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ATO: new guidance on tax treatment of long-term construction contracts

Newsflash

The Commissioner of Taxation recently released a draft ruling, TR 2017/D8, on issues arising from long-term construction contracts. The ruling includes guidance on tax accounting for profits derived and losses incurred during such contracts. It discusses important issues to which any developer must have regard in planning and organising their tax affairs. It emphasises the differences between accounting standards and the requirements of income tax legislation.

'Long-term construction contracts' are contracts that take place over more than one income year. This includes contracts of less than 12 months' duration, but straddling two income years (eg a contract that commenced in May 2017 and completed in September 2017 would be a long-term construction contract, as it straddles both the 2016–17 and 2017–18 income years).

Acceptable Accounting Methods

The Ruling confirms that there are two accounting methods that can be used in accounting for profits and losses. The Basic Approach involves each progress and final payment, and each deductible loss and outgoing, being included in the developer's assessable income in the same year in which the losses, outgoings and payments occur. The Estimated Profits Basis involves the 'ultimate profit or loss' on a contract being allocated on a 'fair and reasonable basis' over the years taken to complete the contract. Once one method is chosen, it must be applied consistently throughout the entire period of the contract.

The Ruling provides some guidance on how to treat payments in specific scenarios. For example, it clarifies that under the Basic Approach, payments cannot be artificially deferred. Payments are included in a taxpayer's assessable income in the year in which the taxpayer became entitled to the payments, even if the taxpayer delayed billing them in an attempt to defer the payments to the following income year.

In relation to the Estimated Profits Basis, the Ruling explains that 'ultimate profit or loss' refers to the 'overall taxable income expected to arise from the contract'. In its discussion of the Estimated Profits Basis, the Ruling emphasises that adjustments may be necessary where income tax treats profits differently to accounting standards. The Ruling explains that costs are only deductible if, using industry experience and sound commercial principles, it can reasonably be concluded that those costs are 'likely to be incurred'. The Ruling emphasises that such costs must be identified with specificity – a general claim for 'wet weather' is not deductible, but a claim based on average rainfall for the area in question, and an estimate of the effect of that rainfall on the construction project, may be deductible.

When using the Estimated Profits Basis, both income and losses must be allocated to particular income years in a manner that 'reflects the progress of a contract'. Multiple methods of doing so are acceptable.

Unacceptable Accounting Methods

The 'completed contracts basis', under which all profits and losses are recorded only upon completion, is not acceptable, despite being an acceptable method of accounting. The Commissioner considers that the Income Tax Assessment Act 1997 (Cth), unlike accounting standards, requires assessable income to be

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determined from year to year. Thus, while an approach that distributes income and losses across years is acceptable, an approach that reports income and losses only at the end of the project is unacceptable. Similar approaches, such as claiming deductions each year but only reporting income at the completion of the project, are similarly unacceptable.

This ruling highlights the potential differences between accounting standards and the requirements of income tax legislation. Developers should ensure that their tax affairs are managed with this difference in mind. If in doubt, a tax or legal practitioner should be consulted.

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15 December 2017