Tax deductions for wages
When are they considered to be capital?

The ATO has released Draft Taxation Ruling TR 2019/D6 which may change the extent to which businesses claim deductions on their labour for the construction of a tangible or intangible capital asset.

Treatment of labour costs

The ruling confirms the ATO's view that labour costs incurred specifically for the creation or construction of capital assets will be capital in nature, and therefore not deductible.

This includes the costs of those employees who perform functions related to the construction or creation of these assets, such as project and human resource managers.

However, the cost of workers or employees whose role:

a) has a remote connection with constructing or creating capital assets, or

b) only involves incidental activities connected with constructing or creating capital assets,

will generally not be regarded as being incurred specifically for constructing or creating capital assets and therefore will not be capital or of a capital nature.

The ATO has provided the following examples to help understand the extent of these exclusions:

• For 'remote connection' – A security guard who is responsible for the security of a project site where capital assets are being created or constructed.

• For 'incidental activities' – A general manager who spends one day a week discussing and preparing reports on the progress of a construction project.

Further, the distinction between being capital or revenue in nature will be made at the time the loss or outgoing is incurred.

This mean that costs related to an employee whose role is initially in the construction of a capital asset but then changes to the maintenance of this asset after construction is finished will be considered as on capital account for the initial period but on revenue account thereafter.

Furthermore, employees may be specifically employed for both constructing or creating capital assets as well as other duties, in which case apportionment of the losses or outgoings is required.

Apportionment

Where apportionment of labour costs is required, the ATO stipulates this be conducted on a fair and reasonable basis.

Apportionment may be straight forward where staff are accustomed to recording time, as is the norm on major development/construction projects.

However, it may be difficult to accurately establish for other full time employees who don't record time, where an accounting based allocation of their time is the norm.

The draft ruling evidences an expectation that taxpayers will be able to justify the reasonableness of the methodologies utilised.

Further, once the ruling is finalised and if it retains its current rationale, taxpayers should expect that the ATO will require labour costs to be allocated to capital assets in a robust fashion.

This is regardless of what may be accepted at this point in time as reasonable allocations.

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As a result, taxpayers will also need to contemplate which, if any, policies and practices may need to be amended to allow for efficient compliance with the tax ruling.

The draft tax ruling is also proposed to be retrospective in its application, and will require businesses to review any alternative positions taken in prior years.

How we can assist

We can assist with reviewing the tax treatment of any active or prior year construction projects undertaken, particularly where an alternative position has been taken.

Where any of your labour costs are not immediately deductible, the subsequent tax treatment also needs to be considered, which is not an aspect contemplated in TR 2019/D6.

Please get in touch with one of our tax experts for more details.

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