

## **QUESTION WE'VE BEEN ASKED QB 13/04**

### **INCOME TAX – RETENTION MONEY**

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This question we've been asked is about ss BD 3, BD 4, CA 1, CB 1 and DA 1.

This item updates and replaces the item "Retention Moneys, Construction Contracts" published in *Public Information Bulletin* No 103, p 1 (March 1980). That item sets out when retention money due on construction projects should be returned as income and the timing of deductions for retention money payable to sub-contractors. The current relevance of this information was identified during a review of content published in *Public Information Bulletins* and *Tax Information Bulletins* before 1996. For more information about the review, please see "Review of Public Information Bulletins" in *Tax Information Bulletin* Vol 23, No 1 (February 2011).

This question we've been asked applies generally to business taxpayers for whom the payment, or the receipt, of retention money is on revenue account. This item applies to contracts generally and not only construction contracts.

#### **Question**

1. A contract to construct an asset provides that the customer will withhold a set percentage from any progress payment (say 10%) 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.
2. When does the contractor:
  - derive as income the retention money the customer withholds; and
  - incur the expenditure of the retention money the contractor withholds from payments to the sub-contractor?

#### **Answer**

3. The contractor derives the retention money as income in the income year in which the works are complete and free of defects and omissions. That is the income year in which any repairs are completed and omissions rectified. That is when the income earning process is completed and an enforceable debt is created. If payment is not to be made unless the work is certified by a third party, for example, by an engineer, the retention money is derived as income when that certificate is given. The same principle applies to derivation of income by the sub-contractor.
4. The contractor also 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 make the payment. It is this that determines when the expense is incurred and not the due date for the payment.
5. If the repairs and rectifications must be certified by a third party, for example, by an engineer, the contractor incurs the expenditure when that certificate is given as that is when the contractor becomes definitively committed to make the payment.

## Explanation

6. "Retention money" can be described generally as "an amount withheld for an agreed period by a purchaser or a contractee as security against the failure to fulfil a contract" (*Shorter Oxford English Dictionary* (6<sup>th</sup> ed, Oxford University Press, New York, 2007)). In some cases, a contract may allow a customer to retain part of a contract payment until identified repairs are made or other breaches of the contract are remedied. It is common in the construction industry for contracts to provide for a retention amount, of a set percentage, to be withheld from each progress payment. These retentions give the customer some comfort that the works will be completed defect-free and to specification.
7. A contract may provide that money can be retained by a customer until a defect is remedied or other condition is satisfied – as is the case in the question and answer above. Some contracts require certification by a third party, such as an independent engineer, before retention money is payable. Alternatively, a contract may simply provide that a set percentage of each progress payment will be retained by the payer until a future date. In that case the retention money is, in effect, a form of security for the payer against defects or inadequacies in the work becoming apparent during the retention period.

*When is income recognised?*

8. An amount of income must be allocated to an income year (s BD 3(1)), which will be the year in which it is "derived" unless that is altered by a specific timing provision in the Act (s BD 3(2)). In determining the time of derivation of income regard must be had to case law (s BD 3(3)). This is subject to an overriding rule that an amount is treated as being derived when credited to the account of a taxpayer or dealt with in some other way in their interest or on their behalf (s BD 3(4)).
9. An amount paid to a contractor, or sub-contractor, in the business of constructing assets or providing other contract services is income (ss CA 1 and CB 1). 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 (see, for example *Arthur Murray (NSW) Pty Limited v FCT* (1965) 114 CLR 314 (HCA); *Bowcock v CIR* (1981) 5 NZTC 61,062 (HC); *CIR v Molloy* (1990) 12 NZTC 7,146 (HC); *Hawkes Bay Power Distribution Limited v CIR* (1999) 19 NZTC 15,226 (CA)) and a debt is created (see, for example *FCT v Australian Gaslight Company* (1983) 83 ATC 4800 (FFedC); *Gasparin v FCT* 94 ATC 4,280 (FFedC); *CIR v Farmer's Trading Company Limited* (1982) 5 NZTC 61,200 (CA)).
10. In *HW Coyle Ltd v CIR* (1980) 4 NZTC 61,558 (HC), the High Court considered the derivation of payments under a construction contract. The Court held that the accounting treatment adopted by the taxpayer did not determine the result and said, at page 61,565, that the court's task was:

...to apply the statutory provisions of the Land and Income Tax Act 1954, now the Income Tax Act 1976, to the Objector concerned and the particular contract.
11. The court held, at page 51,568, 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 are payable.

12. Recognition of income under building contracts was also considered in *Horizon Homes Ltd v CIR* (1994) 16 NZTC 11,064 (HC), in which the High Court followed the approach taken in *Coyle* and, at page 11,079, said:

A taxpayer is not regarded as having derived income to which he is not yet contractually entitled.

13. 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 accounting treatment.

*When is expenditure deducted?*

14. Deductions must be allocated to an income year (s BD 4(1)), which is the year the expenditure is "incurred" unless that is altered by a specific timing provision in the Act (s BD 4(2)). In determining the time of incurrence regard must be had to case law (s BD 4(3)). 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 (see, for example *CIR v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351 (PC), *AM Bisley & Co Ltd and Ors v CIR* (1985) 7 NZTC 5,082 (HC), *HW Coyle Ltd v CIR, Case M123* (1990) 12 NZTC 2,788).
15. Section EA 3 contains a timing rule in relation to expenditure that is incurred before the services for which it is incurred are performed. This section will generally not apply to retention amounts because they represent expenditure on services already performed.

*Terms of contract critical*

16. The correct tax treatment in each case depends on the precise terms of the contract between the parties. If, for example, a contract provides that 10% of payment for work completed to date is to be retained by the payer, and the payer is not liable to pay that amount until an engineer's certificate is provided, then the income earning process is completed if and when the engineer's certificate is provided. The payer will incur, ie, become definitively committed to the payment, if and when the certificate is given.
17. If, instead, a contract simply provides for 10% of a payment for work to date to be retained by the payer until a later date (ie, there is no contractual requirement for repairs to be made or an engineer's certificate to be issued), the income is derived when the work is completed and not at the later designated payment date. Similarly, the payer will be definitively committed to the payment once the work is complete even though actual payment is deferred until a later date.
18. It may be that the practical effect of retaining an amount until an engineer's certificate is given will be the same as retaining it for a period during which the payer can check for defects, inadequate work, etc. However, the tax position depends on the legal rights and obligations of the parties under the contract and not the practical effect of those terms.
19. It has been suggested that a customer (or head contractor) will incur the full cost of works, including all retentions, once the original works have been completed. That is, retentions are incurred even though payment of them is not required unless or until the contractor has repaired all defects and rectified all omissions. As the incurred and derived tests are different, it is 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 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. However, 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 Arrangement Rules*

20. Under the financial arrangement rules in subpart EW, part of a payment can be treated as interest for tax purposes. This can be the case where either goods or services are provided before payment or where payment occurs in advance of the provision of goods or services. However, as a general proposition, no interest will be implied under those 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. The application of subpart EW to construction contracts, including retention payments, is outside the scope of this item.

### **Examples**

#### **Example 1 – Retention Pending Repair**

21. Contractor contracts with Customer to construct and install a large item of industrial plant. The contract allows Customer to retain up to 5% of any progress payment until defects in work to date are rectified. Contractor's contract with Sub-Contractor provides for retentions on the same basis.
22. A sub-component of the plant, installed by Sub-Contractor, is defective and Customer retains an amount from the 30 January progress payment. Contractor retains the same amount from its progress payment to Sub-Contractor. Sub-Contractor completes the replacement of the sub-component by 29 March. Customer pays Contractor the retention on 5 April and Contractor pays Sub-Contractor the next day.
23. Contractor derives the income in the year ending 31 March, as Contractor becomes entitled to payment on 29 March when the repair is completed. Similarly, Sub-Contractor derives the income in the same year. Contractor also incurs the expenditure in the year ending 31 March as Contractor becomes definitively committed to pay Sub-Contractor when the repair is completed.

#### **Example 2 – Requirement for Certification**

24. Builder contracts with Customer to build a high-rise building. Builder must submit claims for progress payments to Engineer who then certifies the appropriate amount to be paid by Customer. Customer may retain up to 5% from any progress payment as security against any defects in the work. A retention amount is payable (as part of the next progress payment) once Engineer has certified that any defects have been remedied or (as part of the final payment) if Engineer has certified that the entire contract work has been completed.
25. Customer retains \$100,000 from the 30 November 2010 progress payment, in respect of identified defects, and Builder completes the repair of those defects on 28 February 2011.
  - If Engineer issues the certificate on 3 March 2011, Builder derives the retention amount as income in the income year ending 31 March 2011 and Customer incurs the expenditure in that year.
  - If instead, Engineer is unable to issue the certificate until 1 April 2011, Builder derives the retention amount as income in the income year ending 31 March 2012 and Customer does not incur the expenditure until that later year.

### Example 3 – Relevance of Defect Liability Period

26. Contractor contracts with Customer to build a chemical plant. The contract provides for Customer to make progress payments. The contract also provides that Customer will retain 10% of each progress payment. Fifty percent of the retention money is to be paid to Contractor on practical completion of the plant. The balance of the retention money is to be paid at the end of a defects liability period that runs to a date after practical completion. Contractor's contract with Sub-Contractor provides for retentions on the same basis.
27. The 50% of the retention money payable on practical completion is derived as income by Contractor when practical completion occurs. That is the point at which everything that must be done to earn the money has been done. If, alternatively, the contract provides that practical completion must be certified by an engineer then the income will be derived on the date when the certificate is given.
28. The timing of derivation of the balance of the retention money will depend on the precise terms of the contract. If the contract provides that it 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 at the end of that period. This is because, by completing the work, Contractor has done all that is required to be done to earn the income. However, 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. The giving of the certificate is something that must be done for the income to be earned.
29. The timing of incurrence by Contractor of the payment of retention money to Sub-contractor will be the same. Contractor will become definitively committed to pay the first 50% of the retention money on practical completion. However, if payment is conditional upon practical completion being certified, then the expense will be incurred if and when the certificate is given. The balance, payable at the end of the defect liability period will also be incurred on practical completion unless there is something more required (eg, certification that the works are free of defects) before payment is required. In that case, the balance will be incurred at the time the certificate is given.

### References

#### Subject references

Derivation of income  
Incurrence of expenditure  
Retention money

#### Legislative references

Income Tax Act 2007, ss BD 3, BD 4, CA 1, CB 1 and DA 1

#### Case references

*AM Bisley & Co Ltd and Ors v Commissioner of Inland Revenue* (1985) 7 NZTC 5,082 (HC)  
*Arthur Murray (NSW) Pty Limited v FCT* (1965) 114 CLR 314 (HCA)  
*Bowcock v CIR* (1981) 5 NZTC 61,062 (HC)  
*Case M123* (1990) 12 NZTC 2,788  
*CIR v Farmer's Trading Company Limited* (1982) 5 NZTC 61,200 (CA)  
*CIR v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351 (PC)  
*CIR v Molloy* (1990) 12 NZTC 7146 (HC)

*FCT v Australian Gaslight Company* (1983) 83 ATC 4800 (FFedC)  
*Gasparin v FCT* 94 ATC 4,280 (FFedC)  
*Hawkes Bay Power Distribution Limited v CIR* (1999) 19 NZTC 15,226 (CA)  
*Horizon Homes Ltd v CIR* (1994) 16 NZTC 11,064 (HC)  
*HW Coyle Ltd v CIR* (1980) 4 NZTC 61,558 (HC)