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14 February 2020

Assistant Commissioner James Beeston
Australian Taxation Office
By email: james.beeston@ato.gov.au

Dear James

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

CPA Australia represents the diverse interests of more than 164,000 members working in 150 countries and regions around the world. We make this submission on behalf of our members and in the broader public interest.

The Commissioner's views as expressed in TR 2019/D6 (**the Draft Ruling**) have far-reaching consequences with a broad spectrum of arrangements and circumstances captured. There is the potential that the Draft Ruling will impose significant compliance burdens and there remains a lack of clarity for certain issues.

We submit that:

- Financial reporting standards do not determine the characterisation of expenditure for tax purposes
- The binding paragraphs of the Draft Ruling should address the character of expenditure, working expenses and on-costs
- The Commissioner's position on apportionment imposes significant compliance costs and may be unreasonable, especially for small and medium sized businesses
- The circumstances of businesses with peripheral or minor activities related to construction or creation of capital assets should be addressed in the Draft Ruling
- Clarity on the deductibility of labour costs associated with the implementation and installation of capital assets should be provided.

Detailed comments are included in the Attachment.

If you have any queries, contact Elinor Kasapidis, Tax Policy Adviser, at elinor.kasapidis@cpaaustralia.com.au or 03 9606 9666.

Yours sincerely

Dr Gary Pflugrath CPA

Executive General Manager, Policy and Advocacy
CPA Australia

Encl.

Attachment

The role of accounting records in determining character of expenditure

The capitalisation of an item of expenditure for accounting purposes should not be included in the Draft Ruling as a relevant factor in determining the character of labour costs.

Generally, the way in which a taxpayer accounts for items of expenditure for financial reporting purposes is determined by the relevant financial reporting standards and has little or no relationship with the taxpayer's assessment of the character of the expenditure for tax purposes. The appropriate tests established in *Sun Newspapers Limited v Federal Commissioner of Taxation* [1938] HCA 73 are the basis for determining the character and should not be altered by reference to other requirements such as those made under financial reporting standards.

AASB 116 *Property, Plant and Equipment* (AASB 116), AASB 138 *Intangible Assets* and the associated interpretations are specific to financial reporting and interdependent with other standards such as AASB 136 *Impairment of Assets* (AASB 136).

Paragraph 7 of AASB 116 notes that the standard is dealing with the accounting recognition of an asset's value which is clearly distinct from the legal question of capital for taxation purposes. While AASB 116 includes a broad range of items in the cost of an asset, such costs may be written off under AASB 136. Accordingly, for accounting purposes, the nature of capitalising costs is regulated through the application of AASB 136 as outlined in paragraph 11.

In our view, the application of these standards is not relevant to determining whether the tests in *Sun Newspapers Limited v Federal Commissioner of Taxation* [1938] HCA 73 should apply to the relevant expenditure. For example, is the Commissioner suggesting that all capitalised costs that are expensed under AASB 136 should be considered 'losses incurred' and thus deductible for income tax purposes?

While there is some judicial support for the role of accounting records in a tax context, this has largely been confined to the ascertainment of the amount of expenditure or loss, or when the amount is taken to have been incurred, to determine whether they are deductible.[1]

The Draft Ruling refers to four cases as general authority, none of which we consider provide strong support for the Commissioner's position that financial reporting standards play a role in determining whether a loss or outgoing is incurred on capital or revenue account:

- In *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes* [1985] PNGLR 129 (the only case of the four to consider the issue of capital/revenue), Justice Brindeyer referred to the usefulness of accounting evidence in circumstances where "*the accounting treatment of an item is not contrary to legal principle"*. Notwithstanding that they were capitalised for accounting purposes, the Court nevertheless held the interest expenses were on revenue account.
- *RACV Insurance Pty Ltd v Commissioner of Taxation* [1975] VR 1 and *Commercial Union Assurance Company of Australia Limited v Commissioner of Taxation* [1977] VicSC 202 both considered the deductibility of outstanding claims liabilities in an insurance context. In each case, the 'long established practice of insurance companies'[2] to include the amounts in their accounts was considered relevant to whether the outgoings could be said to be incurred within that income year.
- Finally, in *Commissioner of Taxation (Cth) v James Flood Pty Ltd* [1953] HCA 65, the High Court, referring to comments made in *Inland Revenue Commissioners v James Spencer & Co* (1952) SLT 266, stressed that although accounting principles may 'assist', "*it is not a matter depending upon 'proper commercial and accountancy practice rather than jurisprudence.'"*[3]

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[1] *Coles Myer Finance Ltd v Federal Commissioner of Taxation* (1992–3) 176 CLR 640, *Commissioner of Taxation (Cth) v James Flood Pty Ltd [1953] HCA 65*, *Commissioner of Taxation (NSW) v Manufacturers' Mutual Insurance Ltd* (1931) 31 SR (NSW) 575, *Nilsen Development Laboratories Pty Ltd v Federal Commissioner of Taxation* (1981) 144 CLR 616.
[2] *RACV Insurance Pty Ltd v Commissioner of Taxation* [1975] VR 1.
[3] This was also confirmed in *Coles Myer Finance Limited v FCT* (1992-1993) 176 CLR 640.

These cases may provide evidence of occasions where the court has considered accounting or commercial principles. But so too are there occasions where the court has declined to do so[4].

More recently, the Federal Court in *Healius Ltd v Commissioner of Taxation* [2019] FCA 2011 rejected evidence as to the accounting treatment of certain contracts, which were stated as including the purchase of the goodwill of a doctor's practice, in determining whether the outgoing was capital in nature. The taxpayer had capitalised the expenditure in their financial statements and reported it to goodwill. At paragraph [47], Perram J noted:

> *The evidence of Mr Duff establishes that the accounting treatment was a result of the accounting standards and not of any particular perception about the nature of the transactions.*

Later at paragraph [71], Perram J concludes:

> *In any event, it is likely correct, as Mr Richmond submitted, that the task for the Court is to determine whether the lump sum payments were deductible or not 'and it would be nothing to the point to say that the company could properly or did, in fact, debit the expenditure in question to its profit and loss account for the income year in question'.*

Further, ATO IDs 2011/42 and 2011/43 use financial reporting standards only for the purposes of a fair and reasonable basis for apportionment, not to indicate character.

Even if it were accepted that accounting evidence is a useful indicator in ascertaining the true nature of labour costs, the Courts have made it clear that accounting records can never be substituted by the test laid down in law[5].

For these reasons, the Commissioner should be cautious in considering 'the accounting, control and governance systems' used to record the costs for construction activities in determining whether workers are specifically employed for the purposes of those construction activities.

Specifically:

- we disagree with the position in paragraph 22 of the ruling that accounting records form a rational and reasonable basis for the classification of labour as being revenue or capital for income tax purposes
- we do not agree with the statement in paragraph 63 that 'there is substantial case law indicating that the way the expenditure is classified and treated for accounting purposes and how the accounting systems record expenditure may be a useful indicator of the facts and circumstances surrounding the expenditure' without cited authorities that address the importance of financial reporting standards in determining whether an amount is capital
- paragraph 66 states that the Commissioner will 'at times' consider accounting treatment to be a relevant factual consideration but does not provide guidance or authorities to assist taxpayers in determining when this will occur
- we recommend that paragraphs 63 to 66 and the example in paragraph 22 be reconsidered given the inappropriate conflation of financial reporting standards with taxation law.

We reiterate that the appropriate test is whether the relevant expenditure (in this case, labour costs) are capital in nature, by reference to the nature of the advantage sought, the way the advantage is to be used and the means adopted to obtain that advantage[6]. No conclusions should be drawn from what a taxpayer is required, under the financial reporting standards, to capitalise.

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[4] See, for example, *Tyco Australia Pty Ltd v FC of T* 2007 ATC 4799*, Healius Ltd v Commissioner of Taxation* [2019] FCA 2011, *Broken Hill Theatres* (1952) 85 CLR 423.

[5] See, for example, *Commissioner of Taxation (Cth) v James Flood Pty Ltd* (1953) 88 CLR 492, *Ogilvy & Mather Pty Ltd v Federal Commissioner of Taxation* 90 ATC 4836*, FC of T v Citibank Ltd & Ors* 93 ATC 4691; *Arthur Murray (NSW) Pty Limited v Commissioner of Taxation of the Commonwealth of Australia* (1965) 114 CLR 314.

[6] *Sun Newspapers Limited v Federal Commissioner of Taxation* [1938] HCA 73.

Characterising labour costs

It is our view that the Draft Ruling does not provide sufficient clarity or reasoning to assist taxpayers in determining whether labour costs are capital or revenue for the large variety of situations faced by business. The issue of the character of the expenditure is not addressed in the binding paragraphs of the Draft Ruling. As Hill J stated in *Goodman Fielder Wattie Ltd v Commissioner of Taxation* [1991] FCA 264:

> *There will be cases where it may be difficult to determine whether the expenditure should properly be regarded as on capital account or as on revenue account. Each case will depend upon its facts but the answer will not be derived merely by counting the number of hours in which the employee is engaged in activities which themselves may be said to involve matters of capital. Further, it will be necessary to determine whether the essential character of the expenditure is a working expense. If it is, then it will ordinarily be on revenue account.*

The Draft Ruling would benefit from discussion of what the Commissioner considers to be working expenses beyond non-binding paragraphs 54 and 55. This can be complemented by a clear distinction between employment to achieve an outcome (e.g. completed construction of a capital asset) and employment for the purposes of general labour. As noted by Lee J. in *Associated Minerals Consolidated Limited v The Commissioner of Taxation* [1994] FCA 900:

> *At the relevant time the staff engaged in supervisory duties rendered their services in the course of ordinary employment of a continuing nature. It is inappropriate to attempt to isolate some part of duties so rendered and treat part of the remuneration paid for those services as being on capital account.*

We suggest that the examples in paragraph 55 be better elucidated as they are currently too vague to be of assistance. It would be helpful to also provide examples of engineers, construction workers, scientists, software developers and similar employees whose wages would be on revenue account, as well as situations involving the creation of intangible assets, such as:

- wages for software developers hired as general employees who work on multiple projects with some time spent on maintaining and updating existing products and other time spent on creating new products
- digital start-ups creating intangible assets with probable future economic benefits.

Guidance on the outcome of capitalising labour costs should also be provided, in particular whether they fall under the capital allowance provisions, form part of the cost base for capital gains or are black-hole expenditure.

Further, the Draft Ruling currently does not clearly state the Commissioner’s view in relation to on-costs such as:

- paid or accrued annual leave
- paid or accrued long service leave
- workers compensation payments
- pay-roll tax payments, and
- fringe benefits tax paid on employee benefits.

Given that such payments are generally not going to be reflected in the state or nature of the asset, we consider that the character of the payment is not for the creation or construction of a capital asset but rather to discharge a legal obligation imposed on the employer. It would be beneficial for the Commissioner to clearly state his view.

Apportionment

The Draft Ruling suggests that apportionment would be required for a wide range of situations in any business creating or constructing capital assets. This creates a significant compliance burden by requiring analysis of each outgoing to determine its characteristics, which will particularly affects businesses with a mix of projects and functions across revenue and capital accounts.

For instances where labour costs are found to be partly on capital account, paragraph 30 suggests that it is fair and reasonable for the Commissioner to expect taxpayers to review 'WBS, time-writing, cost centre allocations, project governance documents, charter of responsibilities, job descriptions, written reports/notes, emails, calendar/diary entries and time sheets' in apportioning labour costs. This level of detail imposes a significant cost on taxpayers and is challenging for large, capital-intensive operations to achieve, let alone for small and medium businesses.

Paragraph 62 of the Draft Ruling states that the Commissioner 'may ultimately adopt' timesheets to determine apportionment of labour costs. However, *Case R13* 84 ATC 186 found that:

> *The Commissioner has apportioned the expenditure on the fare on a time basis….In the light of the decided cases, that appears to be a totally inappropriate method; the proper method is to determine the degree of predominance to be attached to the objects or purposes in the pursuit of which the taxpayer incurred the particular expenditure which is to be the subject of apportionment.*

It should also be recognised that for many small and medium businesses, timesheets and employee cost allocations are not kept, especially where construction or creation of capital assets do not comprise a significant component of their business operations. This is particularly so for entities that are not subject to financial reporting requirements. Therefore, further consideration of what the Commissioner considers to be fair and reasonable apportionment approaches beyond the timesheet and ratio methods suggested in paragraph 62 is required.

The significance of the capital asset to the business should be considered

We understand that the genesis of the Draft Ruling was in the context of infrastructure costs. In those circumstances, or where there is similarly a business of constructing capital assets (for example, oil and gas or telecommunications), we acknowledge that the costs of employees directed to construct those assets may properly be capital in nature in certain cases[7].

However, as it is currently written, the Commissioner's broad-based views can be applied to all businesses, irrespective of the type of business and the relevant size of the capital asset. The Draft Ruling impacts businesses with peripheral or minor activities related to the construction or creation of capital assets, and who have employees primarily undertaking this work.

We consider that it is inappropriate to extend these principles to apply more broadly to all businesses who may, at times, direct their employees to undertake duties that relate to the construction or creation of a capital asset, irrespective of the size of the asset and its importance to the business structure.

The total amount of capitalised labour costs may be insignificant to the overall income generated by the business, such that it is not possible to suggest that such costs provide an enduring benefit to the overall business. Instead, it is arguable that the contribution is simply an ordinary cost of the business itself.

For example:

- a team of five is employed solely to develop operating manuals (i.e. intangible assets) for a business comprised of 10,000 employees
- two employees are hired by a global widget manufacturer with more than $100 million in sales to develop a small app to assist customers to contact their sales agents.

Where the construction of those capital assets does not form part of the business itself (e.g. is not a business involved in the construction of assets such as infrastructure assets), we submit that in those circumstances, the expenditure secures the use of labour for the business during the relevant period and thus would point more towards having a revenue character.

For these reasons, we recommend that the Draft Ruling consider the significance of the capital asset to the business as a relevant factor when characterising labour costs and provide examples.

Depending on the Commissioner's view of this issue, further practical guidance and support may be required given the significant ramifications on all businesses who create or construct capital assets. Such guidance should be

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[7] See *Steele v Deputy Commissioner of Taxation* [1999] HCA 7, at [29].

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practical and remove or minimise the need for taxpayers to analyse all outgoings and apportion labour costs for incidental or peripheral capital asset activities. Particular consideration should be given to small and medium businesses.

Implementation and installation of capital assets

The Draft Ruling should address the characterisation of wages related to activities that occur between the construction or creation of the asset and when that asset is installed and ready for use (i.e. labour costs associated with installation of an acquired software package).

The Draft Ruling applies to capital labour costs incurred specifically for 'constructing or creating' capital assets. It is not clear whether the Commissioner extends this view to costs incurred for the installation or implementation of those assets.

Where an entity acquires a capital asset in relation to its business, it may incur costs associated with bringing that asset into the condition in which it is ready to use (i.e. installing the asset), which would not be included in the costs incurred for the creation or construction of that asset.

However, the examples suggest that it is only once a capital asset when it is 'installed and ready for use' and that labour costs in relation to the asset after that time cease to be capital in nature.

Example 2 outlines the effect of the Draft Ruling on a centralised project management and procurement team. At the conclusion of the project, they are retained to manage and work in the facility. The Draft Ruling concludes that '*[o]nce the facility is installed and ready for use*, the retained employees are then specifically employed in the recurrent ordinary business operations'.

We believe that it is important to understand the ATO's view as to whether the ATO would treat labour costs, associated with 'installation' of an asset, as being on capital account or on revenue account.

An example would be the implementation of an accounting software package. In such an example, the CFO may oversee the installation of the package, while the accounting manager or a staff member may be solely responsible for:

1. ensuring appropriate connection of the accounting software with other software packages in the business
2. customizing the accounting software to suit the needs of the business
3. migrating the old accounting package into the new package
4. testing the accounting package, and
5. installation and roll-out of the package.

While costs associated with installation may be capitalised under AASB 116 (see paragraph 17 of AASB 116), it is unclear how labour costs associated with these activities would satisfy the criteria for being capital in nature for income tax purposes once the capital asset has been acquired.

As this is a common example, it is critical for the ATO to provide appropriate guidance on this, especially given their reference to AASB 116 and the Commissioner's view on the relevance of capitalising costs under that standard.

Further practical guidance is required

Given the far-reaching implications of the Draft Ruling as it is currently written, the ATO will need to develop additional practical guidance which provides detail on arrangements or characteristics that the ATO considers high-risk, fair and reasonable apportionment approaches, safe harbour or de minimus rules for small and medium entities, as well as tailored guidance for primary production and digital businesses.

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