TR 1999/D14 - Income tax: research and development: plant expenditure

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Draft Taxation Ruling
Income tax: research and development: plant expenditure

Contents	Para
What this Ruling is about	**1**
Ruling	**15**
Date of effect	**52**
Explanations	**53**
Appendix A	**after 138**
Detailed contents list	**139**
Your comments	**140**

Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

1. This Ruling discusses those provisions of section 73B of the *Income Tax Assessment Act 1936* ('the 1936 Act') that apply to expenditure incurred in respect of plant[1] used in carrying on research and development activities ('the *plant expenditure* provisions'). It is not concerned with plant that is *post-23 July 1996 pilot plant*.[2]

2. The provisions referred to in this Ruling are in **Appendix A**.

3. This Ruling explains the meaning of the following words and phrases in the definition of *plant expenditure* in subsection 73B(1):

- *plant* and *unit of plant*;
- '*expenditure incurred ... in the acquisition or the construction ... of a unit of plant*'; and
- '*for use by the company exclusively for the purpose of the carrying on ... of research and development activities*'.

4. The Ruling considers the commencement and cessation of exclusive use tests in subsections 73B(4) and (5), the consequences of ceasing to use a unit of plant in the same year as such use commenced, and the treatment of expenditure in respect of items commonly

[1] Including 'pilot plant' acquired or constructed under a contract entered into prior to 23 July 1996.

[2] This type of plant is dealt with in separate provisions in section 73B, namely, subsections 73B(4A) to (4J), 73B(15AA), 73B(15AB), 73B(21A) and 73B(24A). These provisions allow deductions at the concessional rate for *post-23July 1996 pilot plant* spread over the useful life of the plant where the plant is used exclusively in carrying on research and development activities. See subsections73B(1) and (4C) for definition of *post-23 July1996 pilot plant*.

referred to as *prototypes*. This Ruling also considers substance over form in contract arrangements and the application of Part IVA of the 1936 Act.

Class of person/arrangement

5. This Ruling only applies to an *eligible company* (see Appendix A) which is registered under the *Industry Research and Development Act*[3] (*IR&D Act*), as required by subsection 73B(10) of the 1936 Act,[4] and which has incurred expenditure on plant that is for use in the carrying on of *research and development activities*. It does not apply to expenditure that is not in respect of plant.

6. Note that expenditure incurred in the acquisition or construction of plant is precluded from deduction under the general operative provision of section 73B, subsection 73B(14), by virtue of the exclusion contained in the definition of *research and development expenditure* in subsection 73B(1) (see Appendix A).

7. For the purposes of this Ruling, we have distinguished between two categories of plant that a company may use in carrying on research and development ('R&D') activities. The first category is where the item of plant acquired or constructed by the *eligible company* is an ***end-result or object*** of a particular program of R&D activities, and testing or other analysis of its performance is integral to the R&D program ('end-result plant').

8. The particular type of end-result plant dealt with in this Ruling is constructed or acquired on a full-scale basis and is, thus, distinguished from another type of end-result plant - that of 'pilot plant', defined in subsection 73B(1) to be a 'model' (see Appendix A for the full definition of *pilot plant*).

9. The other category of plant is those items used to carry out R&D activities in a facilitative way, i.e., without themselves being the subject of the R&D activities ('facilitative plant').

10. The distinction between these two categories of R&D plant is illustrated as follows. An eligible company purchases a standard computer from a common supplier, to use it to record and analyse the results of certain laboratory experiments. This computer is not the subject of these experiments, nor is it the end-result of them. However, to the extent that the experiments constitute R&D activities, that computer, as an item of plant, is used for the 'purpose of carrying

[3] Pursuant to section 39J or 39P of the *IR&D Act*.

[4] Note that the eligible company is required to be registered with the Industry Research and Development Board in respect of each year and *each research and development activity* in respect of which plant expenditure (or any other section 73B expenditure) is to be claimed.

on' those R&D activities (see, e.g., subsection 73B(4)). This computer is facilitative plant.

11. In contrast, a company acquires and modifies, or constructs, a new, innovatively designed and built full scale mainframe computer, based around new, technically risky components as part of a concerted R&D program to design and produce this new machine. This item of plant is the primary subject of this set of activities, and its use in being tested, having its performance evaluated and being modified, is a use for the purpose of carrying on these activities. To the extent that the activities are R&D activities, there is 'R&D use' of this item of plant. This computer is end-result plant.

12. While this Ruling focuses primarily on end-result plant, the principles discussed herein apply equally (where relevant) to facilitative plant.

13. We do not address the determination of which activities are *research and development activities* in this Ruling. This is a matter which is the responsibility of the Industry Research and Development Board (see Appendix E to Taxation Ruling IT 2552, and the comment on Question 1).[5] An underlying presumption in applying this Ruling is that the activities in respect of which a unit of plant is used are eligible *research and development activities*.

14. This Ruling supersedes paragraphs 22 and 23 of IT 2532 and we will withdraw them when this Ruling issues in final form.

Ruling

Operation of the plant provisions

15. To fully appreciate the matters discussed in this Ruling, it may be useful to consider the broad operation of the plant provisions as they appear in section 73B. The following is a very brief outline of the most important provisions, designed to give some context to the discussion that follows. It should not be used as a substitute for a careful reading of the section, as and when required:

- subsection 73B(15) - allows a deduction based on *qualifying plant expenditure*; also requires the unit of plant to have commenced to be used exclusively for R&D purposes;
- subsection 73B(4) - defines qualifying plant expenditure (subject to subsection 73B(5)); requires the

[5] Note that the IR&D Board has issued a draft Tax Concession Advisory Note on 'R&D claims involving the development, construction and installation of Plant and Equipment'.

company to have incurred *plant expenditure* (as defined in subsection 73B(1));

- subsection 73B(5) – deems there to be **no** *qualifying plant expenditure* where the company has ceased to use the unit of plant exclusively for R&D purposes;
- subsection 73B(21) – notwithstanding subsection 73B(5), provides that a deduction for depreciation may still be allowable;
- subsection 73B(23) – deals with the loss, disposal or destruction of a unit of plant that has been the subject of subsection 73B(15).

Definition of plant expenditure

16. The existence of an amount of *plant expenditure* is the starting point for the operation of all of the provisions outlined above. *Plant expenditure* is defined in subsection 73B(1) in relation to an eligible company as:

> '… expenditure incurred by the company in -
>
> (a) the acquisition, or the construction … of a unit of plant other than post-23 July 1996 pilot plant; or
>
> (b) the construction by the company … of a unit of plant other than post-23 July 1996 pilot plant,
>
> being a unit of plant for use by the company exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities'.

17. The following paragraphs deal with various aspects of this definition.

Plant

18. The definition of 'plant' in subsection 73B(1) includes anything that is plant under Division 42 of the *Income Tax Assessment Act 1997* ('the 1997 Act') and anything that is plant or articles under section 54 of the 1936 Act (the depreciation provisions).

19. We consider that the following principles apply when determining whether an item is 'plant' for the purposes of subsection 73B(1):

- the item is more than the mere setting in which the taxpayer carried on their business (*Broken Hill Proprietary Co Ltd v. FC of T*[6]);
- the item serves a functional purpose in the taxpayer's business operation (*Quarries Ltd v. FC of T*[7]);
- the item is a chattel or fixture kept for use in carrying on a business operation (*Broken Hill Proprietary Co Ltd*); including items in the nature of a 'tool' in the trade that 'plays a part' in the business operation (*Macquarie Worsteds Pty Ltd v. FC of T*[8]);
- the item has an enduring character as an asset used in the taxpayer's business operations, as opposed to being consumed in those operations (*Davies Coop & Co Ltd v. FC of T*[9]); and
- further, the item may be an *article* (by virtue of the inclusion of *articles* in the definition of plant in subsection 73B(1) prior to 1 July 1997, and subsequent to that, by virtue of the inclusion of *articles* in the definition of plant in subsection 42-18(1) of the 1997 Act). The term *articles* takes on the comprehensive meaning it is given in common usage, and includes items that may not normally be considered to be plant because they fail to have the ordinary business or industrial characteristics, such as very small or portable items.[10]

20. Where a company carries on business which includes research and development activities, the term 'plant' includes chattels and fixtures kept for use in carrying on the company's R&D operations. This includes:

- items of facilitative plant; and
- items of end result plant that are used for the purposes of furthering the R&D activities (e.g., testing, analysis, data extraction, modification or development)

where those items are not expected to be consumed or used up in the R&D activities.

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[6] (1967) 120 CLR 240; (1969) 1 ATR 40; (1968) 15 ATD 43.
[7] (1961) 106 CLR 310; 35 ALJR 310.
[8] 74 ATC 4121; (1974) 4 ATR 334.
[9] (1948) 77 CLR 299; 8 ATD 320.
[10] *Case Q11* 83 ATC 14; (1983) 6 CTBR(NS) *Case 75*.

21. We also consider that plant and trading stock are mutually exclusive notions (see *Yarmouth v. France*;[11] *Davies Coop & Co Ltd*).

What is a prototype and can it be an item of plant?

22. The term 'prototype' is commonly and loosely used to refer to any experimental, generally 'first-off' item, developed as a result of R&D activities. 'Prototype' is not a defined term within section 73B, nor is the concept of a prototype referred to in the section. Specific treatment is, however, accorded to *pilot plant* (defined in subsection 73B(1)[12]). We will apply the principles set out in paragraphs 18 to 21 above to determine whether a prototype (other than pilot plant) is an item of plant.

23. For example, where a company develops a prototype of a new line of trading stock, and the item:

(a) is to be used in the R&D operation for testing, analysis or developmental purposes; and

(b) is not expected to be destroyed, consumed or rendered useless in those operations

it is an item of plant.

24. However, where the company expects the item to be rendered useless, consumed or destroyed, the item is not plant.

The treatment of expenditure in respect of prototypes

25. Where a prototype is a full scale end-result plant, or an item of plant of the type described in the example in paragraph 23, the expenditure falls for consideration under the *plant expenditure* provisions of section 73B. It is subject to the exclusive use and the disposal or transfer of use provisions relating to *plant expenditure*, many of which are dealt with in this Ruling.

26. Where a company incurs expenditure in relation to the item which is not plant as described in paragraph 24 above, the expenditure is not plant expenditure and falls to be considered under subsection 73B(14) as *research and development expenditure*.

Unit of plant

27. The determination of what comprises a *unit of plant* depends upon a review of the function and purpose of the items in question and

[11] (1887) 19 QBD 647.
[12] See **Appendix A**.

is a question of fact and degree. A *unit of plant* is an item that has a separate function, and is functionally complete in itself, even though it may not be self-contained or isolated.

28. When an item of end-result plant is being constructed, it become a unit of plant at the time that it commences to serve a functional purpose in respect of the R&D operation being conducted. Relevant functions to which it might be applied include:

- testing the success of the plant and the research;
- providing data for analysis; and
- adapting or modifying the item to further the research.

29. Whilst the item may not be 'complete' or considered to be a unit of plant in a conventional (production) sense at such a time, the R&D function that it is serving gives it the character of a unit of plant in respect of the research and development activities being conducted.

30. A *unit of plant* may, as a consequence of having had major alterations or additions carried out on it, or by being integrated with other units of plant, evolve or merge into a further *unit of plant*. This second unit of plant is then subjected to further testing or analysis in its expanded or integrated form. We consider that a new unit of plant occurs (as opposed to the original unit merely being modified) if the function or use played by the second unit is materially different from that performed by the original unit.

31. We do not consider the merging of the original unit into the second unit to be a cessation of use of the original unit by virtue of its ceasing to exist. Rather, we consider both units to co-exist. Therefore, the expenditure incurred on both units is eligible for deduction as long as the second integrated unit is applied to an R&D purpose or function (provided the other tests of deductibility are met).

Expenditure incurred in the acquisition or construction of a unit of plant…

32. Expenditure incurred in transporting and/or installing items of eligible (i.e., intended to be used, and actually used, exclusively for R&D purposes) plant on-site falls for consideration for deduction under subsection 73B(15) as *qualifying plant expenditure*, not under subsection 73B(14) as *research and development expenditure*, in both of the following circumstances:

- where the transportation and on-site installation occurs after the completion of the construction of the *unit of plant*, so that it can be used for R&D purposes on that site; and

- where the installation and transportation themselves are instrumental in bringing about a new *unit of plant* (e.g., where various components or other units of plant are integrated into a new *unit of plant*).

33. The term 'expenditure' includes the money value of any consideration paid or given otherwise than in cash, by virtue of the operation of section 21 of the 1936 Act.

Design costs

34. We do not consider expenditure incurred in the general design and development of the concept for a new machine or other plant (such as costs of basic and applied research, computer modelling, etc.) to be expenditure on the construction of a unit of plant. However, it may be *research and development expenditure*. In contrast, the costs of the specific design plans for the actual unit of plant itself comprise expenditure in the construction of the unit of plant.

Salary and wage expenditure incurred in the construction of plant

35. Expenditure on salary and wages for staff engaged in the construction of an eligible unit of plant falls for consideration under subsection 73B(15), as *qualifying plant expenditure*, and not under subsection 73B(14) as *salary expenditure*, a component of *research and development expenditure*.

For use … exclusively for the purpose of carrying on … of research and development activities

36. The test of whether expenditure is incurred on a unit of plant '*for use ... exclusively for the purpose of carrying on ... of research and development activities*' is an integral part of the definition of *plant expenditure* in subsection 73B(1). This test involves identifying the ***intended use or uses for the unit***, as gauged at the time the expenditure in respect of the plant is incurred.

37. The test requires that the company intend to use the plant at that time solely and exclusively for the purpose of carrying on R&D activities, regardless of the period of time to which this intention relates. Therefore, if a company constructs end-result plant, even if there is some doubt about whether it can be successfully completed, and intends to use the item:

- to test the success of the R&D program; or to use it for some other R&D purpose; and also
- for a production or other (non-R&D) business purpose;

expenditure on construction of that item does not satisfy the exclusive use intention test.

38. Similarly, if a company intends to use an item of facilitative plant (such as the computer referred to in paragraph 10 above) in R&D activities and on completion of those activities in general administrative duties, the expenditure is not plant expenditure.

Determining the company's intention

39. In determining the company's intentions in relation to the unit of plant, the Commissioner has regard to all of the relevant facts of each case, including:

- the company's stated intentions and plans (including contingency plans) and corporate records thereof;
- the actual uses to which the plant has been applied, and the credibility of any explanations given by the company to justify a claimed change of intention and consequent use;
- the amount of non-essential (from an R&D perspective) activities undertaken and expenditure incurred on the unit of plant, e.g., on cosmetic enhancement or aspects unrelated to the outcome of the R&D;
- the level of expenditure involved;
- whether a full scale plant was preferable to a model from an R&D perspective; and
- the nature of any commitments entered into requiring future use of the plant (e.g., for sale of output of the plant) and whether those commitments are revocable in the event of failure of the plant, or contingency plans are in place to satisfy the commitments from another source.

Note that the above list is NOT exhaustive.

40. None of these factors is necessarily conclusive and in any particular case, other factors may be relevant.

Qualifying plant expenditure

41. The following paragraphs relate to the operation of subsections 73B(4) and (5), which determine whether there is an amount of qualifying *plant expenditure* in relation to the company in relation to the year of income.

42. Once it is established that an amount of *plant expenditure* exists, subsection 73B(4) deems there to be an amount of *qualifying plant expenditure* where, during the year of income, the company commences to use the unit of plant exclusively for the purpose of the carrying on of research and development activities.

43. However, if during the year of income the company ceases to use the unit of plant exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities, subsection 73B(5) states that there shall be no amount of qualifying *plant expenditure* in respect of that year or any subsequent year.

Meaning of 'commences to use … exclusively'

44. The purpose of this phrase in subsection 73B(4) is to identify, in conjunction with subsection 73B(15), when there first appears 'qualifying *plant expenditure*', so that deductibility can commence.

45. To determine what actually comprises a 'unit of plant', the functional use that the item plays in the R&D operation is relevant. A company is taken to '*commence to use ... exclusively...*' the item at the time the unit is actually first **applied** to that use. It does not include the period of time in which the unit of plant is constructed or assembled.

Meaning of 'ceases to use'

46. We consider the term 'ceases to use' in subsection 73B(5) means that a company has ceased to hold and maintain the unit of plant exclusively for the required purposes. This occurs if the company:

- ceases to apply the plant exclusively for R&D purposes; or
- commences to hold the plant for some other purpose; or
- physically uses the plant for another purpose.

47. For example, we do not consider the cessation of physical use of scientific laboratory equipment at the completion of one R&D program, where that equipment is to be used in further R&D projects, to be a relevant cessation of use. Commencing to use the unit of plant for a non-R&D purpose is, however, a cessation of actual exclusive R&D use.

Where cessation occurs in the year of commencement

48. Where the use of a unit of plant exclusively for research and development activities commences and ceases (as per paragraphs 44 to 47 above) within the one financial year, no deduction at all is allowable under subsection 73B(15) for *qualifying plant expenditure*. Any expenditure on such a unit of plant is considered for deduction only under the general depreciation provisions of the 1936 Act or the 1997 Act.

Substance over form in contract arrangements

49. A company may purport to enter into a contract for the provision of R&D services and seek to deduct the costs as *research and development expenditure*. However, it may be apparent from the circumstances that the true nature of the contract is one for the provision of a unit of plant to the company. In these circumstances, it is the substance of the arrangement that determines eligibility for deduction, rather than the form of the contract or the labels given to the expenditure therein.

50. We make a determination of the true character of an expenditure from an examination of all the relevant facts and circumstances. Similarly, we consider the totality of the facts to determine the true intention of the parties where the intention of the parties is that the documents are not to create the legal rights and obligations which they give the appearance of creating.

Part IVA

51. In circumstances where we determine that a company has entered into arrangements with the dominant purpose of obtaining a tax benefit, we may apply Part IVA. For example, a company might use an interposed entity for the purpose of obtaining an immediate deduction rather than having it spread over 3 years, where there is no commercial reason for such interposition.

Date of effect

52. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Operation of the plant provisions

53. A deduction in respect of *plant expenditure* is allowed under subsection 73B(15) where, in the year in which an *eligible company* commences using a unit of plant exclusively for the purpose of carrying on research and development activities, or in either of the two subsequent years, there is an amount of *qualifying plant expenditure* in relation to the unit of plant. The amount of the deduction allowed (where the *aggregate research and development amount*[13] in relation to the company in relation to the year of income is greater than $20,000) is one third of the amount of *qualifying plant expenditure* multiplied by 1.25. Where the *aggregate research and development amount* is less than $20,000, the deduction allowed is one third of the amount of *qualifying plant expenditure*.

54. Subsection 73B(4) provides that there shall, in relation to a unit of plant, be an amount of *qualifying plant expenditure* in relation to the year of income and in relation to each of the two succeeding years of income. It applies where, during the year of income, the eligible company commences to use the unit of plant, in respect of which the company has incurred an amount of *plant expenditure*, exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities.

55. However, under subsection 73B(5), where there would otherwise be an amount of *qualifying plant expenditure* in relation to a unit of plant owned by an eligible company in relation to a year of income and, at any time during the year of income, the company ceases to use that unit of plant exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities, there shall be no amount of *qualifying plant expenditure* in relation to that unit of plant in relation to the year of income or any succeeding year of income.

56. '*Plant*' is defined in subsection 73B(1) to mean:

- things that are plant within the meaning of section 42-18 of the 1997 Act (this meaning applies from the 1996-97 income year onwards; prior to this, the definition referred to things that are plant or articles within the meaning of subsection 54(1) of the 1936 Act); or
- things to which section 42-18 (previously subsection 54(2) of the 1936 Act) would apply if the carrying on of research and development activities were the

[13] See **Appendix A** for the definition of this term.

carrying on of a business for the purpose of producing assessable income; or

- pilot plant other than post-23 July 1996 pilot plant.

57. If, during either of the second or third years following the year of commencement of exclusive use, the unit of plant ceases to be used exclusively for carrying on R&D activities and commences to be used for an income producing purpose that qualifies it for depreciation deductions, subsection 73B(21) provides a mechanism for further deductions to be allowed under the depreciation provisions. This subsection deems the unit of plant to have been acquired by the company at a cost equal to its *written down value*[14] generally on the first day of the year of income in which the change of use occurred. Effectively, the *written down value* is the undeducted portion of the cost of the unit of plant, ignoring any concessional component allowed (i.e., two thirds or one third of the cost of the unit of plant in years two and three respectively).

58. Where a unit of plant that has been used exclusively for the purpose of carrying on R&D activities is then disposed of, lost or destroyed in either of years two or three, an additional deduction[15] is allowed in respect of any loss incurred on such an event and any profit made is included as assessable income, under subsection 73B(23).

Plant expenditure

59. *Plant* is defined in subsection 73B(1) to mean things that are plant within the meaning of section 42-18 of the 1997 Act (for 1997 and prior income years, it means things that are plant or articles within the meaning of subsection 54(1) of the 1936 Act), whether or not depreciation is allowable under those (sub)sections; or things to which section 42-18 (or subsection 54(1)) would apply if the carrying on of research and development activities were the carrying on of a business for the purpose of producing assessable income; or pilot plant other than post-23 July 1996 pilot plant. The definition of *plant* within the respective depreciation provisions is an inclusive one, leaving the core meaning of the term *plant* to be determined by reference to case law.

60. Case law has tended to distinguish the concept of 'plant' from things that are the 'mere setting' in which the taxpayer carries on business. The term does cover things that are in the nature of 'tools' or that 'play a part' in the business operations (*Broken Hill Proprietary Co Ltd*;[16] *Macquarie Worsteds Pty Ltd*;[17] and *Carpentaria*

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[14] See **Appendix A** for the definition of this term.
[15] The additional deduction is at the concessional (125%) rate if the aggregate research and development amount exceeds $20,000.
[16] (1967) 120 CLR 240; (1969) 1 ATR 40.
[17] 74 ATC 4121; (1974) 4 ATR 334.

Transport Pty Ltd v. FC of T[18]). To be an item of *plant* the item needs to serve some functional purpose in the business operations within that setting (*Quarries Ltd*; *Wangaratta Woollen Mills Ltd v. FC of T*;[19] *Macquarie Worsteds Pty Ltd*). An item so closely integrated with its setting, and supported by that setting in a way that makes its functioning possible, may not be possible to separate from that setting in determining whether there is an item of *plant* (Taxation Ruling IT 31; *Wangaratta Woollen Mills*).

61. In *Broken Hill Proprietary Co Ltd*,[20] Kitto J, in considering the term 'necessary plant' in the former subsection 122(1), said at 48:

> 'As to the meaning of the word "plant", it is sufficient at this point to refer to a line of English decisions from *Yarmouth v. France* (1887) 19 Q.B.D. 658, *J Lyons & Co. Ltd. v. The Attorney-General* (1944) 1 Ch. 287 and *Jarrod v. John Good & Sons Ltd* (1963) 1 W.L.R. 214, and to say that in my opinion, in accordance with the exposition to be found in these cases, the word as used in sec.122(1) **includes every chattel or fixture which is kept for use in carrying on of the mining operations**, not being (in the case of a building) merely in the nature of the general setting in which a part of those operations are carried on.' (our emphasis)

62. The term *plant*, as defined in subsection 73B(1), includes *articles* (through inclusion in the subsection 73B(1) definition of *plant* prior to 1 July 1997 and by inclusion in subsection 42-18(1) after that date). The term *articles* is also not defined in either the 1936 Act or the 1997 Act and so takes its meaning from the common understanding of the expression.

63. The *Shorter Oxford Dictionary* meaning of the term includes:

> 'a particular material thing, a commodity, or a piece of goods or property'.

64. The term *articles* has been found to be a very broad and comprehensive word, unlimited by the context in which it appears (*Quarries Ltd*;[21] *Faichney v. FC of T*[22]). Its meaning includes items that may not fall within the meaning of *plant*, due perhaps to their small size or portability (e.g., a watch[23]), or lack of business or industrial characteristics (*Faichney*). It does not include a structure erected or built in situ or a fixture *(Quarries Ltd*; Taxation Determination TD 97/24).

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[18] 90 ATC 4590; (1990) 21 ATR 513.
[19] (1969) 119 CLR 1; 69 ATC 4095; (1969) 1 ATR 329.
[20] (1968) 15 ATD 43.
[21] (1961) 106 CLR 310.
[22] 72 ATC 4245; (1972) 3 ATR 435.
[23] *Case Q11* 83 ATC 14; *Case 75* (1983) 6 CTBR(NS).

65. In order to be an item of *plant* the item must have an enduring character as a piece of machinery, apparatus or appliance used in the taxpayer's operation, as opposed to being consumed in the manufacturing process (*Davies Coop & Co Ltd*[24]).

66. In applying these principles to a research and development operation, every enduring chattel or fixture kept for use in carrying on the research and development operation and serving a functional purpose in those operations, is *plant*. This includes items that are kept to facilitate the R&D operations, such as computers for recording experimental data and design activities, microscopes, test benches, etc. It also includes items constructed as the object of the research and development activities, and kept to be used in testing, analysing or further developing the R&D results.

What is a prototype and can it be an item of plant?

67. A relevant question in looking at research and development *plant* is the treatment to be given to expenditure on a prototype in an R&D operation. The specific question is whether a prototype is, in fact, a unit of *plant* and, thus, the expenditure thereon is *plant expenditure*, or whether this expenditure is *other expenditure* (see paragraph (c) of the definition of *research and development expenditure* in subsection 73B(1)).

68. The term *prototype* does not feature in section 73B. It is commonly used loosely to describe a range of end-result items produced in a research and development operation, the more common being to describe virtually any experimental, usually 'first-off' item. The expression may at times be used to refer to items that are *pilot plant* as defined in subsection 73B(1). It is also used to refer to an item that is the forerunner of a new line of trading stock.

69. A more specific definition of this term is found in *The Frascati Manual 1993*.[25] Paragraph 115 of this publication states that:

> 'A prototype is an original model constructed to include all the technical characteristics and performances of the new product. For example, if a pump for corrosive liquids is being developed, several prototypes are needed for accelerated life tests with different chemicals. A feedback loop exists so that if prototype tests are not successful the results can be used for further development of the pump.'

70. *The Frascati Manual* at paragraph 117 refers to prototypes separately from pilot plants.

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[24] (1948) 77 CLR 299.
[25] OECD Proposed Standard Practice for Surveys of Research and Development (5th edition).

71. The treatment under section 73B of the various forms of 'prototype' (as per the broad understanding of this term) is as follows:

- the section 73B treatment of any such items that fall within the subsection 73B(1) definition of *pilot plant* is specifically prescribed for both pre and *post-23 July 1996 pilot plant* (the operative provisions being subsections 73B(15) and (15AA) respectively);
- expenditure on a 'prototype' that is a *full scale* end-result plant falls for consideration as *plant expenditure*;
- if the expenditure relates to an item that is the forerunner of a new line of trading stock, such as the first of a new line of life jackets, the treatment of that expenditure depends upon whether that 'prototype' performs a plant function in respect of the R&D operation being conducted. To the extent that the 'prototype' is to be used in carrying out the research and development activities, such as by submitting it to durability, longevity and strength testing, it performs such a plant function or, alternatively, is an article used in those operations. As such, the expenditure thereon (labour, materials and a portion of overheads) may fall for consideration as *plant expenditure*, subject to the exclusive use tests and the disposal provisions relating to *plant expenditure* (subject to the next dot point);
- it is not an item of *plant*, however, if during the course of being used in the research and development activities, it is expected to be damaged, destroyed or rendered useless, i.e., in effect it is to be 'consumed' in the research and development operations (*Davies Coop*; Taxation Ruling IT 333) or if the 'prototype' does not perform any plant function in respect of the R&D operations. In these circumstances, the expenditure is considered for deduction under subsection 73B(14) as '*research and development expenditure*'. The majority of expenditure on items that are the forerunners of trading stock lines probably falls into this category.

Unit of plant

72. Identification of what is a *unit of plant* is critical to determining:

- whether the 'unit' is 'for use … exclusively' for the purpose of carrying on R&D activities; and

- when the eligible company 'commences to use' that unit, for the purposes of subsection73B(4).

73. The expression 'unit of plant' is not defined in either the 1936 Act or 1997 Act. The meaning of the (similar) expression 'unit of property' in the investment allowance provisions is considered in Taxation Ruling TR 94/11, and is relevant for these purposes.

74. The basic test put forward in TR 94/11, on the basis of the authorities summarised therein, is a 'function or purpose' test. An item is generally a 'unit of property', according to paragraph 3 of TR 94/11, if it has one or more of the following characteristics:

(a) it is an entire entity in itself, capable of being separately identified or regarded [as such] and having a separate function;

(b) the item is functionally complete in itself. However, the item need not be self-contained or used in isolation. It is not necessary that the item function on its own. It should, however, be capable of performing its intended discrete function;

(c) the item, when attached to another unit of property having its own independent function, varies the performance of that unit [and so a separate unit is created]; or

(d) the item itself performs a definable, identifiable function.

75. Paragraph 5 of TR 94/11 talks about separate units being integrally linked so as to create a single (larger) unit, having its own individual function. However, succeeding paragraphs make it clear that the authorities do not necessarily require absolute functionality, or 'self-containment' from an item for it to be categorised as a 'unit of property': see especially *Tully Co-operative Sugar Milling Assoc Ltd v. FC of T*[26] and *Monier Colortile Pty Ltd v. FC of T*.[27] In *Monier* a base station and executive handset, and each of 16 separate mobile stations (making up a two-way radio system), were held to be separate units of property. This was so despite the fact that the base station was 'useless' without one or more of the mobile stations, and vice versa.

76. Conversely, in *FC of T v. Veterinary Medical and Surgical Supplies Ltd*,[28] discussed in paragraph 23 of TR 94/11, the whole telephone system, comprising a central processing system and seven interactive handsets, was held to be a single unit of property. While

[26] 82 ATC 4454; (1982) 13 ATR 410.
[27] 84 ATC 4846; (1984) 15 ATR 1256.
[28] 88 ATC 4642; (1988) 19 ATR 1593.

not attempting any direct reconciliation of these apparently conflicting decisions, TR 94/11, after citing certain passages from *Tully Co-operative*, does state at paragraph 27;

> 'Thus, whether there is a functionally complete unit or simply a component in a larger system which is the "unit of property" will be a question of fact and degree which can only be decided by reference to the specific facts in issue.'

77. When applying a functional test to research and development *plant*, and in particular to end-result plant, the likely relevant types of function that such plant perform are those such as testing, analysis, data extraction, modification, etc., within the R&D process. We consider each of these functions to be sufficiently complete, definable and identifiable, so as to give the item subjected to those uses the characteristics of a 'unit of plant' in respect of the R&D operations.

78. There are two general fact scenarios that are likely to arise in relation to end-result plant. The first is where an item is designed, developed and constructed as a whole and, once built, is subjected to such R&D uses as testing, data extraction, analysis and modification. Through this process the item may be subjected to retesting, etc., following adjustment or modification of the item. The item in these circumstances is considered to comprise a unit of plant by virtue of performing these R&D functions, assuming the modifications are not so extensive as to create a different **unit of plant**. If this is the case, the comments in paragraphs 79 to 86 below concerning *evolving* units of plant are relevant.

79. The second set of circumstances are an R&D program instigated to develop a complex item of plant that is comprised of many components, with several of the components being experimental, and/or where the integration of the components together may be experimental or risky. Thus, there can be technical uncertainty in both the development of components as well as whether the components can be successfully integrated together to form the larger unit of plant.

80. The answer to 'what are the units of plant' in these circumstances is determined on a factual analysis of the R&D activity being undertaken. As stated by Fox J in *FC of T v. Tully Co-operative*[29] at ATR 500; ATC 4500;

> 'Several items, each of which at some stage could for presently relevant purposes be regarded as a unit, can be combined, or linked or associated together so as to form a larger unit. When one looks to see whether there is a unit, one normally looks to see whether there is a whole something. Whether there is a

[29] (1983) 14 ATR 495; 83 ATC 4495.

whole will normally be judged by the intended function or purpose of that which is being looked at.'

81. In this scenario, the R&D functionality in the initial testing (or other R&D use) of a component stamps that component with the character of a 'unit of plant'. Should this component subsequently be integrated with other components (whether experimental components or not), with the integrated item then being subjected to testing (or other R&D use), then a new 'unit of plant' has been formed. This new 'unit of plant' comprising integrated components is a different one from the **initial** 'unit(s) of plant', both in appearance, complexity and the nature of the testing, etc., carried out. In this way, one or several 'units of plant' may merge together or with other components and be transformed into other 'units of plant'.

82. While it might be expected that such an evolving *unit of plant* would be a concept peculiar to R&D activities, we note that this concept was clearly contemplated in a normal manufacturing environment (see the quote from *Tully Co-operative* in paragraph 80 above).

83. In this second scenario, an amount of *qualifying plant expenditure* exists under subsection 73B(4) from the time each experimental component 'unit of plant' is used in the testing process (or other R&D function). The act of merging these existing 'units of plant', or combining such 'units of plant' with other non-experimental components into a new 'unit of plant', with a different R&D function, produces the following consequences.

84. The first components built and tested, so as to be 'units of plant', give rise to *plant expenditure*, subject to write-off over up to a three year period (dependent upon the period for which these item are 'used' in the R&D activities). On integration of these 'units of plant' together with other units or components, the additional costs incurred in integration (including the costs of other non-experimental components) are the costs attributable to the new *unit of plant*, again subject to a three year write-off from the time the use in the R&D activities commences. The question arises whether the original component 'units of plant', by virtue of ceasing to exist as a 'unit of plant' in their former form, are said to have 'ceased to be used exclusively in carrying on R&D activities' for the purposes of subsection 73B(5). If the answer to this question were 'yes', then entitlement to further concessional deduction for that expenditure would cease.

85. We consider the better view to be that the initial component 'units of plant' continue to be used in carrying on the R&D activities, even though that use takes place when they are integrated into a new 'unit of plant'. In this way, all of the expenditure on experimental

plant used in the R&D operation is eligible for concessional treatment during the period in which such use occurs.

86. A consequence of the discussion in paragraphs 72 to 85 above is that components or items that would not normally be regarded as 'units of plant' in a production or manufacturing operation (because they are not functionally complete in themselves in a manufacturing sense and because they form a part of a larger 'unit of plant') may, *when being developed in an R&D operation*, comprise separate 'units of plant' for those purposes. The key point is that it is the 'use' or 'function' which is served in the *R&D operation* that is important in making this assessment, not the subsequent 'use' or 'function' which the completed item will serve in a production setting.

Expenditure incurred in the acquisition or construction of a unit of plant…

87. The terms '*acquisition*' and '*construction*' are not defined within section 73B, and are interpreted according to their ordinary meanings. The *Shorter Oxford Dictionary* meaning of '*acquisition*' is 'the action of acquiring something', with '*acquire*' defined as 'gain or get as one's own, by one's own exertion or qualities; come into possession of'. '*Construction*' is defined as 'the act of constructing something; the art or science of doing this; the manner in which something is arranged; structure, disposition'. 'Construct' is defined as 'make by fitting parts together; build, erect'.

88. An issue has been raised as to whether this term includes the costs of transportation and installation of a 'unit of plant', i.e., whether such costs are incurred 'in' the acquisition or construction of a 'unit of plant'.

89. A 'unit of plant' (say, for example, a component of an industrial machine that is also a 'unit of plant' in an R&D operation as per paragraph 81) may be built in one location, and then transported to another location, where it is integrated with other components into a larger 'unit of plant' for use in further R&D activities. In this case, the transportation and installation costs are incurred in bringing the latter 'unit of plant' into existence, and are 'incurred in the construction' of that latter 'unit of plant' (see the second dot point in paragraph 32).

90. Alternatively, a 'unit of plant' may be constructed in a factory location, but the use or role that it is to perform in the R&D program can only be carried out in another location (as per the first dot point in paragraph 32). We consider that costs of transportation and installation are costs incurred '*in the acquisition of construction of a unit of plant*' because these costs form a part of the 'cost' of the unit of plant, for reasons outlined in the following paragraphs.

91. We think the wording used in the definition of *plant expenditure* is no broader or narrower in its meaning than the expression '*the cost of the unit to the person*' used as a basis for depreciation in the 1936 Act in former subsection 62(1), or the '*cost*' of the plant for the purposes of Subdivision 42-B for the same purpose in the 1997Act. In other words, we consider the terms 'cost' of a unit and 'expenditure incurred in the acquisition or construction' of a unit to mean the same thing.

92. Such an approach has been endorsed in respect of the investment allowance provisions and the depreciation provisions. It was noted in *Case S51*,[30] at 382, that the words 'acquisition or construction' in the investment allowance provisions should be given a meaning that is in harmony with the operation of the depreciation provisions. The Board of Review thought this was the intended result, as was evident from the choice of the common base of a 'unit of property'.

93. The expression used in the investment allowance provisions is very similar to that used in the definition of *plant expenditure*. Former subsection 82AB(1) read in part:

> '… where -
>
> (a) on or after 1 January 1976, a taxpayer has incurred expenditure of a capital nature (in this section referred to as "eligible expenditure") in respect of the acquisition or construction by him of a new unit of eligible property to which this subdivision applies; …'.

94. In *Tully Co-operative*, which considered this provision, the costs of installation and erection of items acquired from other parties (either by employees of the company or third parties supervised by employees) were found to be costs of construction. Given the similarities between the *plant expenditure* and the investment allowance expressions, there is strong argument for a consistent interpretation as between the investment allowance and *plant expenditure* provisions.

95. Taxation Ruling IT 2142, which was released after, and relied on the decision in *Tully*, states at paragraph 11 that '… while installation need not necessarily involve construction, there is no strict dichotomy between these two concepts (or between the concepts of acquisition and installation)'. This Ruling also states that 'acquisition' may include the costs of transport, delivery and installation.

96. Further, paragraph 5 of Taxation Ruling IT 2197 states that installation costs (which include freight and *delivery* costs, and other expenses that might be incurred in getting the plant and equipment to

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[30] 85 ATC 380.

the site and putting it in place) form a part of the cost of the plant and equipment upon which depreciation and investment allowance deductions may be allowed.

97. The arguments for 'harmony' that were expressed in *Case S51* are equally valid as between the *plant expenditure* definition and the depreciation provisions. Such harmony also provides for a smooth transition of unclaimed *plant expenditure* to the depreciation provisions, as provided for under subsection 73B(21), at its *written-down value* pursuant to subsection 73B(4A). This latter subsection uses the ***cost of the unit*** as a base (adjusted according to the number of years in which claims have been allowed), as opposed to ***the total plant expenditure*** incurred. A lack of such harmony between these concepts would produce a nonsensical result.

Design costs

98. We do not consider general concept design and development costs (such as costs of basic and applied research,[31] computer modelling, etc.) to be costs incurred in the construction of any specific 'unit of plant'. They do not directly relate to the actual bringing into existence of a particular 'unit of plant'. However, we consider costs of preparation of the drawings, plans and specifications for an actual 'unit of plant' to be so related, being direct costs of bringing into existence that 'unit of plant'. These costs are costs of acquisition or construction of that 'unit of plant'.

Salary and wage expenditure incurred in the construction of plant

99. Expenditure incurred by an eligible company on salary and wages, where the labour in question is used to construct an item of 'plant' in respect of which *plant expenditure* can accumulate, potentially falls within both the definition of *salary expenditure* and the definition of *plant expenditure* in section 73B. However, salary expenditure is included within the definition of *research and development expenditure* (which falls for deduction under subsection 73B(14)), *except to the extent that it includes expenditure incurred in the acquisition or construction of plant or pilot plant*. Consequently, any expenditure that comes within the definition of salary expenditure that is incurred in the acquisition or construction of *plant*, does not *comprise research and development expenditure* and falls for consideration solely under the *plant expenditure* provisions.

[31] As these terms are used in the explanatory memorandum to Income Tax Assessment Amendment (Research and Development) Bill 1986, page 15.

For use … exclusively for the purpose of carrying on … of research and development activities

100. The words 'for use' within the definition of *plant expenditure* refer to the use to which it is intended to put the 'unit of plant' (*FC of T v. Stewart*[32]). This intention should be gauged at the time the expenditure on the *plant* is incurred.

101. In the sales tax context, our view is that the test in the words 'for use', relating to the use of goods, is based upon *bona fide* intentions existing at the relevant time and is not necessarily affected by, or dependent on, actual subsequent use: see Taxation Ruling ST(NS) 3.

102. The expression 'for use exclusively' also appears in sales tax law. Paragraph 3.9 of Taxation Ruling ST(NS) 3 says of the term 'exclusively' in the 'for use' test:

> 'When this word is used to qualify the use of the goods, it means that the goods should not be for use in any other way or for any other purpose'.

103. In *Randwick Municipal Council v. Rutledge*,[33] Windeyer J said at CLR 94:

> 'The presence of "exclusively", "solely" or "only" always adds emphasis, and is not to be disregarded. … As Kitto J. said in *Lloyd v. Federal Commissioner of Taxation* ((1955) 93 C.L.R. 645, at p.671), such words confine the use of the property to the purpose stipulated **and prevent use of it for any purpose, however minor in importance, which is collateral or independent, as distinguished from incidental to the stipulated use**.'

104. These passages support the view that the ordinary meaning of the phrase 'for use exclusively' is aimed at examining all intended uses of the unit of plant, regardless of the period of time to which those intentions relate. Thus, any intention to put the unit to use for a 'non-R&D' purpose after the completion of the R&D program, disqualifies the expenditure on constructing or acquiring the unit from being *plant expenditure*.

105. This view of the operation of the '*for use ... exclusively*' test effectively means that the eligibility of end-result plant for concessional treatment is closely aligned with that applying to *pilot plant*, which, by definition, expressly excludes any items that are 'for use in commercial production'. We see this as a fair result, as there is no justification for subjecting experimental *models* of end-result plant

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[32] 84 ATC 4146; (1984) 15 ATR 387.
[33] (1959) 102 CLR 54.

(*pilot plant*) to more restrictive tests than are applied to ***full scale*** end-result plants.

106. In determining what actually comprises a disqualifying intention in an R&D environment (i.e., an intention to use the unit of plant for some purpose other than the carrying on of R&D activities), we acknowledge that the success or otherwise of a unit of end-result plant is sometimes uncertain and indeterminate at the time the expenditure is incurred. This particularly occurs where, due to the inherently risky nature of the R&D program being undertaken, the *end-result* plant as a whole is experimental and the company is bearing the risk of failure in constructing the entire plant.

107. We consider that any non-R&D purpose contemplated by the company at the time of incurring the expenditure, whether it be a certain, planned use, or merely a desired use in the event of successful development of the *plant*, comprises an offending intention, such that the expenditure does not comprise *plant expenditure*. We base this view on the following factors:

- the plain meaning of the phrase *for use ... exclusively*. Specifically, if a company plans to use a unit of plant in its R&D operation and then, if it is successfully developed, to use in production, it cannot, on a normal understanding of the phrase, be said to be '*for use ... exclusively*' for the purpose of carrying on R&D activities. The other possible use prevents the making of such a conclusive statement, which requires that the sole **contemplated** use of the plant be for the requisite purpose; and
- the stringent nature of the test sought to be imposed, as indicated by the requirement that the intended use be *exclusively* for the requisite purpose.

108. Hence, we have formed the view that any future contemplated use of the plant by the company existing at the time the expenditure is incurred, whether conditional upon the success of the R&D program or not, must be taken into account in applying this test.

Alternative views

109. An alternative view of this is that the required intended use of the unit of plant for R&D purposes is one that need only exist in respect of the period of the intended term of the R&D activities. Arguments for this interpretation include:

- as a provision conferring a benefit upon taxpayer's, the phrase 'for use … exclusively' should not be interpreted in a narrow and restrictive way; and

- the legislation itself allows for a change in actual use of the plant, and this is contradictory to a requirement to intend to use the plant solely for research and development activities.

110. With regard to the first of these arguments, we think this interpretation of the phrase '*for use ... exclusively*' is not open on the words of the phrase, and based upon the case law referred to in paragraphs 100 to 108 of this Ruling. This is, therefore, not a case of choosing between a narrow and broader interpretation.

111. As to the second argument, we acknowledge that subsection 73B(21) does recognise the possibility of a change in actual use, without negating the benefit of any deductions for *qualifying plant expenditure* already allowable. We interpret this subsection, however, as a recognition that a change in actual use sometime after the formation of the original intention for use exclusively for R&D purposes, is not seen to warrant the negation of the benefit of any concessional deductions allowable in respect of the unit of plant up to that point. As such, we do not see any policy conflict between the definition of plant expenditure as interpreted in this Ruling and subsection 73B(21).

112. We acknowledge a further alternative view of the operation of the '*for use ... exclusively*' test, as it operates in the circumstances described in paragraph 106 of this Ruling (i.e., where the inherent risk in the activities results in uncertainty as to the success of the plant being constructed). This view recognises that while the '*for use ... exclusively*' test may require the purpose of all future intentions of the company with respect to the plant to be examined, in the circumstances described in paragraph 106, the company does not have an offending intention merely because the company would like to be able to use the plant for other purposes. Any desire the company has for post-R&D usage of the plant may be so conditional as to be said, on one interpretation of the expression, to amount to no more than a **hope** to so use it, so the plant is not '*for use*' for those purposes (i.e., the phrase requires that the plant is *to be* used exclusively for R&D activities). The conditional and uncertain nature of the possible future use prevents a conclusion that the plant is *to be* used or *for use* for those purposes. On the other hand, the plant is clearly *for use* or *to be used* in carrying out the R&D activities.

113. This is based on the view that the expression '*for use ... exclusively*' gives rise to an intention test, and that there are different interpretations available as to the meaning of an 'intention'. At one level this can refer to anything that is contemplated, hoped for or desired, but it can also refer more specifically to something that is

planned for and anticipated.[34] In the circumstances described in paragraph 106, the uncertainty and risk involved in developing the plant prevent a conclusion that the plant is planned or anticipated to be used in production activities. Further, where both a broad and a narrow construction are open of a provision conferring a benefit on taxpayers, the construction adopted should be the one that promotes the beneficial purpose in a reasonable way.[35]

114. This view suggests a mere hope to use a risky experimental plant in production following its development does not, of itself, result in failure to meet the '*for use ... exclusively*' test.

115. We do not accept this argument, given the test imposed is clearly a strong and stringent one, aimed at ensuring that only plant intended to be used exclusively for R&D purposes attracts the concession. This is based upon the normal meaning of the phrase in question and is supported by case law.

Canadian law

116. No Australian case law currently exists on the meaning of the phrase 'for use ... exclusively' in this context. Similar circumstances to some of those being dealt with here were, however, considered by the Tax Court of Canada, in the case of *Highland Foundry Limited v. Her Majesty the Queen*.[36] While the statutory framework dealing with 'scientific research and experimental development' ('SR&ED') under Canadian law was used for guidance when the Australian research and development concession was developed, there is no similarity in the wording of the provisions used within each regime in determining the deductibility of expenditure on plant.

117. Subparagraph 37(7)(c)(ii)of the *Canadian Income Tax Act* allows a deduction for:

> '[A] expenditures each of which was an expenditure incurred for and all or substantially all of which was attributable to the prosecution, or the provision of facilities or equipment for the prosecution, of scientific research and experimental development in Canada'.

118. In *Highland Foundry*, the taxpayer developed a first of its kind sand refiner and claimed the costs as having been made for SR&ED. There was no certainty of success of the plant. After the taxpayer finished the SR&ED program in which the refiner was successfully developed, the Minister of Revenue disallowed the construction costs,

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[34] Refer to the *Shorter Oxford Dictionary* meaning of the words 'for', 'intention' and 'intend'.
[35] *FC of T v. Brambles Holding Ltd* 91 ATC 4285; (1991) 21 ATR 1429.
[36] 94 DTC 1725.

on the basis that the subsequent use of the plant for many years for non-SR&ED purposes meant the expenditure was not all or substantially all attributable to the prosecution of SR&ED. After referring to the fact that the sand refiner was a prototype research model that was the first of its kind and was subsequently patented, the expenditure was found to have been incurred 'all or substantially all' for SR&ED. It was held that the purpose for which the expenditure has been incurred is to be determined at the time of the expenditure and not with the benefit of hindsight.

119. While factual conclusions as to the nature of intentions existing vary from case to case, the conclusion from the *Highland Foundry* case that the company's intentions are to be determined at the time of incurring the expenditure, is consistent with this Ruling. It is likely, however, that if the Australian law were applied to the facts of this case a different result would have eventuated. This is due in part to the fact that the wording of the Canadian law is clearly very different from the Australian law.

Determining the company's intention

120. For practical purposes, where the actual use of a unit of plant is solely for the purpose of carrying on R&D activities, the need to question the company's intention at the time of incurring the expenditure does not arise.

121. Where, however, in reviewing a *plant expenditure* claim, it is established that a unit of plant in respect of which *plant expenditure* is claimed was applied to a use other than an R&D use at any time, we would seek to determine if this other use arose as a result of a change of intention by the company, or if it was always intended that the unit be so applied. In the event of the latter, deductions for *plant expenditure* are disallowed.

122. We emphasise that the key issue to be concluded in relation to the expression '*for use… exclusively*' is **what was in the mind of the company for future use of the plant at the time of incurring the expenditure**. This intention is ascertained by reference to the intention of those who own and control the company at the relevant time (*FC of T v. Whitford's Beach Pty Ltd*[37]), but this is not to say that the surrounding circumstances are irrelevant.

123. In forming a view of the company's intentions for use of the unit of plant at the time of incurring the expenditure, the stated intentions of the company are relevant. However, these should be capable of corroboration by, and should not be denied by reference to, the surrounding facts and circumstances. Any inconsistencies or

[37] Per Mason J 82 ATC 4031 at 4047, (1982) 12 ATR 692 at 710.

differences between the stated intentions and the actual use or other surrounding circumstances should be capable of credible explanation.

124. Where the objective facts cast doubt upon the credibility or reliability of a person's statement of purpose, all of the circumstances must be considered in concluding the true purpose (*Parker Pen (Australia) Pty Ltd v. Export Developments Grants Board*[38]).

125. Matters that may be indicative, to varying degrees, of the intentions of the company in acquiring or constructing the plant could include:

- the company's stated intentions and plans (including contingency plans) and corporate records thereof;
- the actual uses to which the plant has been applied, and the credibility of any explanations given by the company to justify a claimed change of intention and consequent use;
- the number of non-essential (from an R&D perspective) activities undertaken and amount of expenditure incurred on the unit of plant, e.g., on cosmetic enhancement or aspects unrelated to the outcome of the R&D;
- the level of expenditure involved;
- whether a full-scale plant was preferable to a model from an R&D perspective; and
- the nature of any commitments entered into requiring future use of the plant (e.g., for sale of output of the plant) and whether those commitments are revocable in the event of failure of the plant, or contingency plans are in place to satisfy the commitments from another source.

126. None of these factors is necessarily seen as conclusive in itself and in any particular case, other factors may be relevant.

Qualifying plant expenditure

Meaning of 'commences to use … exclusively'

127. As was noted in paragraphs 72 to 86 of this Ruling, the identification of a unit of plant requires a consideration of whether the item in question performs a discrete, identifiable function in the operation being conducted, and is a question of fact and degree. In a research and development operation concerned with an ***end-result*** unit

[38] (1983) 46 ALR 612; (1983) FLR 234.

of plant, this functional use is often that of testing, analysing or modifying, etc., of the item.

128. The date of commencement of use of the unit of plant exclusively for R&D activities is that date on which the unit of plant commences to be applied to those R&D functional purposes. This does not necessarily refer to the first date on which actual physical use occurs; rather, it refers to the time when the unit of plant is completed and held solely for the purpose of carrying on R&D activities.[39] The act of constructing or assembling the unit of plant does not qualify as an R&D use, for the reason that the unit of plant itself does not exist until the construction is completed.

129. The determination of what comprises a unit of plant and when it commences to be used in the R&D operation, is unaffected by the fact that the item may not be completed or used in a conventional 'production' sense and, in fact, it may transform into several such units of plant before it reaches completion in that sense.

Meaning of 'ceases to use'

130. The term 'use' in the context of subsection 73B(5) is not confined to actual physical use. Such a narrow interpretation could lead to the conclusion that switching a unit of plant off at night or during a lunch break was a cessation of use. As was said in *Ryde Municipal Council v. Macquarie University*[40] by Gibbs ACJ at CLR 637:

> 'No-one can doubt that 'used' is a word of wide import, and that its meaning in any particular case depends to a great extent on the context in which it is employed.'

131. In *Transfield Kumagai Contracting Pty Ltd v. FC of T*[41] Grove J said at ATR 1009; ATC 4966:

> 'The word "use" is to be understood in its ordinary meaning of purpose served or object or end and is not restricted to any notion of actual physical use. See *Max Factor & Co. Inc. v. FC of T* 71 ATC 4136; (1971) 124 CLR 353.'

132. A similar interpretation is warranted by the context of subsection 73B(5). Thus, where a company is holding and maintaining a unit of plant solely for the purpose of utilising it for specific research and development activities and, when required, is physically applying it to that purpose and to no other purpose, it is

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[39] See paragraphs 130 to 134 for an analysis of the appropriate meaning of 'use' in the current context.
[40] (1978) 139 CLR 633.
[41] 90 ATC 4960; (1990) 21 ATR 1003.

'using' the unit of plant exclusively for the purpose of carrying on R&D activities. The operation of subsection 73B(5) is not triggered.

133. This interpretation invokes similar tests to those that were legislatively applied to the concessional deduction for R&D building expenditure under subsection 73B(7), prior to the revocation of that provision.[42] Events, in relation to a building, that were stated not to offend subsection 73B(5) were:

- where its use for that purpose had, at that time, ceased by reason only of a temporary cessation of the use of the building by reason of the construction of an extension, alteration or improvement or the making of repairs to the building; or
- it was, at that time:
  - maintained ready for that purpose; and
  - not for use for any other purpose;
  - and its use or intended use for that purpose had not been abandoned.

134. The section operates if either of the following events occur:

- the unit is physically applied to any other purpose; or
- the unit ceases to be held solely for the requisite purpose.

Where cessation of use occurs in the year of commencement

135. Where the usage of a unit of plant exclusively for research and development activities commences and concludes within the one financial year, and the unit of plant is not one held for use in other research and development projects, there is a cessation of use of the plant within that year. Consequently, no amount of *qualifying plant expenditure* exists in that year or any subsequent year for which a deduction can be obtained under subsection 73B(15), by virtue of the operation of subsection 73B(5). Any expenditure on such a unit of plant falls to be considered only under the general depreciation provisions of the 1936 Act.

Substance over form in contract arrangements

136. In determining the amount and type of expenditure that qualifies for concessional treatment under section 73B, we always

[42] Pursuant to subsection 73B(5A) the concessional deduction for building expenditure applies only to buildings bought or constructed prior to 21 November 1987.

have regard to the 'true' character of any expenditures involved, where this is in conflict with the form of any contracts or agreements entered into. That is, the 'labels' used in relevant agreements are not necessarily determinative of the character to be attributed to the expenditure (see *McLennan v. FC of T*;[43] *FC of T v. South Australian Battery Makers Pty Ltd*;[44] *Creer v. FC of T*[45] and *Cliffs International Inc v. FC of T*[46]). In particular, where it is claimed that expenditure is incurred in the provision of research and development services, the matrix of facts surrounding the agreements is examined to determine whether in substance the true character of the expenditure was in the acquisition or construction of plant. See *Reuter v. FC of T*[47] and *FC of T v. Cooling*.[48]

137. Further, there may be cases where the intention of the parties is that the documents are not to create the legal rights and obligations which they give the appearance of creating, i.e., the documents are a sham or façade: see *Snook v. London and West Riding Investments*.[49] In such cases, we consider the totality of facts to determine the true intention of the parties.

Part IVA

138. Part IVA may have application where arrangements are entered into to use interposed entities in an attempt to transform *plant expenditure* into *research and development expenditure*. If the requisite dominant purpose of entering into a scheme to obtain a tax benefit is established, Part IVA may have application. A tax benefit would exist in the form of a deduction of *research and development expenditure* being available in the year incurred, as opposed to being spread over three years as *qualifying plant expenditure* or, if relevant, over such longer period as may be determined under the normal depreciation provisions.

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[43] 90 ATC 4047; (1989) 20 ATR 1771.
[44] 78 ATC 4412; (1978) 140 CLR 645.
[45] 86 ATC 4318; (1986) 17 ATR 548.
[46] 79 ATC 4059; (1979) 9 ATR 507.
[47] 93 ATC 5030; (1993) 27 ATR 256.
[48] 90 ATC 4472; (1990) 21 ATR 13.
[49] (1967) 2 QB 786 at 802.

Appendix A

LEGISLATION EXTRACTS (Grouped for ease of reference)

GENERAL

'eligible company' means a body corporate incorporated under a law of the Commonwealth or of a State or Territory.

Trustee or nominee excluded

73B(3) A reference in this section to the incurring of expenditure by an eligible company does not include a reference to expenditure incurred by the company in the capacity of a trustee or nominee other than expenditure incurred by the company on or after 1 July 1988 in the capacity of a trustee of a public trading trust for the purposes of Division 6C in relation to the year of income in which the expenditure was incurred.

Requirement to register

73B(10) A deduction is not allowable under this section to an eligible company for a year of income in respect of expenditure in relation to research and development activities unless:

(a) the company is registered, in relation to the year of income and in relation to those activities, under section 39J of the Industry Research and Development Act 1986; or

(b) the company is registered, in relation to the year of income and in relation to a project comprising or including those activities, under section 39P of that Act.

'*aggregate research and development amount*' in relation to an eligible company in relation to a year of income, means the sum of -

(a) the research and development expenditure incurred by the company during the year of income; and

(aa) the deductions allowed for core technology expenditure under subsections (12) and (12A) in the company's assessment in respect of the year of income; and

(b) one-third of the total *qualifying plant expenditure* of the company in relation to the year of income; and

(ba) four-fifths of the deductible amount, or the sum of the deductible amounts, of qualifying expenditure in relation to the company in respect of a unit or units of

post-23 July 1996 pilot plant in relation to the year of income

(c) one-third of the total qualifying building expenditure of the company in relation to the year of income

(d) the amount of any deduction that has been allowed, or is allowable, under Division 10D of this part, or under Division 43 of the *Income Tax Assessment Act* 1997 in the assessment of the company in respect of the year of income because of the use by the company of a building for the purpose of carrying on research and development activities; and

(e) interest expenditure;

but does not include expenditure on overseas research and development activities that is not certified expenditure.

PROVISIONS DEALING WITH PLANT EXPENDITURE (excluding post 23-July 1996 pilot plant)

"pilot plant" means an experimental model of other plant for use in research and development activities or for use in commercial production, being a model that is not for use in commercial production but that has the intended essential characteristics of the other plant of which it is a model;

"plant" means:

(a) things that are plant within the meaning of section 42-18 of the Income Tax Assessment Act 1997 (whether or not depreciation is allowable under Division 42 of that Act in respect of the things); or

(b) things to which section 42-18 of that Act would apply if the carrying on of research and development activities were the carrying on of a business for the purpose of producing assessable income; or

(c) pilot plant other than post-23 July 1996 pilot plant;

"***plant expenditure"***, in relation to an eligible company, means expenditure incurred by the company in -

(a) the acquisition, or the construction, under a contract entered into on or after 1 July 1985, of a unit of plant other than post-23 July 1996 pilot plant; or

(b) the construction by the company, being construction that commenced on or after 1 July 1985, of a unit of plant other than post-23 July 1996 pilot plant, being a unit of plant for use by the company exclusively for the

purpose of the carrying on by or on behalf of the company of research and development activities;

"written-down value" has the meaning given by subsections (4A) and (4B).

Qualifying Expenditure

73B(4) Subject to subsection (5), where, during a year of income -

(a) an eligible company commences to use a unit of plant in respect of which the company has incurred an amount of plant expenditure exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities; or

(b) an eligible company commences to use a building, or an extension, alteration or improvement to a building, in respect of which the company has incurred an amount of building expenditure exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities, that amount shall, in relation to that unit of plant, that building or that extension, alteration or improvement, as the case may be, be taken to be an amount of qualifying plant expenditure or qualifying building expenditure, as the case may be, in relation to the company in relation to the year of income and in relation to each of the 2 succeeding years of income.

Plant other than post-23 July 1996 pilot plant

73B(4A) The "written-down value" of a unit of plant other than post-23 July 1996 pilot plant:

(a) that is owned by a company; and

(b) in relation to which a deduction has been allowed under this section from the company's assessable income;

is the amount worked out using the formula:

$$\text{Cost} - \left(\frac{\text{Cost} \times \text{Number of deductible years}}{3}\right)$$

where:

"cost" means the cost of the unit.

"number of deductible years" means the number of years of income in respect of which a deduction has

been allowed from the company's assessable income under this section in relation to the unit.

Cessation of use of plant or building during year

73B(5) Where -

(a) apart from this subsection, there would be an amount of qualifying plant expenditure in relation to a unit of plant owned by an eligible company in relation to a year of income or an amount of qualifying building expenditure in relation to a building, or an extension, alteration or improvement to a building, owned by an eligible company in relation to a year of income; and

(b) at any time during the year of income, the company ceases to use that unit of plant, that building or that extension, alteration or improvement, as the case may be, exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities;

there shall be no amount of qualifying plant expenditure in relation to that unit of plant or no amount of qualifying building expenditure in relation to that building, or that extension, alteration or improvement, as the case may be, in relation to the year of income or any succeeding year of income.

Deduction for Qualifying plant expenditure

73B(15) Subject to this section, where, in the year of income during which an eligible company commences to use a unit of plant exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities or in either of the 2 succeeding years of income, there is an amount of qualifying plant expenditure in relation to the company in relation to the unit of plant -

(a) in a case where the aggregate research and development amount in relation to the company in relation to the year of income is greater than $20,000 - one-third of the amount of that qualifying plant expenditure multiplied by 1.25; or

(b) in any other case - one-third of the amount of that qualifying plant expenditure, is allowable as a deduction from the assessable income of the company of the year of income.

Election that the section not apply

73B(18) An eligible company may elect that this section shall not apply in relation to a unit of plant to which this section would otherwise apply and, where an election is so made, this section does not apply in relation to that unit of plant in relation to the company.

73B(19) An election referred to in subsection (18) in respect of a unit of plant -

(a) shall be exercised by notice in writing to the Commissioner; and

(b) shall be lodged with the Commissioner on or before the date of lodgment of the return of income of the eligible company for the first year of income in which a deduction under this section would be allowable to the company in respect of the unit of plant, or before such later date as the Commissioner allows.

(Repealed with effect from 4 June 1998.)

Deduction allowable only under this section

73B(20) Subject to subsections (21), (21A), (22), (28) and (30), where the whole or a part of an amount of expenditure incurred by an eligible company has been allowed or is or may become allowable as a deduction under this section, that expenditure shall not be an allowable deduction, and shall not be taken into account in ascertaining the amount of an allowable deduction, from the assessable income of the company of any year of income under any other provision of this Act.

Cessation of use and subsequent re-use

73B(21) Subsection (20) does not prevent a deduction for depreciation being allowed to an eligible company in respect of a unit of plant (other than post-23 July 1996 pilot plant) where the company has, before the end of the second year of income (in this subsection referred to as the 'relevant year of income') after the year of income in which the company first used the unit of plant exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities, ceased to use the unit of plant exclusively for that purpose, and where, by reason of the subsequent use of the unit of plant for another purpose, such a deduction becomes allowable, the unit of plant shall be deemed to have been acquired by the company -

(a) at a cost equal to the written-down value of the unit of plant; and

(b) on -

(i) in a case where the unit of plant was used by the company exclusively for that first-mentioned purpose on the first day of the relevant year of income - that day; or

(ii) in any other case - the day on which the unit of plant was first used by the company for that first-mentioned purpose.

Deductions allowable under other provisions outside the three year period

73B(22) Where deductions have been allowed to an eligible company under subsection (15) in respect of expenditure incurred by the company in the acquisition or construction of a unit of plant to which subsection (6) applies in respect of 3 years of income, subsection (20) does not prevent a deduction for depreciation being allowed to the company in respect of the unit of plant in respect of a later year of income, and where such a deduction becomes allowable, the unit shall be deemed to have been acquired by the company immediately after the end of the last year of income in respect of which a deduction was allowed to the company under this section in respect of that expenditure at a cost equal to the written-down value of the unit of plant.

Loss disposal or destruction of Qualifying plant

73B(23) Where -

(a) a deduction has been allowed or is allowable to an eligible company under subsection (15) in respect of expenditure incurred in the acquisition or construction of a unit of plant (other than a unit of pilot plant to which subsection (6) applies);

(b) during a year of income, the unit of plant is disposed of, lost or destroyed;

(c) the company had used the unit of plant before it was disposed of, lost or destroyed exclusively for the purpose of the carrying on by or on behalf of the company of research and development activities; and

(d) no deduction has been allowed or is allowable to the company under section 54 of this Act or Division 42 (Depreciation) of the Income Tax Assessment Act 1997 in respect of the unit of plant;

then -

(e) in a case where the consideration receivable in respect of the disposal, loss or destruction is less than the written-down value of the unit of plant -

(i) if the aggregate research and development amount in relation to the company in relation to the year of income is greater than $20,000 - the amount ascertained by multiplying the amount by which that written-down value exceeds that consideration receivable by 1.25; or

(ii) if the aggregate research and development amount in relation to the company in relation to the year of income is less than or equal to $20,000 - the amount by which that written-down value exceeds that consideration receivable, is allowable as a deduction from the assessable income of the company of the year of income; or

(f) in a case where the consideration receivable in respect of the disposal, loss or destruction is greater than the written-down value of the unit of plant - so much of the excess as does not exceed the difference between the cost of the unit of plant and the written-down value of the unit of plant shall be included in the assessable income of the company of the year of income.

PROVISIONS DEALING WITH RESEARCH AND DEVELOPMENT EXPENDITURE

"*research and development expenditure*", in relation to an eligible company in relation to a year of income, means expenditure (other than core technology expenditure, interest expenditure, feedstock expenditure or expenditure incurred in the acquisition or construction of plant or pilot plant or a building or of an extension, alteration or improvement to a building) incurred by the company during the year of income, being -

(a) contracted expenditure of the company;

(b) salary expenditure of the company, being expenditure incurred on or after 1 July 1985; or

(c) other expenditure incurred on or after 1 July 1985 directly in respect of research and development activities carried on by or on behalf of the company on or after 1 July 1985; and includes any eligible feedstock expenditure that the company has in respect of the year

of income in respect of related research and development activities;

"*salary expenditure*", in relation to an eligible company in relation to a year of income, means the sum of -

(a) the expenditure, not being expenditure referred to in paragraph (b), incurred by the company during the year of income by way of salaries, wages, allowances, bonuses, overtime payments or penalty rate payments for officers or employees of the company, being expenditure incurred directly in respect of research and development activities carried on by or on behalf of the company on or after 1 July 1985;

(b) in relation to each officer or employee of the company who was engaged at any time during the year of income in research and development activities carried on by or on behalf of the company - so much of the expenditure incurred by the company during the year of income in respect of annual leave, sick leave or long service leave for that officer or employee or contributions to superannuation funds in respect of that officer or employee as bears to that amount the same proportion as the proportion of the year of income during which that officer or employee was engaged in research and development activities carried on by or on behalf of the company bears to the proportion of the year of income during which that officer or employee was engaged in any activities carried on by or on behalf of the company; and

(c) so much of the expenditure incurred by the company during the year of income on pay-roll tax and premiums for workers' compensation insurance as the Commissioner considers reasonable having regard to -

(i) the amount of the expenditure incurred by the company during the year of income to which paragraph (a) or (b) applies;

(ii) the total expenditure incurred by the company during the year of income in respect of salaries, wages, allowances, bonuses, overtime payments, penalty rate payments, annual leave, sick leave and long service leave in respect of all officers and employees of the company; and

(iii) such other matters as the Commissioner considers relevant.

Deduction for non-contracted expenditure

73B(14) Subject to this section, where -

(a) an eligible company incurs research and development expenditure (other than contracted expenditure) during a year of income; and

(b) the aggregate research and development amount in relation to the company in relation to the year of income is greater than $20,000, the amount of that expenditure multiplied by 1.25 is allowable as a deduction from the assessable income of the company of the year of income.

Detailed contents list

139. Below is a detailed contents list for this draft Ruling:

	Paragraph
What this Ruling is about	**1**
Class of person/arrangement	5
Ruling	**15**
Operation of the plant provisions	15
Definition of plant expenditure	16
Plant	*18*
What is a prototype and can it be an item of plant?	*22*
The treatment of expenditure in respect of prototypes	*25*
Unit of plant	*27*
Expenditure incurred in acquisition or construction of a unit of plant…	*32*
Design costs	*34*
Salary and wage expenditure incurred in the construction of plant	*35*
For use…exclusively for the purpose of carrying on of research and development activities	*36*
Determining the company's intention	*39*
Qualifying plant expenditure	41
Meaning of 'commences to use…exclusively'	*44*
Meaning of 'ceases to use'	*46*

Where cessation occurs in the year of commencement *48*
Substance over form in contract arrangements 49
Part IVA 51
Date of effect **52**
Explanations **53**
Operation of the plant provisions 53
Plant expenditure 59
What is a prototype and can it be an item of plant? *67*
Unit of plant *72*
Expenditure incurred in acquisition or construction of a unit of plant… *87*
Design costs *98*
Salary and wage expenditure incurred in the construction of plant *99*
For use…exclusively for the purpose of carrying on of research and development activities *100*
Alternative views 109
Canadian law 116
Determining the company's intention 120
Qualifying plant expenditure 127
Meaning of 'commences to use…exclusively' *127*
Meaning of 'ceases to use' *130*
Where cessation occurs in the year of commencement *135*
Substance over form in contract arrangements 136
Part IVA 138
Appendix A **after 138**
Detailed contents list **139**
Your comments **140**

Your comments

140. We invite you to comment on this Draft Taxation Ruling. We are allowing 6 weeks for comments before we finalise the Ruling. If you want your comments to be considered, please provide them to us within this period.

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Commissioner of Taxation
10 November 1999

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Subject references:

- acquisition
- construction
- end-result plant
- plant
- plant expenditure
- facilitate plant
- prototype
- qualifying plant expenditure
- research and development activities
- salary expenditure

Legislative references:

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