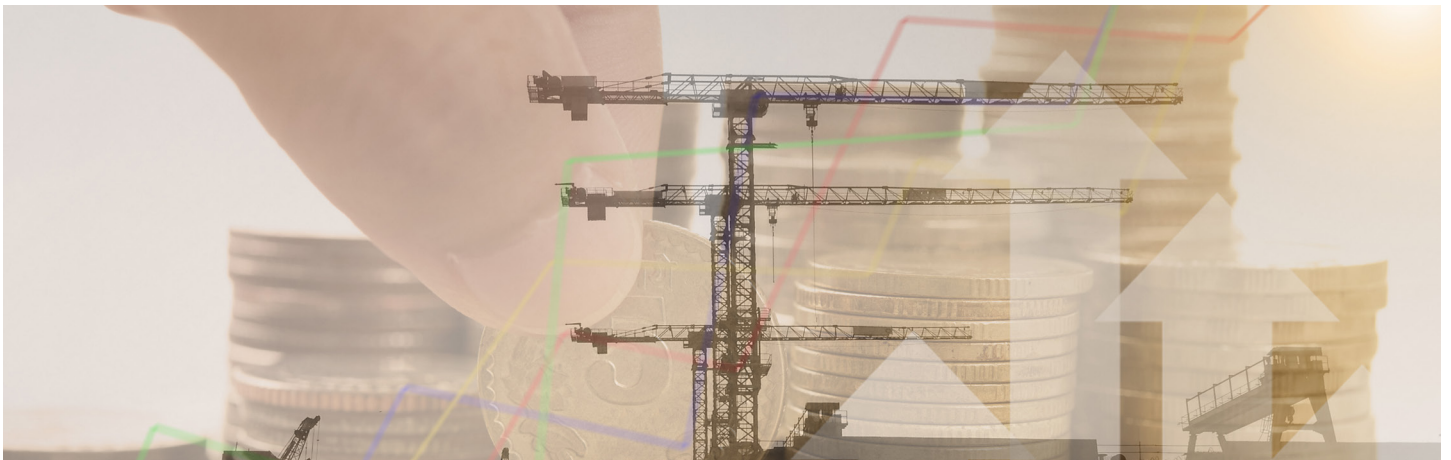


INDUSTRY INSIGHTS

By Robyn Karam

Taxable income for construction companies: The pot of gold at the end of the rainbow



This article will explore how construction companies can unlock hidden value in the form of an income tax refund when a contract or project completes or falls over or the company is subject to a formal insolvency appointment. The key takeaway - always look for the silver lining. When the end is near, all is not necessarily lost.

It is common practice within the construction industry for companies to derive income from “long-term” construction contracts. These contracts relate to construction work where construction extends beyond a year of income.

There are different acceptable methods of determining the taxable income from long-term construction or engineering contracts. Whichever method a taxpayer adopts, it is crucial that it is applied consistently to all years during which the particular contract runs and to all similar contracts entered into by the taxpayer. Taxpayers who have a number of companies in the one group should use the same method of determining taxable income.

This article will focus on the estimated profits basis of determining the taxable income.

Using the Estimated Profits basis

The estimated profits method permits a taxpayer to spread the ultimate profit or loss on a long-term construction project over the years taken to complete the contract. This assumes the basis is reasonable and within accepted accountancy practices.

The expression "ultimate profit or loss" refers to the overall taxable income expected to arise from a particular contract, in effect the notional taxable income.

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.

There are several acceptable methods of allocating notional taxable income over the lifetime of a long-term construction contract. Each method seeks 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.

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

A change in expectations and contract performance

A taxpayer earning income from long-term construction projects is not bound to their initial estimate of ultimate profit or loss. They can make adjustments from year to year. For example, in each year of the contract, the amount of notional taxable income may be determined according to their expectations at the end of each year.

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.

Many people would not be aware that taxation legislation includes a mechanism to ensure that, in the end result, there is not an over-assessment of income tax liability.

Sub-section 170(9) of the Income Tax Assessment Act 1936 is this mechanism. It enables the over-assessment of notional taxable income to be corrected in subsequent years.

It is important to note that whilst the project is in progress, it is not possible to make an amendment to a profit assessment for an earlier year. The reason for this is that, at the time the assessment for that year was made, it was correctly made.

The only provision which would authorise an amendment is sub-section 170(9) and that does not operate until the contract is complete.

In many cases, the impact of not being able to amend assessments before the end of a contract may not be significant.

However, for companies in dire financial straits or experiencing significant cash flow difficulties, this mechanism cannot be overlooked. The ability to amend an earlier tax return and obtain a refund versus utilising carry-forward losses may be the difference to a business' survival or failure.

It will also mean that in circumstances where the termination of a contract is looming, and the threat of crystallising damages to the company's position is real, whether there has been an ultimate profit or loss on a long-term construction project is vitally important. Serious thought must be given to whether or not to accept a termination notice, for example.



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When to apply sub-section 170(9)

Sub-section 170(9) authorises the 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. It ensures that the estimated amounts of income upon which tax has been paid in relevant years, fairly represent profits and/or losses attributable to those years.

Whether or not assessments should be amended in reliance on sub-section 170(9) will depend on the circumstances of each case. An amendment may be

needed where the ultimate taxable income is either more than or less than the total amount of notional taxable income included in assessable income over the years taken to complete the contract. The date of contract completion may be taken as the date a completion certificate is issued.

In some cases, even where the ultimate taxable income equals the total amount of notional taxable income, the yearly allocation may not appear correct. Where the rates of tax payable over the period have not changed, it is unlikely that an amendment to the assessments concerned would be necessary. In other cases, taxpayer's may need amended assessments. For example, in a situation where a proper allocation of profit to earlier years absorbs otherwise undeducted losses, an assessment may require an amendment.

The practical application for construction companies and their advisors

The good news for many companies is that the opportunity to recover over-payment of income tax is possible. This opportunity may arise as a result of a formal insolvency appointment, but this is not the only catalyst. It may also arise if a business, independent of any formal insolvency appointment, is experiencing losses on projects which have either achieved project completion in accordance with the terms of the contract or which have otherwise been terminated. Typically, a business in this position will be experiencing cash flow difficulties and the ability to recoup over-paid income tax will be vital to any business turnaround.

In the event of an insolvency appointment, the cost of lodging income tax returns, where companies have accumulated significant losses, might deter insolvency practitioners. They might consider there to be no benefit to creditors in lodging an income tax return where the only effect will be to crystallise carry-forward losses.

Of course, the effect of section 170(9) may be a tangible benefit such as an available cash refund as opposed to carry-forward losses. As a general rule, these are only valuable to a going concern which passes the same business test. BRI Ferrier has successfully utilised this approach to recover millions of dollars for our clients.



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If you are considering whether this approach may apply to you, ask yourself the following questions:

- ▲ Do you have projects that have been running for a number of years?
- ▲ Do you recognise income based on the estimated profit basis?
- ▲ Were the projects profitable in any of the earlier years?
- ▲ Did you pay income tax in any of the earlier years?
- ▲ Is the contract at an end (e.g. project completion, termination) or at risk of termination? Will losses be realised, reducing ultimate profit or resulting in a greater ultimate loss to that reported in earlier years and thus resulting in an overpayment of tax?

If you answered yes to these questions, you should give serious thought to the implications for your business.

For advice on applying these principles, contact [Robyn Karam](#), Certified Turnaround Analyst and Registered Liquidator.

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With over 160 staff and eleven practices in Australia, New Zealand, Hong Kong and the United Kingdom, we work with clients of all types – from individuals, sole traders and small businesses to public corporations and government entities.

We also work with financiers, solicitors, accountants and creditors to address the needs of all stakeholders when businesses face financial challenges.

BRI Ferrier's team has the expertise and resources to meet any client challenge. By combining our skills and enthusiasm, we achieve the best possible outcomes in all cases where a business experiences financial distress.

How BRI Ferrier can help

BRI Ferrier can assess your current situation and advise on a path forward to minimise further risk.

Early intervention is often the key for a successful restructure of your business. If you or your client is experiencing financial challenges then don't delay, contact us today.

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