchasing a property is "stamp duty". Stamp duty is imposed on the transfer of ownership in the real property.

- Generally, an instrument or transaction may be *"dutiable"* in NSW where it affects property in the jurisdiction of NSW or the instrument is executed by a party in the jurisdiction of NSW.

- Depending on the jurisdiction and type of instrument or transaction, the applicable duty payable may be "nominal" (ie a fixed amount, generally because a concession applies) or "ad valorem" (ie imposed on a sliding scale, with higher rates of duty being payable as the value of the transaction increases).

- The sanctions for the non-payment of duty are broadly similar across the jurisdictions, with penalty tax and interest applying to unpaid duty, and unstamped instruments being unenforceable and inadmissible in evidence until the correct duty is paid.

- Stamp duty paid on the transfer of real property will generally form part of the cost base of the property for the purposes of CGT.

- See Website: Transfer duty | Revenue NSW

Land Tax – State Tax (NSW)

- Land tax is a state-based tax that is payable in relation to property owned by an entity which is located in NSW and is not exempt from the payment of land tax.

- In New South Wales the assessment is made in relation to property which is owned as at 31 December in the year prior to the relevant land tax year. The land tax year is a calendar year.

- There are three main Acts in NSW that regulate the calculation and payment of land tax:

  - *Land Tax Act 1956* (NSW) — sets the land tax rates and thresholds;

  - *Land Tax Management Act 1956* (NSW) — deals with the fundamental issues of who has to pay land tax and when it is payable, as well as the exemptions to land tax; and

  - *Taxation Administration Act 1996* (NSW) — looks at general provisions relating to taxation such as:
    - assessment and reassessment of tax liability;
    - obtaining refunds of tax;
    - imposition of interest and penalty tax;
    - approval of special tax return arrangements; and
    - collection of tax.

- The provisions of the *Taxation Administration Act 1996* (NSW) have been held to apply to land tax.

- In addition to these main Acts, there are a number of other Acts that are relevant to the calculation and payment of land tax.

- See Website: [Land tax | Revenue NSW]

Conclusion

18. Given the constant changing landscape of taxation law it is appropriate to engage appropriately qualified professionals.

19. Taxpayer self-assessment is the basis of the Australian taxation system. This means the responsibility is placed on taxpayers to accurately complete their Business Activity Statements by the specified time (which is usually accepted as an honest lodgement by the Commissioner).

20. To assist taxpayers with their self-assessment, the ATO primarily offers both public and private binding rulings which taxpayers can use to guide them when they self-assess. Private rulings provide taxpayers with an opportunity to ascertain the Commissioner's opinion on the application of certain tax laws to their specific circumstances before they lodge a return. State and territory revenue offices also provide revenue rulings to assist taxpayers in lodging their returns in relation to state and territory tax laws.

21. It is important to be aware of the ATO private ruling process. Useful information is provided on the following ATO website below:

    a. https://www.ato.gov.au/General/ATO-advice-and-guidance/ATO-advice-products-(rulings)/Private-rulings/

22. Thank you for your attention.

Follow up questions are welcome at the following contact at Two Wentworth Chambers:

Email: wcalokerinos@wentworthchambers.com.au.

CASE STUDIES

Case Study - Long term construction contracts

Edited version of private advice
Authorisation Number: 1051823165583

Date of advice: 1 April 2021

Ruling

Subject: Long term construction contracts

Question 1

Would the Machinery Contracts be considered 'long term construction contracts' under Taxation Ruling TR 2018/3 Income Tax: tax treatment of long term construction contracts?

Answer

Yes

Question 2

Where question 1 is answered 'yes', for Machinery Contracts where a right to payment exists throughout the contract term, would the **estimated profits basis** be an allowable methodology under which to recognise the associated income and expenses?

Answer

Yes

This ruling applies for the following period

1 July 20XX to 30 June 20XX

The scheme commences on

1 July 20XX

Relevant facts and circumstances

The Company (Company A) is a privately held company.

The group specialises in the design, manufacture and supply of mineral processing solutions and associated machinery for the mining industry. Many of the machines are offered in fully mobile or semi-mobile designs.

Many of the machines manufactured are bespoke with adjustments made to the design to fit a customer's specific site and circumstances.

The machinery is manufactured on site. Given the size of the projects, the contracting arrangement ordinarily starts with a Contract for Supply of Equipment (a Machinery Contract) being signed by both parties. After the engagement terms are agreed a specific scope of work is prepared for each machine ordered.

The manufacture of a machine can take between 6 - 24 months, including installation, acceptance testing and monitoring phase (as required under the contract).

The value of the machinery can be anywhere from $XXX,XXX to $XX,XXX,XXX.

The Machinery Contracts are ordinarily scoped on a cost-plus basis and include a detailed estimate of the expenditure required to manufacture the machine.

Machinery Contract terms can be negotiated with the clients, however, there are two main types of contract terms for the manufacture of machinery:

- Distinct performance obligations which trigger the right to payment when milestones are met; and

- A right to payment exists throughout the term of the contract.

Additional information was supplied supplying an Example Machinery Contract: Manufacture and Supply Contract (Without installation), amongst other information. This information and attachments form part of these facts.

Expenditure Estimates/Pricing

The detailed expenditure estimate is not made available to the customer and therefore do not form part of the contract terms. However, the price is determined by Company A on a cost-plus basis, with a breakdown of the contract price provided to the customer.

As per the example contract provided, the quoted price includes the cost of all labour, management, supervision, services, personnel, plant and equipment, materials, logistic costs, profit and overheads.

Performance Obligations

The Contractors General Obligations, Design Obligations and Manufacturing Obligations are outlined within the standard terms of the agreement.

Rights to Payment

A right to payment exists throughout the contract- where the contract is terminated, the contractor is entitled to a portion of the contract price due for the work executed prior to the date of termination but not yet paid, including the cost of materials ordered by the contractor.

The general payment conditions and obligations are outlined in the example contract and are based upon a percentage completion basis on set milestones being achieved.:

Contract Specifics/Scope of Work

This example customer has very detailed contract specifics to ensure the equipment fits the site specification. Some of the specification may be considered as identifier for the Company.

The key specifics have been summarised as follows:

- The Manufacture and supply of X machines with an operating throughput of XXXX tonnes per hour;
- Quoted sales price - $X,XXX,XXX (GST exclusive);
- Payment to be received in line with progressive milestone payments; and
- Period of contract X months (approx. XXXX 20XX - XXXX 20XA).

Appendix X provided supplied the details of clauses within this Contract. Specific relevant clauses not already highlighted are clauses in respect to title and risk.

You have stated that in accordance with the company's financial statements, Company A's revenue recognition policy for manufacturing sales is as follows:

> *"Revenue is recognised as distinct performance obligations when delivered or where the contract results in services that have a right to payment. For contract revenue that has a right to payment that exists, a percentage completion basis will be applied."*

The treatment of the contracts with distinct performance obligations is in line with standard derivation principles outlined in section 6-5 of the *ITAA 1997*. The timing of this revenue is not in question.

The question arises in relation to the Machinery Contracts for which a right to payment exists throughout the project but is not derived until such time that a milestone is met. For accounting purposes, this income is recognised on a percentage completion basis under **AASB 15 Revenue from Contracts with Customers.**

The chosen method must be applied consistently to all income years over which the specific contract runs and any contracts of a similar nature (including service or maintenance contracts).

You state that the estimated profits basis would be the most reasonable approach as it is similar to the AASB 15 standard with the appropriate adjustments made for tax purposes.

Estimated Profits Basis Methodology - Percentage Completion

In the case of Machinery Contracts, each machine is costed in detail during the contracting phase. As such, the percentage completion basis is prepared on the basis of:

Percentage Completion = Expenses incurred in a financial year

- Total estimated costs

The percentage completion is then applied to the total sales value of the Machinery Contract, allowing a reasonable portion of the gross profit margin to be recognised throughout the project.

Company A has implemented several controls to ensure the percentage completion reasonably represents the status of the project. Prior to approval, the calculated percentage is presented to the project team for each Machinery Contract to confirm whether the outcome is a reasonable allocation. Once incorporated, the calculations are reviewed by Company A's auditors while completing the year end audit.

Upon preparation of the tax return, the percentage calculations are reviewed again from a tax perspective to confirm that all expenses have been incurred under section 8-1 of the *ITAA 1997* (or any other relevant tax provision). Where expenses have not been incurred for tax purposes, the necessary adjustments are made in the tax reconciliation such that the taxable income accurately reflects the tax position of the company.

You note that where there are no tax adjustments necessary, the estimated profits basis will allow Company A to recognise the revenue for Machinery Contracts in line with the AASB 15 standard.

You consider this policy should be an allowable methodology as:

- It spreads the gross profit margin across the project timeline on a reasonable basis where a right to payment under the Machinery Contract exists throughout the contract's term;
- It is in line with accepted accounting practices (AASB 15) and is approved by the company's auditors
- It is reviewed specifically from a tax perspective to ensure all expense amounts are actually incurred; and
- The reasonableness is confirmed by multiple parties to ensure there is no shortfall in amounts.

Relevant legislative provisions

Income Tax Assessment Act 1997 section 4-15

Income Tax Assessment Act 1997 section 6-5

Income Tax Assessment Act 1997 subsection 6-5(1)

Income Tax Assessment Act 1997 subsection 6-5(2)

Income Tax Assessment Act 1997 section 8-1

Reasons for decision

Question 1

Summary

It is considered that the Machinery Contracts, where the contract extends beyond a year of income (either extending for over a year or a period less than a year which straddles two income years) constitute a long-term construction contract for the purposes of **TR 2018/3**.

Detailed Reasoning

TR 2018/3 Income tax: tax treatment of long-term construction contracts (TR 2018/3) outlines the Commissioner's view on the income tax treatment of long term construction contracts.

TR 2018/3 defines '*long term*' construction work as that which extends beyond one year of income. This definition encompasses contracts which run for less than 12 months but straddle two income years. The Machinery Contracts in question are undertaken between 6 - 24 months and, therefore, would meet the definition of *'long term'* under **TR 2018/3**.

For the purposes of **TR 2018/3**, '*construction*' takes its ordinary meaning. That is, "*the process or method of building or making something, especially roads, buildings, bridges, etc.*" As outlined in paragraph 2 of TR 2018/3, "Income from long term construction contracts would include: ... income from the construction of major plant items."

Paragraph 2 of TR 2018/3 provides that income from long term construction contracts would include income from construction of buildings, bridges, dams, pipelines, tunnels and other civil engineering projects and income from construction of major plant items including ships and transport vessels. In particular, TR 2018/3 refers to income from similar contracts in associated fields such as air conditioning contracts, major electrical wiring or rewiring contracts, major refurbishment of hotels....

Paragraph 3 excludes the following from being a long-term construction contract:

> A long-term construction contract does not include a contract for the sale and supply of what may ordinarily be regarded as the sale of trading stock, for example, it does not include a contract for the supply and installation of office furniture in a new building even though the furniture may need to be assembled upon delivery

In consideration of your circumstances in relation to paragraph 3 of TR 2018/3, activity under the Machinery Contracts relates to supply and installation of equipment and systems that are integral to the successful operation of assets for the purpose which they are employed, therefore, they are integral to the construction of the major plant, in your circumstances major plant for use on a mining site.

That is, the machinery manufactured by Company A is considered to be fundamental to the operation of their customers' mine sites. On this basis, the machinery manufactured by Company A would be considered to constitute major plant items and, therefore, the manufacture of the machinery would meet the definition of 'construction' as outlined in **TR 2018/3**.

Further, the activities you are performing under the Machinery Contracts do not appear to be sales and supply over time of what would ordinarily be regarded as trading stock. Therefore, paragraph 3 would not act to exclude the Machinery Contracts from the application of TR 2018/3 in determining your taxable income.

This paragraph would appear to suggest that if an item was trading stock, then it would be excluded from the operation of TR 2018/3. The example given in TR 2018/3 of delivering and installing items of furniture (trading stock) progressively over a period of time does not align with the nature of the long term construction of the heavy mining equipment and the testing and installation thereof.

As the construction of the mining machinery and associated testing and installation over a period of time can be considered as representing the manufacture of major plant components and, therefore, aligning with the nature of those acceptable items, it is reasonable to conclude that the Commissioner intended **TR 2018/3** to apply to contracts of the nature of the Machinery Contracts.

Therefore, it is considered that the Machinery Contracts involving the design, manufacture and supply of mineral processing solutions and associated machinery, where the contract extends beyond a year of income, either extending for over a year or a period less than a year which straddles two income years, constitutes a long-term construction contract for the purposes of TR 2018/3.

Question 2

Summary

Yes, you may adopt the 'estimated profits basis' in respect of the Machinery Contracts, where a right to payment exists throughout the contract term, to recognise the associated income and expenses.

Detailed Reasoning

The Commissioner has formed the view in **Question 1** that the Machinery Contracts are long term construction contracts.

Accordingly, you may apply **TR 2018/3** when determining your taxable income and are eligible to apply either the 'basic approach' or the 'estimated profits basis'.

Paragraph 5 of TR 2018/3 states:

> *5. The principles and practices which apply in recognising for income tax purposes, income derived from and expenses incurred in long term construction contracts are:*
>
> *(a) All progress and final payments received in a year are to be included in assessable income and income tax deductions allowed for losses and outgoings to the extent permitted by law. [See Basic approach]*
>
> *(b) Notwithstanding (a) any method of accounting which has the effect of allocating, on a fair and reasonable basis, the ultimate profit or loss on a contract over the years taken to complete the contract will be acceptable. [See Estimated Profits Basis]*

TR 2018/3 discusses the requirement for consistent application of these methods. In particular, paragraph 6 of TR 2018/3 states that whichever of the methods is adopted by the taxpayer it must be applied on a consistent basis to 'all years during which the particular contract runs and to all similar contracts entered into by the taxpayer'. In addition, it is also stated that 'taxpayers who are companies in the one group should adopt the same method of determining taxable income'.

In the practical application of this view, where it is more appropriate to use a particular method to determine taxable income that is different to the method previously applied, any change must be applied consistently to new contracts entered into within a given income year. You cannot apply a different method to existing contracts.

It is considered that your percentage completed methodology aligns to the estimated profits basis as it "permits a taxpayer to spread the ultimate profit or loss on a long term construction project over the years taken to complete the contract, the basis is reasonable, is in accordance with accepted accountancy practices and appropriate adjustments are made for tax purposes."

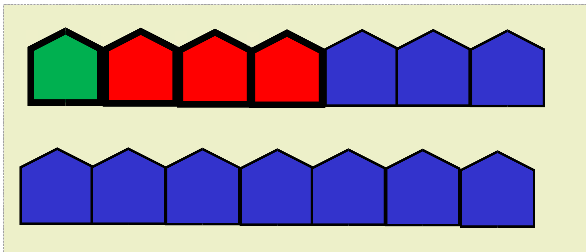
This policy is considered to qualify as an allowable methodology because:

- It is a method of accounting which has the effect of allocating, on a fair and reasonable basis, the ultimate profit or loss on a Machinery Contract over the years taken to complete the contract;
- It spreads the gross profit margin across the project timeline on a reasonable basis;
- It is in line with accepted accounting practices (AASB 15) and is approved by the company's auditors;
- It is reviewed specifically from a tax perspective to ensure all expense amounts are actually incurred; and
- The reasonableness is confirmed by multiple parties to ensure there is no shortfall in amounts.

Therefore, you may adopt the *'estimated profits basis'* in respect of the Machinery Contracts, entered into on or after 1 XXXX 20XX, where a right to payment exists throughout the contract term, to recognise the associated income and expenses.

Case Study - Mixed investment and sale projects

MIXED INVESTMENT/DEVELOPMENT



FACTS:

- **Thomas attained a property for the purpose of subdivision, building 1 shop (Green), 3 terrace houses (Red) and 48 townhouses for lease (Blue).**
- **To repay the bank, Thomas estimates that the shop, the 3 terrace houses and 15 townhouses would be sold (i.e. 36% of the project).**
- **In fact, only the shop, 3 terrace houses and 13 townhouses were sold (32% of the project)**

What tax issues arise?

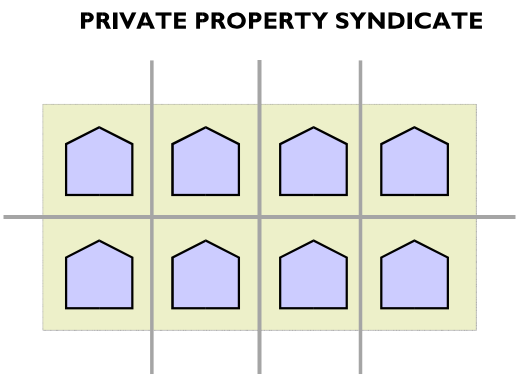
See the case of *ARM Construction P/L v FCT (case attached to paper)*:[15]

- The properties intended to be sold and in fact sold would be a profit-making scheme. The balance would retain their capital status.

- Although the taxpayer intended to sell an additional 2 townhouses, that expectation does not appear to make those 2 townhouses part of the profit-making scheme.

[15] *ARM Construction P/L v FCT* 87 ATC 4790, 4806; (1987) 19 ATR 337.

Case Study – Private property syndicate projects – Unit Trust



FACTS:

- Thomas and seven unrelated people acquired a property in a unit trust for the purpose of subdivision, building a house on each block and distributing the block in specie (in kind) to each unitholder.
- To reconcile the mixed purposes, the property should be subdivided and each block distributed in kind to the relevant unit holder.
- This will ensure the property is not trading stock and is not a profit-making scheme. This will permit the various unit holders to have different intentions.

What tax issues arise?

The terms of the unit trust will be vital.

- The unit holders of a traditional unit trust hold a tenants-in-common interest in all of the property (not any identifiable part of the property).[16]

- After subdivision, each unit holder owns a proportionate interest in each block.

- The partition and exchange of interests so that each unit holder owns one block absolutely represents a proportionate disposal of an interest in all other blocks.

[16] *CSR (Vic) v Karingal 2 Holdings P/L* [2003] VSCA 214.

- The disposal of the various interests will, therefore, have income tax consequences.[17]

If a special purpose unit trust is used where each unit in the trust grants a beneficial interest in the particular block of land, then the unitholder will have an absolute entitlement to the land and there is no partition and exchange.[18]

- The unit holder exemption exempts an in-kind transfer of land by the principal unit trust to a unit holder who was a unit holder at the time the land was acquired.

The transfer must be a transfer in the capacity of beneficiary and not on sale. There must not be any collateral consideration.

- The beneficiary must receive the property in its capacity that it owned the units. Where the unit holder was a company there must be no change in ownership control or as a trustee there must be no change in the relevant beneficiary from the date the land was acquired by the principal unit trust.

- The unit trust is treated as a separate entity for GST purposes and the in-kind distribution of property will have GST consequences.[19]

[17] *Determination* TD 92/148.
[18] Sec. 116-30 ITAA 1997; cf TR 2004/D25; *CSR (Vic) v Victoria Gardens Developments P/L* [2000] VSCA 233.
[19] By analogy with partnerships see *Rulings* GSTR 2003/13 & GSTR 2003/D5.

Taxation Ruling

Income tax: tax treatment of long term construction contracts

Contents Para

This publication provides you with the following level of protection:

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

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

Summary – what this ruling is about

1. This Ruling explains the methods acceptable to the Commissioner for returning income derived and recognising expenses incurred in long term construction projects. This Ruling affirms that the completed contracts method remains unacceptable under the income tax law.

Definitions

2. For the purposes of this Ruling, **'long term'** construction contracts refer to contracts under which construction work extends beyond one year of income. A construction contract which runs for less than twelve months, but straddles two or more income years is therefore regarded as a long term construction contract. The word **'construction'** takes its ordinary meaning. Income from long term construction contracts would include: income from construction of buildings, bridges, dams, pipelines, tunnels and other civil engineering projects; income from related activities such as demolition, dredging, heavy earth moving projects, etcetera; and income from the construction of major plant items including ships and transport vessels. It may also include income from similar contracts in associated fields depending on the facts and circumstances (that is, the contract and substance of the agreement), like air conditioning contracts, major electrical wiring or rewiring contracts, major

refurbishment of hotels, stores, etcetera, major construction management contracts, etcetera.

3. A long term construction contract does not include a contract for the sale and supply of what may ordinarily be regarded as the sale of trading stock, for example, it does not include a contract for the supply and installation of office furniture in a new building even though the furniture may need to be assembled upon delivery.[1]

Ruling

4. In contracts which extend beyond one income year, it is not permissible to defer the bringing of profits or losses to account until the contract is completed. [See **Unacceptable methods**]

5. The principles and practices which apply in recognising for income tax purposes, income derived from and expenses incurred in long term construction contracts are:

(a) All progress and final payments received in a year are to be included in assessable income and income tax deductions allowed for losses and outgoings to the extent permitted by law. [See **Basic approach**]

(b) Notwithstanding (a) any method of accounting which has the effect of allocating, on a fair and reasonable basis, the ultimate profit or loss on a contract over the years taken to complete the contract will be acceptable. [See **Estimated Profits Basis**]

Consistency of method

6. Whichever of the acceptable methods of determining taxable income from long term construction contracts is adopted by an entity, it is to be applied consistently to all years during which the particular contract runs and to all similar contracts entered into by the entity. (Service or maintenance contracts, being for the provision of services rather than for construction, are not within the scope of this Ruling and are not therefore ‘similar contracts’.)

Basic approach

7. All payments received or receivable are returned as assessable income in the year in which they are derived and expenditure is deductible in the year in which it is incurred.

[1] Income from the sale of trading stock is derived for income tax purposes when the stock is sold and a debt created notwithstanding that the debt is not payable until a future year: *J Rowe & Son Pty Ltd v. Federal Commission of Taxation* [1971] HCA 80.

Progress and final payments

8. All progress and final payments received in a year should be included in assessable income and income tax deductions allowed for losses and outgoings to the extent permitted by the income tax law.[2]

9. Assessable income arising from long term construction contracts includes not only progress and final payments actually received in a year but also amounts billed or billable to customers in a year for work carried out and certified as acceptable for payment by the appropriate person authorised to do so in the contract.[3] A taxpayer cannot defer assessment of contract income by refraining from or postponing billing until after the close of the income year when there was an entitlement under the contract to bill before the year end. Nor can the assessment of contract income be deferred by refraining from or postponing the obtaining of certification from the relevant party.

Up-front payments

10. For taxpayers who use the basic approach in determining taxable income, up-front payments[4] of contract price or advance progress payments are assessable income.

11. As a general rule an up-front payment or advance progress payment should be recognised as assessable income between its receipt and when the next progress payment is due. There may be situations where the circumstances surrounding an up-front payment warrant it being included in assessable income in a different period[5] or over a longer period. For example, if the payment was to enable the purchase of equipment etcetera, for use over the whole of the contract it would be proper to spread it over the whole period of the contract.

Retention clauses

12. For taxpayers who use the basic approach in determining taxable income, amounts retained under a retention clause[6] should not be included in assessable income until the taxpayer either receives them or is entitled to receive them from the customer.[7] Symmetrically, if the taxpayer, being a contractor, retains amounts

[2] Income assessable under section 6-5 and deductions allowed under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).
[3] *Henderson v. Federal Commissioner of Taxation* [1970] HCA 62.
[4] An up-front payment is part of the contract price, paid to a contractor at the time of, or prior to, beginning work.
[5] Cf *Arthur Murray (NSW) Pty Ltd v. Federal Commissioner of Taxation* [1965] HCA 58.
[6] A ‘retention clause’ is a provision in the contract for the customer to retain a portion of the contract price until the maintenance period specified in the contract has passed.
[7] *HW Coyle Ltd v. Commissioner of Inland Revenue (New Zealand)* 80 ATC 6012; 11 ATR 122.

from sub-contractors, the amounts so retained are not deductible until such time as they are due to the sub-contractors.

13. Where retention money is conditionally[8] paid by the customer to the contractor before it is actually due, the money will not be assessable income until the contractor is entitled to it.

14. Where contractors obtain bank guarantees (in lieu of customers retaining amounts from progress or final payments), in which the customers are guaranteed payment by the bank if the contractors become liable under the terms of warranties during the retention period, the inclusion in assessable income of amounts due to the contractors should not be reduced by the amounts guaranteed. If a contractor is required to pay to a bank any amount under the terms of a guarantee arrangement the amount so paid will qualify for income tax deduction when it is paid.

Work-in-progress

15. Work-in-progress does not represent trading stock. Work-in-progress is not on hand in the sense contemplated by Subdivision 70-C of the ITAA 1997. Property in it would normally belong to the client or customer, with the contractor having rights to sue for work done.

Expected costs

16. Accounting standards and practices cannot supplant the income tax law in determining whether deductions are allowable.[9] Tax law does not permit deductions for costs or losses which are expected to arise in performance of long term construction contracts. For taxpayers who use the basic approach, it is only losses and outgoings which are incurred during an income year which may be allowed as deductions.

Estimated Profits Basis

17. This basis permits a taxpayer to spread the ultimate profit or loss on a long term construction project over the years taken to complete the contract, provided the basis is reasonable, is in accordance with accepted accountancy practices and appropriate adjustments are made for tax purposes.

18. In this context, '**ultimate profit or loss**' refers to the overall taxable income expected to arise from a particular contract. It requires the total receipts expected to be received under the contract

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[8] For example, on condition that the contractor remedies any defects before the building is handed over or accepted by the owner.
[9] *HW Coyle Ltd v. Commissioner of Inland Revenue (New Zealand)* 80 ATC 6012; 11 ATR 122; *Grollo Nominees Pty Ltd v. Commissioner of Taxation* (1997) 97 ATC 4585; (1997) 36 ATR 424.

to be regarded as assessable income and income tax deductions to be allowed for expected losses and outgoings to the extent permitted by tax law, on the assumption that the losses and outgoings would actually be incurred over the period of the contract. In this context, 'ultimate profit or loss' does not mean:

- the result of the comparison between receipts and expenditure, or
- a figure determined by the application of accountancy principles.

19. Ultimate profit or loss is in effect notional taxable income expected to arise under a particular contract and it is the notional taxable income which may be spread over the years taken to complete the contract. Another way of determining notional taxable income is to begin with the expected overall net profit or loss for accounting purposes and make appropriate adjustments for income tax purposes.

20. Because the estimated profits basis focuses on the end result of a long term construction contract, the question of when an income tax liability attaches to up-front payments, advance progress payments and amounts withheld under retention clauses does not arise.

Accounting standard

21. The estimated profits basis is similar to the accounting standard AASB 15 *Revenue from Contracts with Customers*[10] but, as was held by the Full Federal Court in *Grollo Nominees*[11] and noted at paragraphs 18 and 19 of this Ruling, appropriate adjustments must be made for income tax purposes.

22. The introduction of AASB 15 does not necessarily bring into line the accounting recognition of revenue with the tax law. Revenue is recognised under accounting principles when performance obligations of the contract are satisfied, that is, when control has passed to the customer.[12] In contrast, the tax law recognises income when it is derived and expenses when they are incurred.

Costs taken into account

23. Only costs that are identified as likely to be incurred over the period of the contract and which are properly deductible are taken into account in calculating notional taxable income. These costs are estimated relying upon the taxpayer's experience in the construction

[10] The Australian Accounting Standards Board (AASB) published AASB 15 *Revenue from Contracts with Customers* in December 2014 with an effective start date of 1 January 2018.
[11] *Grollo Nominees Pty Ltd v. Commissioner of Taxation* (1997) 97 ATC 4585 at 4608-09; (1997) 36 ATR 424 at 452.
[12] AASB 15 *Revenue from Contracts with Customers* at paragraph 31.

industry and using sound commercial or business principles. The estimations must be well documented and can vary from year to year.

24. Costs of materials and labour are examples of properly deductible costs. General claims for a 'management reserve' or for 'additional costs arising from wet weather, industrial disputes etcetera', are not sufficiently informative about the actual costs involved to be properly deductible.

25. It is not sufficient to make a general claim for unspecified costs likely to arise on the happening of some future event. The calculation of notional taxable income needs to be more exact. The likely effect those future events will have on costs must be quantified. For example, where operations are conducted in a region with an average historical rainfall of 500ml per year, it would be reasonable to estimate the impact of that weather on the project and calculate the delay costs in respect of the contract activities.

26. It is permissible to take into account a reasonable amount for probable costs in remedying defects etcetera, during the maintenance period.

Tender costs

27. Tender costs are not taken into account in the estimated profits basis.[13] Although tender costs are attributable to the construction contract, they are severable from it and occur at a time before the beginning of the contract.

Methods of allocating notional taxable income

28. There are a number of acceptable methods of allocating notional taxable income over the years taken to complete a long term construction contract. They each seek to recognise notional taxable income in a manner that reflects the progress of a contract. The particular method used will depend upon the nature of a contract.

29. In a cost plus contract[14], the amount of notional taxable income to be included in assessable income in each year will be determined by ascertaining the percentage that notional taxable income bears to agreed cost and applying the percentage to costs incurred in a year.

30. In fixed price contracts, it will be a matter of determining the notional taxable income year by year and including an appropriate amount of the notional taxable income in assessable income of each year.

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[13] They may be deductible under section 8-1 of the ITAA 1997 in the year in which they are incurred.

[14] A contract where the contractor is to be paid for agreed cost plus a percentage or fixed fee.

31. Any other method which achieves the same broad result would also be acceptable. Whatever method is used, it must be applied consistently. [See **paragraph 6** of this Ruling.]

32. A basic principle of the income tax law is that liability to income tax is an annual event and, if it appears at the end of an income year that there is a profit element in a long term construction contract – regardless of the stage reached – the law operates so that an appropriate amount of the profit converted to notional taxable income must be returned. In the very early stages of a long term construction contract, it may not be apparent that any profits have been derived.

Recognising a loss

33. An 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.

Example 1

34. *A construction company is in the fourth year of a five year contract. At the end of the fourth year it seems probable that the company will incur an ultimate loss of $1,000 from the contract. The contract at the end of this income year is 80% complete with 20% having been performed during this income year. The construction company will return in this income year a loss sufficient to recognise the company has completed 80% of the contract, that is, the loss returned 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 the next income year, if the probable loss is realised, the company will return a loss of $200 representing the final 20% of the work on the contract.*

Changes over the contract period

35. In many cases, particularly where the contract price is fixed as a certain amount, the notional taxable income will not remain the same over the life of the contract. Estimates of costs and forecasts of profits prepared during contract negotiations are likely to change. The end result may differ markedly from initial expectations as a result of increases in costs, industrial issues, delays, inclement weather, disputes etcetera.

36. A taxpayer deriving income from long term construction projects is not irrevocably bound to the figure for profit or loss initially expected. It is something which can be adjusted from year to year, that is, in each year of the contract the amount of notional taxable income may be determined according to expectations existing at the close of each year.

Example 2

37. *If, using the figures in the below table, the notional taxable income had fallen to $200 in year 3, the amounts included in assessable income in years 1 and 2 (being $240 total) would have exceeded the total profit. The operation of subsection 170(9) of the Income Tax Assessment Act 1936 (ITAA 1936) enables the over-assessment to be rectified.*

	Year 1	**Year 2**	**Year 3**
(a) Estimated notional taxable income	$500	$400	$300
(b) Percentage of contract completed	20%	60%	100%
(c) Notional income to be returned = (a) × (b)	$100	$240	$300
(d) Less income already returned	$0	$100	$240
Assessable income	**$100**	**$140**	**$60**

38. *If, on the other hand, it appeared in year 2 that the contract would result in a loss, it would not be possible at that time to amend the assessment for year 1 to exclude the profit assessed in that year. At the time the assessment for year 1 was made, it was correctly made. The only provision which would authorise amendment is subsection 170(9) of the ITAA 1936, which does not operate until the contract is complete.*

Subsection 170(9)

39. Where the estimated profits basis is used, subsection 170(9) of the ITAA 1936 extends the period of time to amend an assessment where the ultimate taxable income from the contract differs from the previously anticipated amount that was used to calculate assessable income. The provision allows amendment of assessments to ensure that:

- income tax liability arising from contracts extending beyond one year of income is restricted to the ultimate profit or loss on the contracts, and
- estimated amounts of income upon which tax has been paid in relevant years accurately represent profits and/or losses attributable to the relevant years.

40. The provision contemplates the inclusion of an estimated amount of income derived by the taxpayer in the relevant year from an operation; the profit or loss in which was not ascertainable at the end of the year because the operation extended over more than one year.[15]

[15] *Grollo Nominees Pty Ltd* op. cit. (1997) 97 ATC 4585 at 4615; (1997) 36 ATR 424 at 459.

41. This provision ensures that a taxpayer's income tax liability is limited to the ultimate taxable income derived from the contract.

Unacceptable methods

42. Neither the 'completed contracts basis' (which returns profits and losses on completion of a contract) nor the 'emerging profits basis'[16] is an acceptable method for determining taxable income from long term construction contracts. Liability to income tax has to be determined annually. In the case of long term construction projects it is the position at the end of each year that has to be taken into account. Subsection 170(9) of the ITAA 1936 is the mechanism provided in the income tax law to ensure that, in the end result, there is not an over assessment of income tax liability.

43. A variation of these methods, which claims deductions for expenditure incurred in the year in which it is incurred, but does not include amounts derived under the contract in assessable income until the year in which the contract is completed or substantially completed, is similarly unacceptable.

Date of effect

44. This Ruling applies to years of income commencing both before and after 7 March 2018. 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).

Commissioner of Taxation
7 March 2018

[16] *Grollo Nominees Pty Ltd* ibid. (1997) 97 ATC 4585 at 4604 and 4608; (1997) 36 ATR 424 at 446 and 451.

Appendix 1 – Compliance approach

This Appendix sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow the advice in this appendix in good faith and consistently with the ruling section, the Commissioner will administer the law in accordance with this approach.

Amending assessments under subsection 170(9)

45. Whether or not assessments should be amended in terms of subsection 170(9) of the ITAA 1936 will depend upon the circumstances of the case. In requesting an amended assessment, taxpayers engaged in long term construction projects should provide a statement reconciling the ultimate taxable income with the amounts of notional taxable income included in assessable income over the years taken to complete the contract.

46. In some cases, notwithstanding that the ultimate taxable income may equal the total of the amounts of notional taxable income; it may appear that the yearly allocation was not correct. Where the rates of tax payable over the period have not altered it is unlikely that amendment to the assessments concerned is necessary. In many cases variations of this nature in one contract will be offset by variations in other contracts. In other cases taxpayers may request amended assessments, for example, a proper allocation of profit to earlier years to absorb otherwise undeducted losses. In these cases assessments should be amended.

Estimated Profits Basis interacting with other provisions

47. The term ‘ultimate profit or loss’, as explained in paragraphs 18 and 19 of this Ruling, refers to the overall taxable income expected to arise from a particular contract. It requires the receipts expected to be received under the contract to be regarded as assessable income and deductions to be allowed for expected losses and outgoings to the extent permitted by law (assuming the losses and outgoings are actually incurred).

48. A taxpayer who uses the Estimated Profits Basis may use notional taxable income to work out their income tax liability. It is not appropriate to use this notional amount for eligibility tests in the tax law that rely on other principles. For example, it is not appropriate to use notional taxable income in determining whether an entity is a ‘base rate entity’ within the meaning of section 23AA of the *Income Tax Rates Act 1986* as that provision relies on ‘aggregated turnover’. ‘Turnover’ requires the total receipts expected to be received under the contract to be regarded as assessable income.

Appendix 2 – Detailed contents list

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

References

Previous draft:

TR 2017/D8

Previous Rulings/Determinations:

TD 92/131; TD 92/186; TD 94/39; TD 94/65; TD 94/87

Legislative references:

- ITAA 1936
- ITAA 1936 170(9)
- ITAA 1997
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 Subdiv 70-C
- TAA 1953
- Income Tax Rates Act 1986
- Income Tax Rates Act 1986 23AA

Cases relied on:

- Arthur Murray (NSW) Pty Ltd v. Federal Commissioner of Taxation (1965) 114 CLR 314; (1965) 39 ALJR 262; (1965) 14 ATD 98; [1965] HCA 58
- Grollo Nominees Pty Ltd v. Federal Commissioner of Taxation (1997) 73 FCR 452; (1997) 36 ATR 424; (1997) 147 ALR 330; 97 ATC 4585
- Henderson v. Federal Commissioner of Taxation (1969) 119 CLR 612; (1969) 43 ALJR 172; (1969) 15 ATD 298; 69 ATC 4049; (1969) 1 ATR 133; [1970] HCA 62
- H.W. Coyle Limited v. Commissioner of Inland Revenue (New Zealand) 80 ATC 6012
- J Rowe and Son Pty Ltd v. Federal Commission of Taxation [1971] HCA 80; (1970) 124 CLR 421; (1970) 45 ALJR 21; (1970) 2 ATR 121; 71 ATC 4001

Other references:

- AASB 15 Revenue from Contracts with Customers

ATO references

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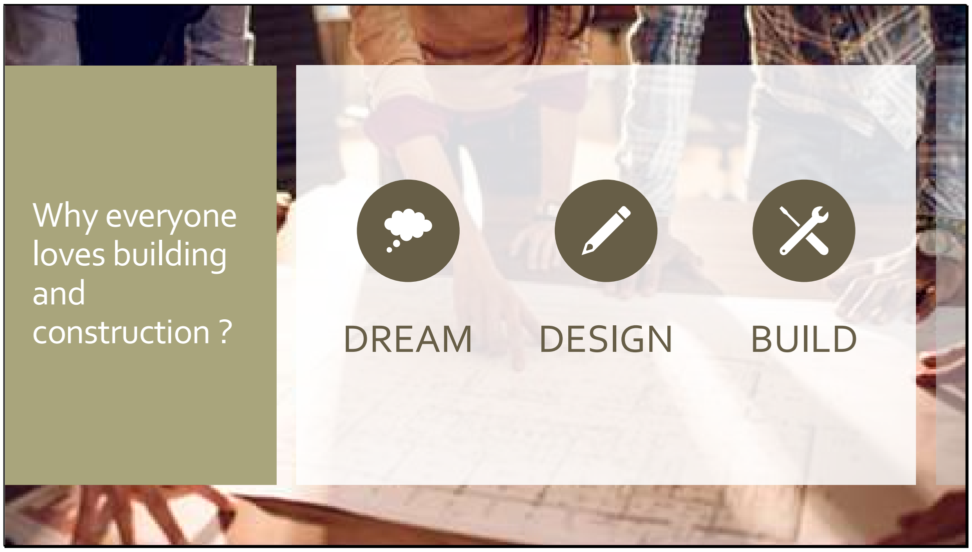
Slide 1


Tax Treatment of Construction Contracts
William Calokerinos
Two Wentworth Chambers

Slide 2


Why everyone loves building and construction ?
DREAM
DESIGN
BUILD

Slide 3

Seminal Concepts – Part A

Slide 4

DESIGN AND CONSTRUCT CONTRACT AASB 4902

Slide 5

See the written paper - pages 6 to 12 inclusive .

Slide 6

Income Tax Concepts – Part B

Slide 7

- TR 2018 /3

See written paper – pages 12 to 15 inclusive.

Slide 8

Slide 9

Slide 10

CASE STUDY –

See pages 35 to 41

Authorisation Number:
1051823165583

Question 1: Would the Machinery Contracts be considered 'long term construction contracts' under Taxation Ruling TR 2018/3 *Income Tax: tax treatment of long-term construction contracts*?

Slide 12

Question 2: Where question 1 is answered 'yes', for Machinery Contracts where a right to payment exists throughout the contract term, would the estimated profits basis be an allowable methodology under which to recognise the associated income and expenses?

Relevant Facts and Circumstances:

1. The Company (Company A) is a privately held company.

2. The group specialises in the design, manufacture and supply of mineral processing solutions and associated machinery for the mining industry. Many of the machines are offered in fully mobile or semi-mobile designs.

3. Many of the machines manufactured are bespoke with adjustments made to the design to fit a customer's specific site and circumstances.

4. The machinery is manufactured on site. Given the size of the projects, the contracting arrangement ordinarily starts with a Contract for Supply of Equipment (a Machinery Contract) being signed by both parties. After the engagement terms are agreed a specific scope of work is prepared for each machine ordered.

5. The manufacture of a machine can take between 6 - 24 months, including installation, acceptance testing and monitoring phase (as required under the contract).

6. The value of the machinery can be anywhere from $900,000 to $10,000,000**.**

7. The Machinery Contracts are ordinarily scoped on a cost-plus basis and include a detailed estimate of the expenditure required to manufacture the machine.

8. Machinery Contract terms can be negotiated with the clients, however, there are two main types of contract terms for the manufacture of machinery:

- Distinct performance obligations that trigger the right to payment when milestones are met; and
- A right to payment exists throughout the term of the contract.

Expenditure Estimates/Pricing

The detailed expenditure estimate is not made available to the customer and therefore do not form part of the contract terms. However, the price is determined by Company A on a cost-plus basis, with a breakdown of the contract price provided to the customer.

As per the example contract provided, the quoted price includes the cost of all labour, management, supervision, services, personnel, plant and equipment, materials, logistic costs, profit and overheads.

Slide 18

Performance Obligations

The Contractors General Obligations, Design Obligations and Manufacturing Obligations are outlined within the standard terms of the agreement.

Rights to Payment

A right to payment exists throughout the contract- where the contract is terminated, the contractor is entitled to a portion of the contract price due for the work executed prior to the date of termination but not yet paid, including the cost of materials ordered by the contractor.

Slide 20

The general payment conditions and obligations are outlined in the example contract and are based upon a percentage completion basis on set milestones being achieved.

Contract Specifics/Scope of Work
This example customer has very detailed contract specifics to ensure the equipment fits the site specification. Some of the specification may be considered as identifier for the Company.

Slide 21

The **key specifics** have been summarised as follows:

- The Manufacture and supply of X machines with an operating throughput of XXXX tonnes per hour;
- Quoted sales price - $X,XXX,XXX (GST exclusive);
- Payment to be received in line with progressive milestone payments; and
- Period of contract X months (approx. XXXX 20XX - XXXX 20XA).

Slide 22

Appendix X provided **supplied the details of clauses within this Contract.** Specific relevant clauses not already highlighted are clauses in respect to title and risk.

You have stated that in accordance with the company's financial statements, Company A's **revenue recognition policy** for manufacturing sales is as follows:

Slide 23

Revenue Recognition

"Revenue is recognised as distinct performance obligations when delivered or where the contract results in services that have a **right to payment**. For contract revenue that has a right to payment that exists, **a percentage completion basis will be applied**."

Slide 24

The treatment of the contracts with distinct performance obligations is in line with standard derivation principles outlined in section 6-5 of the *ITAA* 1997 (Cth). The timing of this revenue is not in question.

Slide 25

The question arises in relation to the Machinery Contracts for which a right to payment exists throughout the project but is not derived until such time that a milestone is met. For accounting purposes, this income is recognised on a percentage completion basis under AASB 15 *Revenue from Contracts with Customers*.

The chosen method must be applied consistently to all income years over which the specific contract runs and any contracts of a similar nature (including service or maintenance contracts).

Slide 27

You state that the estimated profits basis would be the most reasonable approach as it is similar to the AASB 15 standard with the appropriate adjustments made for tax purposes.

Slide 28

Estimated Profits Basis Methodology - Percentage Completion

In the case of Machinery Contracts, each machine is costed in detail during the contracting phase. As such, the percentage completion basis is prepared on the basis of:

$$\text{Percentage Completion} = \frac{\text{Expenses incurred in a financial year}}{\text{Total estimated costs}}$$

Slide 29

The percentage completion is then applied to the total sales value of the Machinery Contract, allowing a reasonable portion of the gross profit margin to be recognised throughout the project.

Slide 30

Company A has implemented a number of controls to ensure the percentage completion reasonably represents the status of the project. Prior to approval, the calculated percentage is presented to the project team for each Machinery Contract to confirm whether the outcome is a reasonable allocation. Once incorporated, the calculations are reviewed by Company A's auditors while completing the year end audit.

Slide 31

Upon preparation of the tax return, the percentage calculations are reviewed again from a tax perspective to confirm that all expenses have been incurred under section 8-1 of the ITAA 1997 (or any other relevant tax provision). Where expenses have not been incurred for tax purposes, the necessary adjustments are made in the tax reconciliation such that the taxable income accurately reflects the tax position of the company.

Slide 32

You note that where there are no tax adjustments necessary, the estimated profits basis will allow Company A to recognise the revenue for Machinery Contracts in line with the AASB 15 standard.

You consider this policy should be an allowable methodology as:

- It spreads the gross profit margin across the project timeline on a reasonable basis where a right to payment under the Machinery Contract exists throughout the contract's term;

Slide 33

- It is in line with accepted accounting practices (AASB 15) and is approved by the company's auditors

- It is reviewed specifically from a tax perspective to ensure all expense amounts are actually incurred; and

- The reasonableness is confirmed by multiple parties to ensure there is no shortfall in amounts.

Slide 34

Relevant legislative provisions

Income Tax Assessment Act 1997 section 4-15

Income Tax Assessment Act 1997 section 6-5

*Income Tax Assessment Act 1997 s*ubsection 6-5(1)

Income Tax Assessment Act 1997 subsection 6-5(2)

Income Tax Assessment Act 1997 section 8-1

Slide 35

Reasons for decision

- See pages 38 to 41 inclusive of

Slide 36

State Taxes: Land Tax and Stamp Duties Consequences

Slide 37

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