2 June 2009

The Manager
Corporate Tax Unit
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: consolidation@treasury.gov.au

Dear Sir

Tax Laws Amendment (2009 Measures No. 4) Bill 2009: Consolidation

We thank you for the opportunity to provide comment on the exposure draft of *Tax Laws Amendment (2009 Measures No. 4) Bill 2009: Consolidation* ("the **ED**").

The Property Council of Australia is the peak body representing the interests of owners and investors in Australia's $320bn property investment sector.

This submission relates to one specific issue identified by members in the ED. We have not formed a view or made any specific comment on the other issues in the consultation.

A further submission may be made regarding our additional thoughts on this issue and other issues within the ED. We are aware that you have a tight timeframe for considering amendments and do not intend that this should delay your timetable.

1. Relevant Provisions

This submission deals with item 2 of Schedule 1 to the ED, being the proposed substitution of s701-55(6) for that set out in the ED.

In particular, we are concerned that example 1.3 in the explanatory material that accompanied the ED ("the **EM**") is unclear and confusing given the wording of s701-55(6) in the ED.

Specifically, the proposed legislation rightly does not contain a timing rule for claiming the deduction, but the EM contains an example with respect to construction contracts which states that the deduction is to be claimed at the end of the contract. This is not in keeping with the two acceptable timing methods under IT 2450 (being the basic method, or the emerging profits method).

The EM example should adopt a timing method consistent with IT 2450.

Proposed s701-55(6) in the ED

The proposed section 701-55(6) clarifies the meaning of "an asset's tax cost is set", by relevantly stating that:

> *(6) If any provision of this Act… is to apply in relation to the asset by including an amount in assessable income, or by allowing an amount as a deduction, in a way that brings into account… any of the following amounts:*
>
> *…*
>
> *(c) expenditure in respect of the asset;*
>
> *…*
>
> *the expression means that the provision applies… as if the… expenditure had been incurred or paid to acquire the asset at the particular time for an amount equal to its tax cost setting amount.*

Accordingly, the proposed s701-55(6) amendment deems the head company of a consolidated group to have incurred expenditure in respect of an asset that is not previously dealt with by section 701-55 at the time the subsidiary member joins the head company's tax consolidated group. The proposed section 701-55(6) is silent with respect to the time at which the head company gets to take that deemed expenditure into account in determining its taxable income or tax loss.

Example 1.3 in the EM

The proposed section 701-55(6) is silent as to timing, however the EM provides a number of examples which suggest the time at which the head company can take the deemed expenditure into account.

In the context of long-term construction contracts, example 1.3 in the EM (on pages 15 and 16) provides:

Example 1.3: Long-term construction contract

> *Head Co acquires all of Company J's membership interests. Consequently, Company J joins Head Co's consolidated group.*
>
> *Company J has a partially completed construction contract at the joining time – that is, broadly, it has partially performed some work under the contract that has not yet been completed to a stage where a recoverable debt has arisen. For accounting purposes, Company J has estimated the amount of partly earned unbilled income as $25,000.*
>
> *Under the tax cost setting rules, the construction contract is a reset cost base asset. The tax cost setting amount allocated to the asset is $20,000.*

> *If the construction contract is a revenue asset (as defined in section 977-50) of Company J, then subsection 701-55(6) will apply to specify the use of the tax cost setting amount for the contract by Head Co. That is, Head Co can use the tax cost setting amount for the contract ($20,000) to work out:*
>
> - *the amount of profit to be included in assessable income under section 6-5 in respect of the contract* ***when it is completed****; or*
> - *the loss to be deducted under section 8-1 in respect of the contract* ***when it is completed****.* [Emphasis added]

Accordingly, example 1.3 states that the tax cost setting amount allocated to a construction contract should be taken into account by the head company at the completion of the relevant contract.

2. Submission

Time for taking tax cost setting amount of construction contracts into account

The time for taking into account the expenditure that the head company is deemed to incur in respect of a long-term construction contract in example 1.3 of the EM (i.e. the completion of the contract) is in contrast to the two tax accounting methods that the Australian Taxation Office ("**ATO**") accepts in income tax ruling IT 2450 ("the **Ruling**").

In the Ruling, the ATO states that:

> *34. In CM 639 it is stated that* ***the completed contracts basis is not an acceptable method for determining taxable income from long term construction contracts****. This is still the case. The reason that it is not acceptable is, as is stated earlier, that 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. Sub-section 170(9) 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.* [Emphasis added]

The ATO requires that a taxpayer consistently recognise income from a long-term construction contract using either:

- the basic method (i.e. recognise revenue as derived and costs as incurred); or
- the emerging profits method (i.e. recognise an estimated profit on the contract on a "percentage completed" basis).

Neither of the methods that the ATO permits would allow a taxpayer to calculate its profit or loss on the contract when it is completed. Indeed, para

34 of IT 2450 specifically disallows deferring the recognition of profit or loss on a construction contract until the completion of that contract. This is a long established position. Indeed, para 5 of the Ruling notes that CM 639 was issued in 1951, and para 3 of the Ruling refers to Income Tax Order No 128, issued as far back as 1915.

Given that the purpose of s 701-55(6) is to simply deem a head company to have incurred expenditure in relation to an asset (i.e. a construction contract), but that the Act will otherwise apply as normal, then the timing for taking into account the tax cost setting amount of a long-term construction contract set out in example 1.3 of the EM is incorrect.

Instead, the tax cost setting amount of a long-term construction contract should be taken into account by a head company:

- if the head company tax accounts for long-term construction contracts using the basic method – when the tax cost setting amount expenditure is deemed to be incurred (i.e. at the joining time of the relevant subsidiary member); or
- if the head company tax accounts using the profit emerging method – by taking that cost into account in estimating the profit which the head company is to return over the remaining life of the construction contract.

For completeness, we note that example 1.2 in the EM already suggests that a head company can claim a deduction for the tax cost setting amount of consumable stores at the joining time of the subsidiary member, where the "incurred basis" of tax accounting for consumable stores is used.

If you require any further information, or would like to discuss this submission, please contact Andrew Mihno on 0406 45 45 49.

Yours faithfully,

Roberto Fitzgerald
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