



### WEEKLY COMMENT: FRIDAY 27 SEPTEMBER 2013

1. Inland Revenue recently released Question We've Been Asked QB 13/04 *Income Tax – Retention Money* (“the QWBA”) in final form. The final version contains some significant additions to the draft version circulated earlier this year, and it is worth commenting on the additions.
2. The QWBA concerns:
  - (a) The timing of the derivation of income in the form of retention money due on construction contracts; and
  - (b) The timing of deductions for retention money payable to sub-contractors.
3. The subject was previously dealt with in *Public Information Bulletin* No 103, p 1 (March 1980). All Public Information Bulletins are being reviewed as set out in “Review of Public Information Bulletins” in *Tax Information Bulletin Vol. 23, No. 1 (February 2011)*.
4. The facts scenario is that a customer will withhold 10% from any progress payment as security for the contractor delivering the work free of defects or omissions. The same term is in the sub-contract between the contractor and a sub-contractor engaged on the project. The questions concerns when the contractor derives as income the 10% retained by the customer, and when he incurs as expenditure the 10% he retains from payments to the sub-contractor.
5. The answers are:
  - (a) The contractor derives the retention money as income in the income year in which the works are complete and free of defects and omissions, which is when the income earning process is completed and an enforceable debt is created.
  - (b) If payment is not to be made unless the work is certified by a third party, such as an engineer, the retention money is derived as income when the certificate is given.
  - (c) The contractor incurs the expenditure of the retention money payment to the sub-contractor in the income year in which all repairs are completed and omissions rectified, because that is when the contractor becomes definitively committed to making the payment.

### **Importance of the contract**

6. The revised final version of the QWBA stresses the importance of the terms contained in the contract between the parties. If a contract requires retention until the occurrence of a particular event, such as the provision of an engineer's certificate, then that will be the date on which the income is derived and the expenditure is incurred. On the other hand, if no event is specified and the contract merely provides for retention until a later date, the income will be derived, and the expenditure will be incurred, when the work is completed.

### **Recognition of income**

7. The *Shorter Oxford English Dictionary* definition is quoted so as to describe "retention money" as "an amount withheld for an agreed period by a purchaser or a contractee as security against the failure to fulfill a contract".
8. Section BD 3(3) of the Income Tax Act 2007 states that in determining the time of derivation of income regard must be had to case law, subject to an overriding rule in s. BD 3(4) that an amount is treated as being derived when credited to the account of a taxpayer or dealt with in their interest or on their behalf.
9. Case law has established that, with limited exceptions, business income is derived when a taxpayer has done all that is necessary to earn the income:
  - (a) *Arthur Murray (NSW) Pty Limited v FCT* [1965] HCA 58, (1965) 114 CLR 314 concerned tuition fees for dancing lessons received in advance by a company. The High Court of Australia held that the fees paid in advance did not constitute income derived because the lessons had not been given.
  - (b) *Hawkes Bay Power Distribution Limited v CIR* [1999] NZCA 90, (1999) NZTC 15,226 in which Goddard J concluded that the Commissioner had acted correctly in making assessments of the company's income for each year in question on the accruals basis. The issue was whether or not income had been derived by the company from supplying electricity before it was billed. The Judge concluded that based on its Terms and Conditions of Supply (which had regulatory force), Hawke's Bay Power was entitled to be remunerated for the electricity it had supplied at the point of supply; and that entitlement was not delayed until the consumer's meter was read or an invoice sent. Good accounting practice required its income entitlement to be assessed, matched against its costs in supplying the electricity and returned as income for taxation purposes.
  - (c) A third relevant case is *Gasparin v Federal Commissioner of Taxation* (1994) 94 ATC 4,280. The contracts of sale of land held as trading stock became unconditional in one year and were for settlement in the next year. The Federal Court of Australia held that income from sale was not derived until settlement when a debt accrued due from the purchaser. The court applied the standard principle governing contracts for the sale of land stated by Salmond J in *Ruddenklau v Charlesworth* [1925] NZLR 161 that it is only where the contract has been completed by the execution and acceptance of a conveyance that unpaid purchase money may become a debt and be recovered accordingly. Up to then the vendor may sue for specific performance or for damages for breach.
10. The derivation of payments under a construction contract was considered by The High Court in *HW Coyle v CIR* (1980) 4 NZTC 61,558 (HC). The Court held that the accounting treatment

adopted by the taxpayer did not determine the result and said that the court's task was to apply the statutory provisions of the Income Tax Act to the taxpayer and the particular contract. In that case it was held that the retention amounts under the contract had not been derived or earned and should not be included in the assessable income of the taxpayer until they were payable.

11. *Horizon Homes Ltd v CIR* (1994) 16 NZTC 11,064 (HC) also concerned recognition of income under building contracts. The High Court followed the approach taken in *Coyle* and held that a taxpayer is not regarded as having derived income to which he is not yet contractually entitled.
12. It is noted in the QWBA that the core provisions have been introduced into the Income Tax Act since the *Coyle* and *Horizon Homes* decisions. However, the cases are consistent with the core provisions in focusing on the statutory tests rather than the accounting treatment.

### **Deduction of expenditure**

13. Section BD 4(3) states that in determining the time of incurrence regard must be had to case law. It is stated in the QWBA that case law has established that a taxpayer must have paid, agreed to pay or become definitively committed to a payment for an expense to be incurred. The cases referred to are *HW Coyle, AM Bisley & Co Ltd and Ors v CIR* (1985) 7 NZTC 5,082 (HC), *Case M123* (1990) 12 NZTC 2,788, and the Privy Council decision in *CIR v Mitsubishi Motors New Zealand Limited* [1995] UKPC 38, (1995) 17 NZTC 12,351, which concerned the vendors' commitment to warranty repairs at the time that the motor vehicles were sold.
14. It is noted in the QWBA that the timing rule in s. EA 3 for expenditure incurred before the services are performed will generally not apply to retention amounts because they represent expenditure on services already performed.
15. The QWBA contains a brief discussion about the correspondence in timing between when an expense relating to a retention amount is incurred and when the corresponding income is derived. The Commissioner agrees that the incurred and derived tests are different and, in some cases, this may mean that an expense is incurred before corresponding income is derived. It is noted that it has been argued that the customer can incur the retention payments on completion of the original works but the contractor will not derive that income until the repairs are completed and omissions rectified. The Commissioner's position is that if work remains to be done before retentions are legally payable under the contract, the payer has not incurred that amount as the payer has not yet become definitively committed to the payment.

### **Financial arrangements rules**

16. It is stated in the QWBA that, as a general proposition, no interest will be implied under the financial arrangements rules where, essentially, the amount paid is the amount the parties would have agreed to pay if payment took place at the time services are performed or property transferred. The rules also do not apply to certain short term agreements. It is noted that beyond that, the application of the financial arrangements rules to construction contracts, including retention payments, is outside the scope of the QWBA.

## Examples

17. The exposure draft version of the QWBA contained two examples. The final version has three. Example 1 is a straightforward case of work relating to a retention being completed before balance date, but the payment is made immediately following balance date. In this case, the income is derived in the year when the work is completed, and not in the subsequent year when payment is made.
18. Example 2 concerns a contract that requires an engineer's certificate before a retention amount can be paid. The timing of the recognition of income coincides with the time at which the engineer's certificate is provided.
19. Example 3 is new and deals with the terms of a contract and the relevance of a defect liability period:
  - (a) If any portion of a retention amount is payable upon practical completion of the work, then the income is derived, and the expenditure is incurred, at the time of practical completion;
  - (b) If the contract provides that the balance of the retention money will be paid at the end of a period that runs to a time after completion of the work (the defects liability period), then the income will be derived when the work is completed, and *not the end of that period*, because by completing the work the contractor has done all that is required to earn the income; (emphasis added)
  - (c) If the contract provides that the balance will be paid at the end of a defects liability period provided an engineer certifies that the works are free of defects, then the income will not be derived until that certificate is given.



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