

NSW Tax Forum

Salient Issues in the Construction Industry

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1. Introduction

1. This paper critically discusses the tax risk management tools relevant to the Construction industry. It is pertinent to observe that the construction industry has constantly evolved and operates in several areas of law – so addressing the challenges cited above is paramount within a legal framework is the first key step in addressing risk. Construction companies face an array of challenges¹ that require prioritising of the following competing factors:
 - (a) investment decisions,
 - (b) balancing optimal cost
 - (c) risk
 - (d) performance, whilst securing relevant development opportunities.
2. The Author argues that Tax Advisers prudently should have a solid understanding of the present challenges that their construction companies' clients operate in. It is the author's view that decision making that supports the safe, sustainable, and integrated management of assets, that deliver service outcomes that realise value from their client's assets is integral to assessing of tax risk for construction companies.

1.1 Challenges in 2024

3. The Construction industry in NSW presently faces unprecedented challenges:
 - (a) **Solvency risks** - Major industry disruption relate to the liquidation of multiple, large, and well-known head contractor building firms.
 - (b) **Downstream effects of insolvency** - Principal head contractors entering liquidation are leaving downstream subcontractors, suppliers, and sub-subcontractors in the lurch with respect to the status of their subcontracts.
 - (c) **Supply chain issues for materials inputs** - Construction materials readily available before the pandemic often come with long lead-times and increased price tags. Increasing costs of materials and costs of labour results in construction projects advance drastically reduced profit margins.

¹ Such as the following article: *The Cracks in Construction: Insolvency at 10-Year High*, Website URL (15 August 2023): <https://employsure.com.au/blog/whats-causing-the-high-levels-of-construction-insolvency>

- (d) **NSW Building Commissioner** - in 2023, NSW Fair Trading has issued more than 30 work rectification orders across building sites.
 - (e) **Interest rate environment** - The recent increase in interest rates, aimed at curbing inflation, has affected the demand for new homes.²
 - (f) **Apprentice shortages** - the scarcity of skilled labour has been a significant obstacle for construction companies in recent years, while 2023/2024 has seen a continuation of labour shortages.
 - (g) **Fixed-price contacts** - Construction companies that entered within fixed price contracts must now deliver on a backlog of fixed-price contracts agreed between 2020-2022.
4. Intermingled with the challenges is the **risk** - risk is everywhere – it is well known that construction industry presently faces major difficulties following the Covid-19 pandemic, the long-lasting effects in 2024, continue to bring about various unanticipated risks and challenges. The Tax Adviser may adopt an approach that recognises the intersection of the three key inputs that are typically Contractual terms:
- (a) Time –
 - (b) Quality –
 - (c) Costs –
5. As we know - when things go wrong, they go wrong.

Consider the disastrous **Mascot Towers** development in Sydney. Locked out of their homes and business premises for almost 5 years, the NSW Strata Law has failed the owners of Mascot Towers. It goes without saying - the Mascot Towers in Sydney is a strata disaster: ³

- (a) On or around 18 April 2019, significant structural cracks were first identified in the transfer beams of Mascot Towers during a routine inspection.
- (b) On the evening of 14 June 2019, Fire and Rescue NSW issued an order that all occupants be evacuated, because the building was deemed to be unsafe and at risk of collapse.
- (c) On 21 August 2019, the Fire and Rescue NSW confirmed the decision to evacuate the development was made because of engineers advising the building was unsafe, and

² The latest figures from the Housing Industry Association (HIA) show sales of new homes are dropping at 4.6% per month (42% lower than this time last year).

³ This is an analysis of *The Owners – Strata Plan No 80877 v Lannock Capital 2 Pty Ltd* [2023] NSWSC 1401 (Peden J) (24 November 2023).

occupants' safety could not be guaranteed. Shortly thereafter, some commercial lots were able to be reoccupied.

1.2 Assessing Risk

6. There are several considerations in assessing risk.
7. The first consideration for any construction companies and their Advisers is identification of safety issues for their projects - safety is always the paramount issue. Safety issues extends to both the inhabitants of the buildings and the workers on construction sites. As the below diagram illustrates – safety is always the paramount concern.



8. With respect to workers on construction sites, a comprehensive safety audit of the project (SWMS document) is the minimum that must be implemented. A SWMS is a document that sets out the high-risk construction work activities to be carried out at a workplace, the hazards arising from these activities and the measures to be put in place to control the risks.
9. The second concern for construction companies and their Tax Adviser is the application of the relevant legislative and regulatory environment that the construction companies operate in as these companies operate under the watchful eye of the NSW Building Commission. In NSW, the law compels certifiers, design and building practitioners, developers, home building tradespeople, businesspeople, and other professionals, with respect to their compliance of the laws cited below:⁴

(a) *Architects Act 2003 (NSW)*

(b) *Building and Development Certifiers Act 2018 (NSW)*

(c) *Building and Construction Industry Security of Payment Act 1999 (NSW)*

(d) *Building Products (Safety) Act 2017 (NSW)*

⁴ In some cases, together with other governmental bodies and ministers.

- (e) *Design and Building Practitioners Act 2020* (NSW)
 - (f) *Environmental Planning and Assessment Act 1979* (NSW)
 - (g) *Gas and Electricity (Consumer Safety) Act 2017* (NSW)
 - (h) *Home Building Act 1989* (NSW)
 - (i) *Plumbing and Drainage Act 2011* (NSW)
 - (j) *Residential Apartment Buildings (Compliance and Enforcement Powers) Act 2020* (NSW)
 - (k) *Strata Schemes Development Act 2015* (NSW)
- (“the relevant NSW construction legislation”)**

10. The third concern for construction companies and their Tax Adviser is application of the relevant tax risk framework and a prudent tax compliance framework supports corporate solvency for construction companies. Tax Advisers prudently ought to adopt a **tax risk framework** that supports and promotes the following:

1. **TR 2018/3** : the application of income tax considerations for long term construction contracts.
2. Relevant case law.⁵
3. GST issues, stamp duty considerations and land tax considerations.⁶
4. A broad understanding of the relevant NSW construction legislation.
5. Have the appropriate Insurance:
 - 1 Young builders/contractors Licenses and Insurance policies.
 - 2 Construction Insurance - conditions under standard contract.
 - 3 Liability Insurance.
 - 4 Decennial Liability.⁷
 - 5 Home Warranty Insurance.
 - 6 Compliance with the National Construction Code (**NCC**).

⁵ Cases law including the following case: Full Federal Court : *Grollo Nominees Pty Ltd & Ors v FCT* (1997) 97 ATC 4585 -

⁶ More information - see Website: [Transfer duty | Revenue NSW](#)

More information - see Website: [Land tax | Revenue NSW](#)

⁷ New Legislation implemented October 2022 for Class 2 work.

1.2.1 National Construction Code (NCC)

11. The National Construction Code (NCC) sets the **minimum** requirements for safety, health, amenity, and sustainability in the design and construction of new building. Secondly, all building products applied must be fit for purpose, and thirdly, defect rectification costs are in the billions per year.⁸
12. One of the current seminal frameworks is the 2022 National Construction Code (**NCC**),⁹ that sets the minimum requirements for safety, health, amenity, and sustainability in the design and construction of new buildings. Most building defects occur due to builders and the contractors not taking appropriate consideration of the relevant codes and standards.
13. The NCC is published in three volumes. The Building Code of Australia (**BCA**) is Volumes One and Two of the NCC and the Plumbing Code of Australia (**PCA**) is Volume Three of the NCC. When reading and considering construction contracts, an ability to comprehend the commercial significance, including tax imposition, is a skill.

1.2.2 AS 4902-2000 - Design and Construct Contract

14. AS 4902, more formally known as AS 4902-2000 General Conditions of Contract for Design and Construct, is one of the most widely used forms of head contract for design and construct projects in Australia. AS 4902 is published by Standards Australia Limited, which is part of SAI Global. This contract is protected by copyright, and you must pay a licence fee to use it. You can purchase a copy of the AS 4902 in the link below.¹⁰
15. AS 4902-2000 General conditions of contract for design and construct, published by **Standards Australia** (and copyright owned by SAI Global), is an important contract. Understanding the contractual terms and the legal framework which construction companies operate in is fundamental.
16. In simplest terms - a Construction Contract (**contract**) may be defined as a legal binding agreement between two parties in which:

1. One party (**the Principal**) promises to pay the contractual sum of money;

⁸ ABC News: NSW's building industry is reforming after years of apartment defects, but comes too late for many owners
Website: [NSW's building industry is reforming after years of apartment defects, but comes too late for many owners - ABC News](#)

⁹ Website: [National Construction Code | NCC \(abcb.gov.au\)](#)

¹⁰ [Find Standards | Intertek Inform](#)

and in return

2. The second party (**the Contractor**) agrees to construct a defined scope of building (or engineering) works.
-
17. The nature of the parties' rights and obligations in the contract conditions will define the allocation of commercial **risk** (including taxation), between the Principal and Contractor in a construction project. Accordingly, a written contract is the usual form to document the contracting party's intention that outlines contractual conditions which document whether the Principal or Contractor bears the financial consequences of specific events that may occur during the construction works.
 18. The conditions of the contract may be thought of as a risk-allocation document to ensure the success for a project. The wording of conditions in the form of a contract is, therefore, of utmost significance. It is vital that the Contractor carefully reads and appreciates the commercial implications of a proposed contract supplied at a tender stage by the Principal.
 19. Parties at the tender stage ought to:
 - (a) Prices the tender submissions appropriately for the risk it is agreeing to bear and if necessary;
 - (b) Identify any contract conditions which are too risky for its business, and qualify to tender price accordingly as being subject to negotiation of these contract conditions;
 - (c) The ability to comprehend the commercial significance of contract conditions is important for all Advisers to construction companies;
 - (d) For example, the relevant contract conditions will determine:
 1. The Contractor has a right to claim from the Principal any extra costs incurred if it encounters ground conditions at the site which are harsher than expected at the tender stage (for example, high water table or hard rock);
 2. The Contractor is entitled to an extension of time to complete the work under the contract if it is delayed by various events such as industrial action and adverse weather conditions.
 20. The working of the conditions in the form of contract is, therefore, of utmost commercial significance. Even though there are several publishers of contracts, many industry bodies use the Standards Australia precedents.¹¹ This paper considers AS 4902-2000 General conditions of

¹¹ See the Website: [myBIG | mybig](https://myBIG.com.au)

contract for design and construct, published by **Standards Australia** (and copyright owned by SAI Global).

21. As the formal title suggests, AS 4902 contains the general conditions of contract. You will need to compile the other contract documents and complete the Annexure Part A.

(a) One thing you will need is a document to formalise your entry into a contract that contains the AS 4902 general conditions.

(If you buy AS 4902, you will notice that there is nowhere to sign).

(b) This is normally done in one of two ways:

1. a 'formal instrument of agreement', or
2. a letter of acceptance.
3. Both documents serve much the same purpose, although most principals prefer a formal instrument of agreement to ensure there is no doubt about which documents are included in the contract.

1.2.3 The basic features of AS 4902-2000

22. Some of the basic features of AS 4902 are as follows:

1. **Lump sum price.** The contractor is required to execute the works for a fixed price and within a fixed timeframe.
2. **Fixed timeframe.** The contractor is required to ensure the works are completed by an agreed 'date for practical completion', or else liquidated damages will apply.
3. **Practical completion.** The contract acknowledges that construction projects can often be used and occupied before all works are completed and all minor works are completed. This is embodied in the concept of 'practical completion'.
4. **Variations.** The contract prescribes a process for dealing with variations. Relevantly, the contractor may not vary the works unless directed in writing.
5. **Extensions of time.** The contractor may claim extensions of time to the date for practical completion if it is delayed by a 'qualifying cause of delay', such as an act or omission by the Principal. The contractor can also claim delay costs in some circumstances.
6. **Provisional sums.** Where the design of part of the works is not sufficiently developed to enable the contractor to provide a fixed price, the parties can agree on a 'provisional sum' instead. The price of these items is adjusted once the final cost is known.

7. **Separable portions.** The works can be divided into separable portions (or stages), with each of them potentially having a different access date, date for practical completion and liquidated damages rate.

23. There are several features that set **AS 4902** apart from other standard form contracts.

They include:

1. No time bars (for the most part). Clause 41.2 provides that a party's failure to comply with a notice or claim requirement will entitle the other party to claim damages for a breach of contract, but will not bar or invalidate the claim. Note that there are exceptions (for example, in relation to a latent condition), and a failure by the contractor to notify a claim may nonetheless result in the contractor losing its entitlement.
2. Apportionment of concurrent delays. Where a delay is caused by a qualifying cause of delay and a non-qualifying cause of delay, the contract allows the superintendent to apportion the resulting delay according to the respective contributing causes. This is different to AS 4300 and other forms of contract, where the existence of a concurrent non-qualifying cause of delay will disentitle the contractor from claiming an extension of time.
3. Relief for latent conditions. The effect of a latent condition is a deemed variation. The contractor can claim the costs associated with a latent condition, except those incurred more than 28 days before it notified the superintendent of the issue.
4. Dispute resolution. Arbitration is the default method for resolving disputes (as opposed mediation, expert determination, resolution by a dispute board or other types of dispute resolution process). You can read about the difference between arbitration and mediation [here](#).
5. Deemed approval of Extension Of Times. If the superintendent does not respond to the contractor's request for an extension of time within 28 days of receiving it, the request is deemed to have been approved and an extension of time will be granted for the full amount of time claimed.

24. Many principals will not agree to sign AS 4902 in its unamended form. Instead, they will often seek to incorporate amendments or special conditions. This is principally for three reasons.

1. First, AS 4902 is almost 25 years old.

Since then, various pieces of legislation have been passed that can affect the parties' rights and obligations under the contract. Examples include legislation concerning GST, security of payment, proportionate liability, personal property security and work health and safety.

2. Second, and as mentioned earlier, many principals consider the risk profile of AS 4902 to be too heavily weighted in favour of the Contractor. For example, Principals will often incorporate time bars, remove any deemed approval provisions, and introduce clauses that will reduce the circumstances in which adjustments to the contract sum or date for practical completion can be claimed.
3. Finally, Principals will sometimes seek to clarify how the design approval process operates. For example, when documents are required to be submitted, how the design review process will work and how a deadlock between the contractor and the superintendent is to be resolved.

1.3 Building Commission NSW

25. Building Commission NSW body is central to rebuilding trust and capability in the construction sector and delivering on the NSW Government's housing commitments. Under the leadership of David Chandler OAM, the NSW Building Commissioner, Building Commission NSW is leading the charge to ramp up standards in the Construction Industry.
26. The NSW Government is presently working hard to increase confidence in our building industry.¹² In reaction to construction disasters, the NSW government created the Building Commission NSW body. This body was created initially as it was the NSW Government's desire to prevent a Mascot Towers happening in NSW.
27. In 2023, there unfortunately been a continuation of work rectification orders being issued, such as the following:
 - (a) the Laneways Rosebery,¹³ which remains empty and has serious structural defects,
 - (b) the Toplace's Vicinity complex in Canterbury¹⁴ that has "*potential and serious defects*". Administrators appointed to Toplace estimate about 600 creditors have been impacted by its financial woes and residents at the Vicinity complex now fear they'll have to foot the multi-million-dollar repair bill.
28. As a result of community concerns, the NSW Government introduced in 2020, two laws to regulate the building and construction industry with a focus on the residential building sector:
 - (a) The *Design and Building Practitioners Act 2020* (**DBP Act**) introduced new obligations and mandatory requirements for industry practitioners to ensure design and building work are compliant with the Building Code of Australia (BCA).

¹² NSW Government: [Reforming building laws in NSW | Have Your Say](#)

¹³ **ABC News:** <https://www.abc.net.au/news/2023-07-03/laneways-rosebery-sydney-empty-after-unmet-rectification-orders/102525868>

¹⁴ <https://www.architectureanddesign.com.au/news/vicinity-residents-in-limbo-with-building-defects>

- (b) The *Residential Apartment Buildings (Compliance and Enforcement Powers) Act 2020* (**RAB Act**) granted sweeping powers for the NSW Buildings Commissioner and authorised officers to act against defective building work.

1.4 Wave of Reform in NSW in 2024

29. Finally, brief commentary of the state of play in 2024/2025 for the construction industry in NSW. The NSW State Government is intent for further reform. Due to the continuation of serious safety and solvency concerns for the industry, the construction industry in 2023 is facing a wave of reform. After an initial focus on the residential building sector, the NSW Government has now set its sights on the commercial sector by proposal a new licensing scheme, as well as expanding the Building Commissioner's powers to commercial buildings.
30. The NSW Government is proposing to regulate, for the first time, the builders and designers undertaking commercial work. Accordingly, in response to further difficulties in NSW, the NSW State Government has from 1 December 2023:
- (a) set up a the **newly formed Building Commission NSW** that will regulate building and construction in NSW. The new Building Commission brings teams from NSW Fair Trading and the Office of the Building Commissioner together into one unit, aimed at providing an integrated and consistent approach to building and construction regulation in NSW.
 - (b) Introduced numerous new Bills, such as the following (inter alia):
 - (a) *the Building Bill 2023* (NSW).
 - (b) *The Building Legislation Amendment Bill 2023* (passed both Houses).
31. This next phase of reforms is also focused on strengthening consumer protections and the regulator's enforcement powers, as well as making all relevant people in the supply chain responsible for their work (including suppliers of building products). The goal of any construction contract is to allocate risk – a building contract is a risk allocation tool.
32. During the period of 2023 to 2025, the building industry has seen or will see reform (inter alia):
- (a) The legislation *Design and Building Practitioners Act (2020)* (**DBPA**), now has been expanded to include Class 2, 3, and 9c buildings;¹⁵
 - (b) **Duty of Care** to avoid economic loss is in all Class of Buildings.
 - (c) When the DBPA Act applies
 - 1. a waterproof design is required that identifies products and finishes

¹⁵ See **Annexure One** – Class of Buildings.

2. a new Australian Standard AS3740 has been published
 3. the standard AS4654.2021, is currently being written
 4. The 2022 NCC will be replaced in 2025 - the **2025 NCC** will require 1:80 falls in all concrete and waterproofing directly adhered, with tiles directly.
33. The key takeaway point is this – the relevant NCC and standards are not best practice, but a minimum standard. All building products used in a building project must comply with the NCC and be fit for their intended purpose. Non-compliance carries heavy costs¹⁶, with potential liabilities for damage.
34. Every stakeholder involved in a construction project must be aware of the compliance and conformance of building products and material. If products or materials are non-compliant or non-conforming, depending on where the stakeholder is in the supply chain, they may be subject to legal, commercial and taxation risk and liabilities.
35. Tax advisers play an important role in this process - the construction industry is certainly one industry where the management of cash flow is paramount – and the management of taxation issues with expert advice, an essential requirement to manage cash flow for any construction company.

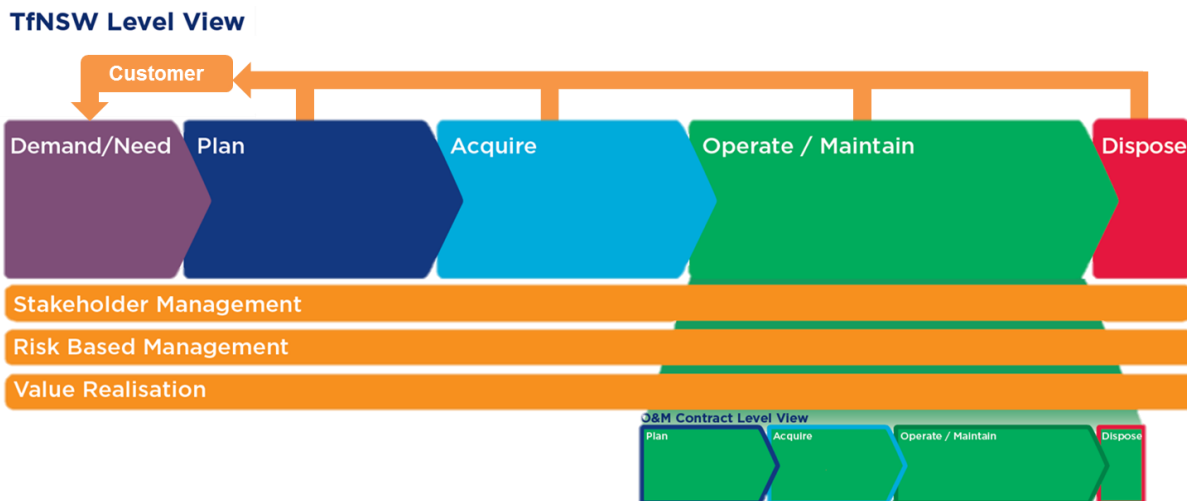
¹⁶ Defect remediation costs of \$2.57 billion per year. Waterproofing is typically only 2% of construction costs and 98% of future remediation costs.

2. Tax Risk Management

2.1 Income Tax Risk Management

36. **TR 2018/3** outlines that ATO’s considered view that gains and losses arising from a long-term construction contract are appropriately allocated over the life of the project. The ATO’s ruling¹⁷ asserts that there two acceptable methods of bringing income and deductions under long term construction contract to account results in relevant taxpayers recognising the taxable income arising from their contracts over the terms of those contracts. The acceptability of these methods was cited with approval in the case of *Grollo Nominees Pty Ltd & Ors v FCT* (1997) 97 ATC 4585¹⁸ and described in detail below in the paper.

37. Section Two of the Paper introduces the seminal issues relating with tax risk management and detailed understanding of the project lifecycle. Project lifecycles are important to assessing risk, typically described in an asset management plan:



38. The diagram above include the concept of “value realisation” - there is no point to a project if value is not realised.

Advisers manage the following:

- (a) **Business Management** through Project Management & Quality Software;

¹⁷ **TR 2018/3** replaced the withdrawn ruling IT 2450 - **IT 2450** - *Income Tax : Recognition of Income From Long Term Construction Contracts* (1 October 1987).

¹⁸ Cited with in TR 2018/3 at page 5, footnote 11.

- (b) **Cashflow** insights and trends through Financial Management;
- (c) **Workforce Planning** with Time Tracking and Labour Management.

2.1.1 Tax Risk Management

39. The first aspect of tax risk management is to be aware of the application of wide range of legislation that affects Tax Advisers. The main legislative instruments that regulate Australian income taxation laws for the construction industry are cited below:

- (a) *Acts Interpretation Act 1901* (Cth)
- (b) *Administrative Decisions (Judicial Review) Act 1977* (Cth)
- (c) Commonwealth of Australia Constitution Act, s 51(ii), s 53, s 55, s 90, s 114
- (d) *Freedom of Information Act 1982* (Cth)
- (e) *Fringe Benefits Tax Assessment Act 1986* (Cth)
- (f) *Income Tax Assessment Act 1936* (Cth)**
- (g) *Income Tax Assessment Act 1997* (Cth)**
- (h) *International Tax Agreements Act 1953* (Cth)
- (i) *Taxation Administration Act 1953* (Cth)**
- (j) *Administrative Decisions (Judicial Review) Act 1977* (Cth)
- (k) *Taxation Administration Regulations 1976* (Cth)
- (l) *A New Tax System (Goods and Services Tax) Act 1999* (Cth) ("**GST Act**")
- (m) *A New Tax System (Goods and Services Tax) Regulations 1999* (Cth) ("**GST Regulations**")
- (n) *Taxation Administration Act 1953* (Cth).
- (o) *Acts Interpretation Act 1901* (Cth).

(***the relevant Tax law***)

40. The second aspect of tax risk management is to be aware of the various taxation regimes that 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;¹⁹
2. as a profit-making scheme;²⁰ or
3. as a taxable gain on the disposal of a CGT asset.²¹

¹⁹ Div. 70 ITAA 1997.

²⁰ Sec. 6-5 ITAA 1997.

²¹ Pt 3.1 and 3.3 ITAA 1997.

41. A Tax Adviser may adopt the following strategies for practical tax risk management for Construction Companies:
- (a) Distinguishing between and the taxation of trading stock, profit making schemes and capital gains property development;
 - (b) The selection of ownership and development structures to undertake property development;
 - (c) Main residence projects;
 - (d) Mixed investment and sale projects;
 - (e) Mixed investment and sale projects;
 - (f) Partition and exchange and in specie distribution investment projects;
 - (g) GST residential development classifications;
 - (h) GST going concern disposals.
 - (i) Practical implication for managing cash flow that included detailed cash flow statements.

42. In addition to successful practical risk management strategies, successful construction companies leverage cash flow management strategies to maintain healthy profit margins. To maintain the healthy margins in the construction industry, construction companies ought to manage the following cash flows using the optimal structure.

The relevant cash flows include the following:

- (a) **Operating cash flow** = operating income + non-cash expenses + change in working capital;
 - (b) **Investing cash flow** = purchase/sale of capital expenditures + purchase/sale of marketable securities + business acquisitions (the investments you bought) - business divestitures (the investments you sold);
 - (c) **Financing cash flow** = issue/repayment of debt + issue/repayment of equity - (dividend payments + debt repayments)
43. Selecting the *landowner structure* for a property project is not always possible.²² Legitimate tax planning uses tax policy distinctions/disconformities to reduce the overall effective tax rate and apply Checklist to confirm the strategy adopted. Consider the following matters within a

²² Example - 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.

Checklist:

- (a) The fact that land may be *trading stock* for tax purposes - trading stock is characterised as being objects acquired for the purpose of manufacture, sale or exchange in the ordinary course of business.²³
- (b) *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.
- (c) *Capital gains tax implications* - A capital gain or loss may arise upon the occurrence of a CGT event (e.g. a transfer)²⁴ in respect of a CGT asset (e.g. land),²⁵ unless an exemption applies, rollover relief defers the capital gain, or a provision denies the loss.
- (d) A capital gain arises where the proceeds from the CGT event exceed the adjusted acquisition costs of the CGT asset.²⁶ A capital loss arises where the proceeds from the CGT event are less than the adjusted acquisition costs of the CGT event.²⁷
- (e) Capital gains on assets acquired before 20 September 1985 are disregarded.²⁸
- (f) A net capital gain is included in the assessable income of the taxpayer.²⁹
- (g) Differences in expense treatment for *development costs*:
 - 1. *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.
 - 2. Post-CGT buildings and intangible improvements to pre-CGT Assets are *separate* post-CGT Assets.
 - 3. These improvements are subject to the CGT regime, requiring capital proceeds to be apportioned.
 - 4. A post-CGT building or structure is a separate asset to the pre-CGT land.⁶²
- (h) *Consider GST Issues* - 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

²³ *FCT v St Hubert's Island P/L* 78 ATC 4104; (1978) 8 ATR 452.

²⁴ Sec. 104-10 ITAA 1997 - Disposal of a CGT Asset: CGT event A1.

²⁵ Sec. 108-5 ITAA 1997.

²⁶ Sec. 102-5 ITAA 1997.

²⁷ Sec. 102-10 ITAA 1997.

²⁸ Sec. 104-10(5) ITAA 1997 - Disposal of a CGT Asset: CGT event A1; *Determination* TD 7.

²⁹ Sec. 102-5 ITAA 1997.

pass on the GST to the recipient as part of their contractual relationship.

44. GST Tax, despite being robust, involves risk due to the contractual relationship between vendor and purchaser. 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.
45. 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:

(a) 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.

(b) 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.

- (c) 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!

46. 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:

(a) **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.

(b) **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.

47. 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.
48. 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.
- (a) Consider a company structure
- (b) Consider a trust structure.
- (c) Consider an 'unincorporated joint venture'.

2.1.2 TR 2018/3 - long-term construction contracts

49. The third aspect of tax risk management is to be aware of the seminal public tax rulings and private tax rulings. The Australian Tax Office (ATO) has increasingly become concerned with methods which deferred the taxing point of income and/or profits under these long-term contracts and due to taxpayers attempting to defer the income to be taxed until a later year.
50. The Commissioner of Taxation released a public taxation ruling, **TR 2018/3**, which provides guidance on reporting profits derived and losses incurred from long-term construction contracts.

While the understandings are not vastly different to a previous release from 1987 (IT 2450), it is a healthy reminder that long-term construction contracts must be correctly accounted for to ensure tax payments are suitably timed.

51. 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.
52. 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.
53. The taxation ruling specifically noted the ruling applies to the construction of:
 - (a) Buildings;
 - (b) Bridges;
 - (c) Dams;
 - (d) Pipelines;
 - (e) Tunnels;
 - (f) Other civil engineering projects; and
 - (g) Major plant items:
 - (a) Ships
 - (b) Transport vessels
 - (h) Activities of:
 - (a) Demolition;
 - (b) Dredging; and
 - (c) Heavy earth moving projects
 - (i) Other similar contracts in associated fields
 - (a) Air conditioning contracts;
 - (b) Major electrical wiring & rewiring contracts;
 - (c) Major refurbishments of hotels, stores; and

(d) Major construction management contracts.

54. The Commissioner of Taxation view in relation to a *long-term construction contract* is twofold:

(a) 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.

(TR 2018/3 at paragraph [2])

(b) a construction contract, which extends beyond one year of income, is therefore regarded as a long-term construction contract.

(TR 2018/3 at paragraph [2])

55. A long-term construction contract does **not** include a contract of sale and supply of trading stock.

2.1.3 TR 2018/3 – Approaches to revenue recognition.

56. The income taxation of a construction project is complex.

57. The TR 2018/3 ruling confirms the ATO's view that there are two methods that can be used to record profits and losses on long-term construction contracts. Whichever of the acceptable methods below is adopted, the approach must be applied consistently to all years during which the construction contract runs and to all similar contracts entered by the entity (TR 2018/3 at paragraph [6]):

Two Acceptable Methods:

(a) The Basic Approach

(b) The Estimated Profits Approach.

58. 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.

59. Once one acceptable method is chosen, it must be applied consistently throughout the entire period of the contract. In Taxation Ruling **TR 2018/3**, the ATO affirmed the view they have practiced in the past, that the following applies:

(a) The **completed contracts method** remains **unacceptable**. This method is unacceptable as it 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.

The ATO have made it quite clear in TR 2018/3, the deferring of taxable income until the end of the contract **will not** be tolerated.

(b) The “**Basic Approach**” is an **acceptable method** and the preferred approach. This method is acceptable as:

(a) all progress and final payments are derived and assessed in first year of the project and included as assessable income;

and

(b) deductions are allowed, to the extent permitted by law, when they are incurred.

(c) This approach relies on the application of the following clauses within the Construction Contract:

1. 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.
2. 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.
3. Retention clauses – amounts retained under a retention clause are not assessable until received or are entitled to be received.
4. 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.
5. Expected costs – are generally not deductible. Only costs and expenses incurred are allowable deductions

(c) The “**Estimated Profits Approach**” is also an **acceptable method**. Any accounting method for the ultimate profit³⁰, which allocates the profit on a fair and reasonable basis over the contract period, will be **acceptable**. This method removes the timing issues of up-front payments, advance progress payments, and amounts withheld under retention clauses, because the approach is focused on the result. For that reason, the approach is a notional taxable income.

³⁰ Accounting standard – AASB 15 – revenue from contracts with customers is like the estimated profits basis. Nevertheless, adjustments must be made for income tax purposes.

The ATO considers this approach to be acceptable as:

- (a) The *ultimate profits or losses* refers to the overall taxable income expected to arise from a particular construction contract.
- (b) the computation of the *ultimate profit or loss* may be spread over the years taken to complete the construction contract.
- (c) Total receipts to be regarded as assessable income.
- (d) Tax deductions for expected losses and outgoings whereby 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.
- (e) The following costs that are **not deductible** or are not deductible *until incurred*:
 - 1. Management reserves
 - 2. Additional costs due to wet weather
 - 3. Industrial disputes.
- (f) Tender costs are not taken to be deductible against the construction contract.
- (g) The method of allocating notional taxable income – this approach seeks to recognise notional taxable income in a manner that reflects the progress of a contract.

60. TR 2018/3 at [35] and [36] states the following:

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.

2.1.4 TR 2018/3 - Example 2 ³¹ -

Estimated Profits Approach - Changes over the contract period

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) x (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)

³¹ TR 2018/3 -page 8.

39. Where the estimated profits basis is used, subsection 170(9) of the Income Tax Assessment Act 1936 (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.*

2.2 GST Risk Management

61. 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.

62. 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.
63. 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).
64. 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).
65. 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*.
66. Practitioners to limit any risks of tax litigation may apply a GST checklist to limit the risk of dispute. Below is one such checklist. 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.

2.3 GST Checklist

67. The sixth aspect of GST risk management is to apply an effective GST checklist to the taxpayer's circumstances.

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.

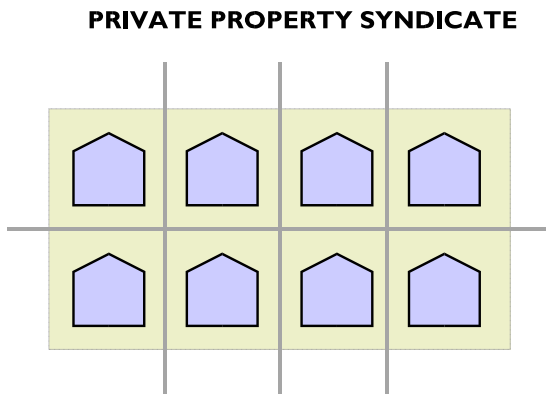
- If cancellation of GST Registration is an option, will that cancellation result in an increasing adjustment?
- Confirm that the purchaser of a going concern is correctly identified and registered for GST and that the requisite agreement has been made and documented.
- Confirm that the “going concern” 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.

3. Structuring considerations

68. Section Three of the Paper introduces the seminal issue of structuring considerations. An important aspect of tax risk management is to take care when structuring a construction business, for the following reasons:

- (a) If the business is intended to be on capital account and changes in structure of the business, such as changing of shareholding, or a change of purposes in a constitution, those changes may transform a capital account business into a property development business that is on revenue account;
- (b) The practice of establishing a separate development entity 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*³².

3.1 Case Study – Private property syndicate projects – Unit Trust



69. Consider the following facts:

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.

³² *FCT v Whitfords Beach P/L* [1982] HCA 8.

- 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?

70. The terms of the unit trust will be vital. The reasons for that assertion are the following:
- (a) 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).³³
 - (b) After subdivision, each unit holder owns a proportionate interest in each block.
 - (c) 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.
 - (d) The disposal of the various interests will, therefore, have income tax consequences.³⁴
71. If a special purpose unit trust is used where each unit in the trust grants a beneficial interest in the block of land, then the unitholder will have an absolute entitlement to the land and there is no partition and exchange.³⁵ 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.
72. 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.
73. The unit trust is treated as a separate entity for GST purposes and the in-kind distribution of property will have GST consequences.³⁶

³³ *CSR (Vic) v Karingal 2 Holdings P/L* [2003] VSCA 214.

³⁴ *Determination TD 92/148*.

³⁵ Sec. 116-30 ITAA 1997; cf TR 2004/D25; *CSR (Vic) v Victoria Gardens Developments P/L* [2000] VSCA 233.

³⁶ By analogy with partnerships see *Rulings* GSTR 2003/13 & GSTR 2003/D5.

4. Conclusion

74. Given the constantly changing landscape of in the Construction industry, it is appropriate to engage appropriately qualified professionals. 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).

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

76. 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.

77. In conclusion, always seek advice from appropriately qualified professionals. Thank you for your attention.

78. Follow up questions are welcome.

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5. ATTACHMENTS

- Attachment One - UTNCC-Building-classifications
- Attachment Two - Bill Passed - NSW Home Building
- Attachment Three - Draft Building Bill

