

**EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY | HUKIHUKI HURANGA
- MŌ TE TĀKUPU ME TE MATAPAKI ANAKE**

Deadline for comment | Aukatinga mō te tākupu: **11 December 2026**

Please quote reference | Whakahuatia te tohutoro: **PUB00537**

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QUESTIONS WE'VE BEEN ASKED | PĀTAI KUA UIA MAI

Income tax – Retention money

Issued | Tukuna: Issue date

QB XX/XX

This question we've been asked explains when a person derives retention money as income and when they incur the expenditure of retention money for income tax purposes. It discusses how the contractual terms governing retention money affect the timing of income recognition and deductions, including how the specific timing rule in s EA 3 and the financial arrangements rules apply in certain situations. This guidance is important for taxpayers who use retention arrangements including those in the construction industry.

Key provisions | Whakaratonga tāpua

Income Tax Act 2007 – ss BD 3, BD 4, EA 3, YA 1 ("short-term agreement for sale and purchase")

REPLACES | WHAKAKAPIA

- This QWBA updates and replaces QB 13/04: Income tax – Retention money *Tax Information Bulletin* Vol 25, No 10 (November 2013).

Question | Pātai

A contract to construct an asset, to which the Construction Contracts Act 2002 (CA 2002) applies, provides that the customer will withhold a set percentage from any progress payments as security for the contractor to deliver the work free of defects and omissions.

The subcontract between the contractor and a subcontractor engaged on the project contains an equivalent term in relation to the subcontract works.

This question we've been asked addresses two related questions:

- When does the contractor derive as income the retention money that the customer has withheld and when does the subcontractor derive as income the retention money that the contractor has withheld?
- When does the contractor incur the expenditure of the retention money that they withheld from payments they made to the subcontractor?

Answer | Whakautu

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 defects and omissions in the completed works are rectified. At that time the income-earning process is complete and an enforceable debt created. The same principle applies to the subcontractor in deriving retention money in relation to the subcontract works.

If the terms of contract require a third party (eg, an engineer) to certify that the works are complete and free of defects and omissions, the contractor or subcontractor would derive the retention money in the income year in which that certificate is issued.

The contractor incurs the expenditure of the retention money at the point when each progress payment from which they have withheld the retention money is payable. At that point the contractor is definitively committed to paying the retention money. The subcontractor has completed the work to which the progress payment (including the retainable amount) relates. The contractor can only use the retention money to pay the subcontractor or to remedy defects in the subcontractor's work at the subcontractor's own cost.

Key terms | Kīanga tau tāpua

Retention money refers to a part of the contract price withheld as security for the performance of contractual obligations.

Explanation | Whakamāramatanga

1. The Commissioner has been asked when a person derives retention money as income and when a person incurs the expenditure of retention money for income tax purposes.
2. Retention money is a common arrangement in construction contracts where a person (a customer or contractor) retains part of an amount otherwise payable to another person (a contractor or subcontractor) until that other person completes the work and remedies any defects. Retention arrangements can also apply to contracts outside the construction industry.
3. The issues considered in this question we've been asked (when does a person derive retention money as income and when do they incur expenditure on retention money) apply to contracts generally, not just construction contracts. It considers the income tax treatment of retention money where a person receives or pays the retention money on revenue account.¹ That is, its focus is on situations where the retention money relates to an amount that would, when a person derives or incurs it, be income or deductible expenditure.
4. The tax treatment of retention money depends on the legal rights and obligations created by the contract between the parties. For this reason, it is crucial to consider the terms of the contract.
5. All legislative references are to the Income Tax Act 2007 unless otherwise stated.

¹ For example, an amount paid to a contractor or subcontractor in the business of constructing assets or providing other contract services is income (ss CA 1 and CB 1).

When does a person derive retention money as income?

6. Income is allocated to the income year in which a person derives it unless a provision in any of Parts C or E to I requires a different basis for allocation (s BD 3(2)). For a discussion on how the financial arrangements rules in Part E apply, see from [27].
7. In determining when a person derives income, it is essential to consider relevant case law (s BD 3(3)). Income that a person has not previously derived is treated as derived when credited to their account or otherwise dealt with in their interest or on their behalf (s BD 3(4)).
8. To have derived an amount of income, a person must have earned that amount by performing or discharging the obligations for which the payment was made. That is, they must complete the income-earning process. The income-earning process is complete when a legally enforceable right to income or a debt arises, or the right to be paid otherwise crystallises: *Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 (HCA); *CIR v Farmers Trading Company Ltd* (1982) 5 NZTC 61,200 (CA); *Hawkes Bay Power Distribution Ltd v CIR* (1999) 19 NZTC 15,226 (CA); *Henderson v FCT* 70 ATC 4016 (HCA); *Australian Gas Light Co & Anor* (1983) 52 ALR 691 (FCA).
9. A person is not regarded as having derived income to which they are not yet contractually entitled: *Hawkes Bay Power*; *Henderson*; *HW Coyle Ltd v CIR* (1980) 4 NZTC 61,558 (HC); *Horizon Homes Ltd v CIR* (1994) 16 NZTC 11,064 (HC).
10. Financial reporting standards² and commercial accounting practice have some relevance in determining when a person derives income. However, they are not determinative and their relevance will always be subject to the statutory scheme and the most appropriate approach for income tax purposes: *Horizon Homes*; *CT (SA) v Executor Trustee and Agency Company of South Australia Ltd* (1938) 63 CLR 108 (*Carden's Case*) (HCA); *Arthur Murray*; *CIR v The National Bank of New Zealand* (1976) 2 NZTC 61,150 (CA).
11. Example | Tauira 1 illustrates when a contractor and subcontractor derive retention money under a common retention money arrangement.

² Including New Zealand Equivalent to International Financial Reporting Standard 15 Revenue from Contracts with Customers (NZ IFRS 15).

Does holding retention money on trust affect derivation?

12. In some cases, the person withholding the retention money (party A) holds that money on trust (for party B). For example, the CC Act 2002 provides that retention money is trust property, held on trust by party A for party B, until:³
- it is paid to party B;
 - it is used to remedy defects in party B's performance of its obligations under the construction contract, but only if the contract permits this and the parties comply with the contract; or
 - party B gives up any claim to it or it otherwise ceases to be payable to party B.
13. The Commissioner's view is that the existence of a trust of the nature described above does not change the timing of when a person derives retention money. The purpose of deeming retention money to be held on trust is to protect money that is payable to party B from party A's creditors. While party B has an equitable interest in the retention money when the trust arises, the timing of when it derives the retention money still depends on the contractual terms governing payment of the retention money. As discussed above, a party derives retention money when the income-earning process is complete.

What if retention provisions are void?

14. In *Stevensons Structural Engineers 1978 Ltd (in liq) v McMillan & Lockwood (PN) Ltd* (2024) NZHC 2415 a subcontractor carried out works under subcontracts that allowed the contractor to retain part of the contract price as retention money. Broadly, the subcontracts provided for 50% of the retention money to be released shortly after the subcontractor completed the subcontract works (first tranche), while the balance was payable shortly after practical completion of the head contract (second tranche).⁴ The subcontractor went into liquidation at a time when it had only partially completed its obligations under the subcontracts and before the contractor had released the retained amounts.
15. The court concluded the clause on the release of the second tranche was prohibited under the CC Act 2002 because payment depended on matters other than the subcontractor's own performance of its contractual obligations.⁵ As a result, the court

³ Section 18C of the CC Act 2002.

⁴ See [26] for the court's summary of the release of retentions under the subcontracts.

⁵ Section 18(1)(a) of the CC Act 2002 provides that any term in a construction contract is void that purports to make the payment of retention money conditional on anything other than the

found that all the retention provisions in the subcontracts were void and of no legal effect. The contractor was not contractually entitled to deduct any retentions or to retain the retention money.

16. *Stevensons* is a case about the consequences where statute renders a retention clause ineffective, rather than about deriving and incurring retention money. The possibility that a retention clause may be void under the CC Act 2002 does not affect the Commissioner's view that in the usual case, where retention clauses are valid, a party derives retention money when the income-earning process is complete and an enforceable debt is created.
17. Further, the Commissioner considers that in a situation such as the one in *Stevensons*, the subcontractor derives the retention money when the court orders its release, even if the actual payment occurs later. Although the contractor originally withheld the retained amounts from progress payments that a subcontractor earned when it performed its work, the subcontractor was not contractually entitled to demand payment of the retention money while the retention clause remained operative. Before the court's order, the retention money was not payable and no enforceable debt had arisen for those amounts.

When does a person incur expenditure on retention money ?

18. A deduction is allocated to the income year in which a person incurs the expenditure unless a specific timing provision applies (s BD 4(1) and (2)). For a discussion on how s EA 3 applies see from [22] and the financial arrangements rules in Part E, from [27].
19. In determining when expenditure is incurred, it is essential to consider relevant case law (s BD 4(3)). The courts have established that a person incurs expenditure when they have paid the expenditure or become definitively committed to making the payment. As most businesses account for tax on an accrual basis, they may incur expenditure before making a payment. As Richardson J explained in *CIR v Mitsubishi Motors New Zealand Ltd* (1994) 16 NZTC 11,099 (CA),⁶ deductions are not confined to amounts actually paid and may extend to expenditure to which the person is definitively committed.
20. A liability does not need to be indefeasible before a person can incur it. In *CIR v Glen Eden Metal Spinners Ltd* (1990) 12 NZTC 7,270 (CA), Richardson J explained that a taxpayer may be definitively committed to expenditure even though the liability may

performance of party B's obligations under the contract. The CC 2002 Act defines party B under s 18A.

⁶ At 11,102.

subsequently be reduced or avoided by the actions of others. Merely theoretical contingencies can be disregarded: *Mitsubishi Motors New Zealand*.

21. Example | Tauira 2 illustrates a situation where a contractor incurs retention money that it withheld from progress payments it made to a subcontractor under a common retention money arrangement.

Application of s EA 3 to retention money

22. As discussed at [18], a deduction is allocated to the income year in which the expenditure is incurred unless a specific timing provision applies. A specific timing provision that may be relevant to retention money is s EA 3, which applies when a deduction has been allowed for expenditure and some or all of the expenditure is unexpired at the end of the person's income year.
23. The effect of applying s EA 3 is that the unexpired portion of the person's expenditure at the end of an income year is added back as income for the income year and the person is allowed a deduction for that amount in the following income year.⁷
24. Whether s EA 3 applies depends on the particular facts and on the nature of the expenditure to which the retention money relates. Typically retention money is part of the consideration payable for work performed and materials supplied under a contract. Accordingly, retention money may represent expenditure on services or goods.
25. Expenditure on services is unexpired at the end of an income year if the services have not been performed by the end of the year (s EA 3(5)). Expenditure on goods is unexpired at the end of an income year if the person has not used up the goods in deriving income and the goods are not destroyed or rendered useless (s EA 3(4)).
26. Whether s EA 3 applies depends on the particular facts. However, often s EA 3 does not apply because the retention money is withheld from a payment made for work already performed and materials already supplied or used in performing that work.

Application of the financial arrangements rules to retention money

27. The financial arrangements rules (FA rules) govern the tax treatment of financial arrangements.⁸ The FA rules essentially require parties to a financial arrangement to spread income or expenditure from the arrangement over its term. The key purposes

⁷ A person who is allowed a deduction is excused from complying with s EA 3 if the expenditure is of a kind described in DET E12: Persons excused from complying with s EA 3 of the Income Tax Act 2007 *Tax Information Bulletin* Vol 21, No 2 (April 2009): 13.

⁸ The FA rules are in subpart EW.

of the rules are to prevent deductions for expenditure being accelerated and income recognition being deferred.

28. Whether the FA rules change the income year in which a person derives or incurs retention money depends on the particular facts, including the terms of the contractual arrangements that the parties entered into.
29. As discussed above, retention money arrangements are particularly common in the construction industry. Further, contractors and subcontractors in that industry may use the standard form construction industry subcontract agreement SA-2025 (SA-2025).⁹ The Commissioner considers that where the parties contract under SA-2025 (or its predecessor, SA-2017), the outcome is that the FA rules do not apply, or, if they do apply, they do not result in income or expenditure that the FA rules require to be spread.
30. Financial arrangements occur when money (or money's worth) is received now in consideration for money to be paid later, unless the Act specifically excludes them. Where it excludes arrangements from being financial arrangement, they are taxed under general or specific rules.¹⁰
31. The standard form subcontract agreement (SA-2025) is a financial arrangement because construction services are exchanged for payments made at a future time. However, the contract will be an excepted financial arrangement if it is a short-term agreement for sale and purchase.¹¹
32. A short-term agreement for sale and purchase includes an agreement to acquire or dispose of property or obtain or supply services that is continuous and where the seller renders periodic invoices and under which settlement is to take place, or services are to be performed, within 93 days after the date on which each invoice is rendered.¹²
33. To the extent the standard form subcontract agreement is an agreement for the sale and purchase of services (eg, construction services), it will generally be an excepted financial arrangement because:
 - the services are provided continuously (ie, without interruption from the date the contract is entered into until the works are completed);

⁹ Previously the standard form construction industry subcontract SA-2017.

¹⁰ See s EW 4, which sets out what is not a financial arrangement.

¹¹ See s EW 5(22).

¹² See para (a) of the definition of "agreement for the sale and purchase of property or services" and "short-term agreement for sale and purchase" in s YA 1.

- payment claims (invoices) for the services are rendered periodically by the subcontractor; and
 - the services are performed within the required 93 day period on the basis that payment claims are rendered for work already done.
34. To the extent the standard form subcontract is an agreement for the sale and purchase of property (eg, the agreement provides for items of property to be supplied separately from the property being constructed), the agreement will be an excepted financial arrangement if settlement is required within 93 days of the date the agreement is entered into. Whether this requirement is satisfied will depend on the particular facts.
35. However, to the extent the standard form subcontract is not an excepted financial arrangement there is unlikely to be any income or expenditure to spread under the FA rules on the basis that:
- the value of the property or services would be the price for the property or services agreed between the parties;
 - what is paid under the contract will equal the value of the property and services the subcontractor provides;
 - there is no interest component in the standard form subcontract; and
 - the subcontract provides for the ownership of any property supplied by a subcontractor to transfer to the contractor immediately on payment to the subcontractor.

Examples | Tauria

Example | Tauria 1 – A contractor and subcontractor deriving retention money

Wooden Build Ltd contracts with a customer to construct a commercial building.

The contract allows the customer to retain a percentage of progress payments made until Wooden Build Ltd completes the work and remedies any defects. The contract provides that the customer will release 50% of the retention amounts on the issue of a certificate of practical completion. The customer is then to release the balance on the latest of completing a 12 month defects liability period, or rectifying defects in the contract works notified within the defects liability period.

Wooden Build Ltd subcontracts part of the work to Stone Beam Ltd. Its subcontract with Stone Beam Ltd also allows it to retain a percentage of progress payments made until Stone Beam Ltd completes the work and remedies any defects. The contract provides for Wooden Build Ltd to release 50% of the retention amounts once notice of completion of the subcontract works is issued and the balance on the latest of completing of a 12 month defects liability period, or rectifying defects in the subcontract works notified within the defects liability period.

Over the contract period, the customer withholds a total of \$120,000 from progress payments made to Wooden Build Ltd. In line with the requirements of the CC Act 2002, the customer holds the retention money on trust for Wooden Build Ltd.

Similarly, Wooden Build Ltd withholds a total of \$40,000 from progress payments it makes to Stone Beam Ltd and holds the retention money on trust for Stone Beam Ltd.

It will be a matter of fact as to when work is complete and free of defects and omissions such that the contractor and subcontract derive the income. In this example:

- the notice of completion of the subcontract works is issued on 15 October 2025;
- the certificate of practical completion is issued on 7 April 2026; and
- both the contractor and subcontractor rectify defects notified within the defects liability period before the end of the defect liability period (which in both contracts is 7 April 2027).

Wooden Build Ltd derives \$60,000 of the retention money as income in its income year ending 31 March 2027. This is because it is entitled to payment of 50% of the retention money (50% of \$120,000) when the certificate of practical completion is issued (7 April 2026).

Stone Beam Ltd derives \$20,000 of the retention money as income in its income year ending 31 March 2026. This is because it is entitled to payment of 50% of the retention money (50% of \$40,000) when the notice of completion of the subcontract works is issued (15 October 2025).

Both Wooden Build Ltd and Stone Beam Ltd derive the balance of the retention money in their income year ending 31 March 2028. This is because the defects liability period ends on 7 April 2027 and all defects notified within that period were rectified before this date.

Variation

If, for example, Wooden Build Ltd notified Stone Beam Ltd of a defect in the subcontract works on 4 April 2027 that Stone Beam Ltd did not rectify until 3 June 2027, under the terms of the contract Stone Beam Ltd would derive the balance of the retention money on 3 June 2027 (also in its income year ending 31 March 2028).

Example | Taura 2 – A contractor incurring retention money

Wooden Build Ltd from Example | Taura 1 withheld a total of \$40,000 from progress payments it makes to Stone Beam Ltd as follows:

Date	Progress payment payable	Retention money amount
1 March 2025	\$150,000	\$15,000
1 May 2025	\$200,000	\$7,500
1 July 2025	\$280,000	\$14,000
1 September 2025	\$70,000	\$3,500
		\$40,000

Under the terms of its contract with Stone Beam Ltd (and consistent with the provisions in the CC Act 2002), Wooden Build Ltd can only use the retention money to:

- pay Stone Beam Ltd for its work;
- remedy defects in Stone Beam Ltd's work on behalf of Stone Beam Ltd and at Stone Beam Ltd's cost; or
- pay the person lawfully entitled to the money if Stone Beam Ltd gives up any claim to the money or the money otherwise ceases to be payable to Stone Beam Ltd.

Wooden Build Ltd incurs \$15,000 of the retention money amount in its income year ending 31 March 2025 and the remaining \$25,000 in its income year ending 31 March 2026.

When each progress payment becomes payable, Wooden Build Ltd is definitively committed to paying the retainable amount to Stone Beam Ltd.

The cost of remedying any defects is a cost of Stone Beam Ltd, not Wooden Build Ltd. That is, using the retention money to rectify defects is merely one mechanism for applying money that has already become an expense of Wooden Build Ltd (rather than evidence that Wooden Build Ltd has not yet incurred the expense).

While Wooden Build Ltd's liability may be defeasible (in the unlikely event Stone Beam Ltd gives up any claim to the retained money or it otherwise ceases to be payable to Stone Beam Ltd), Wooden Build Ltd has a present liability to pay the retention money in the future.

Draft items produced by the Tax Counsel Office represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, or practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

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References | Tohutoro

Legislative references | Tohutoro whakatureture

Construction Contracts Act 2002 – ss 18A, 18C, 18(I)(1)

Income Tax Act 2007 – ss BD 3, BD 4, CA 1, CB 1, EA 3, EW 4, EW 5, YA 1 (“agreement for the sale and purchase of property or services”, “short-term agreement for sale and purchase”)

Case references | Tohutoro kēhi

Arthur Murray (NSW) Pty Ltd v FCT (1965) 114 CLR 314 (HCA)

Australian Gas Light Co & Anor (1983) 52 ALR 691 (FCA)

CIR v Farmer's Trading Company Ltd (1982) 5 NZTC 61,200 (CA)

CIR v Glen Eden Metal Spinners Ltd (1990) 12 NZTC 7,270 (CA)

CIR v Mitsubishi Motors New Zealand Ltd (1994) 16 NZTC 11,099 (CA)

CIR v The National Bank of New Zealand (1976) 2 NZTC 61,150 (CA)

CT (SA) v Executor Trustee and Agency Company of South Australia Ltd (1938) 63 CLR 108 (HCA)

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HW Coyle Ltd v CIR (1980) 4 NZTC 61,558 (HC)

Stevensons Structural Engineers 1978 Ltd (in liq) v McMillan & Lockwood (PN) Ltd (2024) NZHC 2415

Other references | Tohutoro anō

DET E12: Persons excused from complying with section EA 3 of the Income Tax Act 2007 *Tax Information Bulletin* Vol 21, No 2 (April 2009): 13

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