TD 2013/D9 - Income tax: when will Design Expenditure incurred by an R&D entity be included in the cost of a tangible depreciating asset within paragraph 355-225(1)(b) of the Income Tax Assessment Act 1997 (and therefore not able to be deducted under section 355-205)?

This cover sheet is provided for information only. It does not form part of *TD 2013/D9 - Income tax: when will Design Expenditure incurred by an R&D entity be included in the cost of a tangible depreciating asset within paragraph 355-225(1)(b) of the Income Tax Assessment Act 1997 (and therefore not able to be deducted under section 355-205)?*

This document has been finalised by TD 2014/15.

There is a Compendium for this document: **TD 2014/15EC** .

Draft Taxation Determination

Income tax: when will Design Expenditure incurred by an R&D entity be included in the cost of a tangible depreciating asset within paragraph 355-225(1)(b) of the *Income Tax Assessment Act 1997* (and therefore not able to be deducted under section 355-205)?

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Background

1. This Draft Taxation Determination is concerned with where an **R&D entity**[1] incurs expenditure on various stages of design activities (**Design Expenditure**), connected with it beginning to hold a tangible depreciating asset, where that expenditure also falls within the terms of section 355-205.[2] This expenditure will typically be incurred in cases where the R&D entity is constructing the asset itself, or having another entity construct it on its behalf, as distinct from acquiring the asset 'off the shelf'. The asset begins to be 'held' by the R&D entity at the time that construction is completed. At this time the R&D entity is the legal owner of the asset, and therefore, the holder under item 10 in the table in section 40-40.

[1] As defined in section 355-35 of the *Income Tax Assessment Act 1997* (ITAA 1997). Unless stated otherwise, all legislative references are to the ITAA 1997. In this Draft Taxation Determination, terms used in a defined way have been bolded where that use is first explained.

[2] Section 355-205 deals with the entitlement of R&D entities to deduct amounts of expenditure for the purpose of calculating any tax offset they are allowed under section 355-100. A key condition for this entitlement is that the expenditure be incurred by the R&D entity 'on one or more *R&D activities'.

Ruling

2. Design Expenditure will not be deductible under section 355-205 where it is covered by paragraph 355-225(1)(b) because it is 'included in the ***cost**[3] of a tangible depreciating asset for the purposes of Division 40 (as that Division applies as described in section 355-310[4] or otherwise)'. Subsection 40-185(1) in Division 40 relevantly means that Design Expenditure will only be included in the cost of the asset where it has been incurred 'in relation to holding' that asset. More particularly, subsection 40-180(3) will apply to include Design Expenditure in the cost of the asset where it has been incurred 'in relation to starting to hold' the asset, on the proviso that the expenditure is 'directly connected with holding the asset'.

3. The necessary direct connection under subsection 40-180(3) will exist where the Design Expenditure is both *directed to and results in* the R&D entity beginning to hold the asset in question. This is a question of fact and degree, and will depend in large part on identifying the final shape, features and performance of the particular completed asset. Having identified the final shape, features and performance of the asset, it will be possible for an R&D entity to determine at the time they begin to hold the asset (within the meaning of this expression in Division 40), whether particular Design Expenditure was directed to and results in the asset coming to be held.

4. Design Expenditure which is directed to, but does not result in, the entity beginning to hold the asset, is not included in the cost of the asset for the purposes of Division 40, and hence, will not be affected by the exclusion in paragraph 355-225(1)(b).

Note: Design Expenditure is tested for whether it is included in the asset's cost at the time the R&D entity begins to hold the asset: see subsection 40-180(1). This might be several years after the expenditure was incurred, and require a re-evaluation of whether or not amounts claimed under section 355-205, are in fact not deductible under that section because of paragraph 355-225(1)(b).

Example

5. Atlantis Innovations Limited ('AIL') carries on a worldwide salvage and undersea exploration and research business. Over what ends up being a five year project of R&D activities it contracts with various entities to design, construct and test a mini unmanned submersible vessel. If successful, AIL will use the mini unmanned submersible vessel in its undersea salvage business.

Year 1

6. In Year 1 of the project AIL engages a design company with specialist underwater vessel engineering expertise, to be involved as a technology partner. This collaboration is based however on AIL owning all the results and intellectual property arising from the project, including from the activities of the design company.

[3] * denotes a term defined in section 995-1.
[4] A key effect of section 355-310 in this respect is to substitute a reference to 'a *taxable purpose' in Subdivisions 40-A to 40-D (other than for the purposes of sections 40-100, 40-105 and 40-110) for 'the purpose of conducting one or more of the [relevant] *R&D activities': refer subsection 355-310(2).

7. The activities of the design company in Year 1 only involve the collection and analysis of data, including numerous meetings with the directors of AIL to finalise the desired performance specifications of the new vessel, including the range of various types of sensors and other recording modules which might be able to be developed. Broad concept designs are developed by the design company in Year 1 to enable the directors of AIL to evaluate the feasibility of proceeding to the detailed design of the vessel, but no detailed designs which would allow the construction and testing of the vessel are produced at this stage.

8. While the work of the design company in Year 1 is directed broadly to bringing the new vessel into existence it concerns a preliminary stage of the project in which there is considerable uncertainty over the final shape, features and performance of the vessel. It is not possible therefore to say there is a direct connection between this expenditure AIL incurred to the design company and the bringing into existence of the vessel.

9. AIL decides to notionally deduct all of this expenditure under section 355-205 as none of the expenditure will be included in the cost of the vessel for the purposes of Division 40.

Year 2

10. In Year 2 AIL and the design company engage with a range of hardware and software developers and suppliers to evaluate the performance of existing sensor and recording module products in order to decide which new products of this type AIL will itself need to develop. At the end of Year 2 AIL has sufficient information to decide to build the full scale vessel, knowing however, that proof of the performance of the new technology will require a period of undersea trials.

11. The decision to commit to building the full scale vessel is also made knowing that during the detailed design and initial testing phase various technological challenges concerning the integration of the hardware and software elements may arise, and analysis of a range of options is likely to be necessary in order for these to be overcome.

12. AIL decides to notionally deduct all of this expenditure under section 355-205 as there is still considerable uncertainty over the final shape, features and performance of the vessel and none of the expenditure incurred to the design company during Year 2 will be included in the cost of the vessel for the purposes of Division 40. This expenditure lacks the necessary direct connection to AIL beginning to hold the vessel as a tangible depreciating asset.

Year 3

13. During Year 3 the design company spend a considerable amount of time in preparing detailed design documentation for the new vessel, including descriptions of the performance specifications for the new hardware and software elements. Various simulation techniques are used to test the integration of these elements, but these are limited in their ability to identify all of the problems that might be encountered in the construction of the new vessel.

14. All of the expenditure incurred by AIL to the design company in Year 3 is directed to bringing the new vessel into existence. However, it is not possible, at the end of Year 3, to predict accurately how much of this expenditure concerns elements of the design that will be part of the vessel that is constructed. The expert engineering evidence available to AIL shows however, that a considerable part of the design work performed in Year 3 that is the subject of this expenditure is likely to relate to features to be part of the final full scale vessel. That is, a considerable degree of certainty exists about the final shape, features and performance of the final full scale vessel.

15. AIL decides not to claim any of the expenditure as a notional deduction under section 355-205. AIL decides to wait until it begins to hold the vessel as a tangible depreciating asset in order to decide what proportion of the expenditure will be included in the cost of the asset for the purposes of Division 40.

Year 4

16. During Year 4 construction of the full scale vessel commences along with onshore trials of various hardware components and their associated software in a mock-up of the vessel. These trials show a need to investigate three specific options for the integration into the vessel of one type of sensors and four specific options for implementing the command system.

17. Eventually, after a considerable period of investigation by the design company, AIL is able to decide which one of the three specific sensor options is best, and which one of the four specific command system options is most appropriate.

18. During Year 4 there is a portion of expenditure incurred to the design company in this year that cannot be said to result in the final shape, features and performance of the vessel. That portion relates to those options for the sensors and command system which were investigated but ultimately rejected in deciding the final shape, features and performance of the vessel. AIL considers that portion of expenditure may qualify as being able to be deducted under section 355-205.

19. Completion of the construction of the vessel occurs towards the end of Year 4 and AIL is able to commence a detailed examination, in accordance with section 40-180, of the expenditures which form the 'cost' of holding the asset for the purposes of Division 40. AIL decides that the cost will include the expenditure incurred to the design company in Year 3, as the examination shows all of this expenditure is directly connected with bringing the vessel into existence. Similarly, AIL decides that the cost will also include the expenditure incurred to the design company in Year 4 apart from the portion referred to in paragraph 18 above which they decide, consistent with their earlier consideration, can properly be deducted under section 355-205.

Year 5

20. In Year 5 AIL subjects the completed vessel to a lengthy period of ocean trials. Various tests are performed at this time of the new hardware and software components incorporated into the vessel. No expenditure is incurred to the design company in Year 5.

Summary

21. In summary, the following expenditures incurred to the design company are not excluded under the cost exclusion as they are not included in the cost of the vessel for the purposes of Division 40:

- Year 1 expenditure associated with the collection and analysis of data, identification of various types of sensors and other recording modules which might be able to be developed and the creation of broad concept designs.
- Year 2 expenditure associated with evaluating the performance of existing sensor and recording module products in order to decide which new products of this type will need to be developed.
- Year 3 and 4 expenditure on the rejected sensor and command system options or on any other aspect of the vessel not finding its way into the completed vessel.

The following expenditures incurred to the design company are excluded under the cost exclusion because, as AIL determines in relation to the completed vessel, once it has begun to be held, they are included in the cost of the vessel for the purposes of Division 40:

- Year 3 expenditure associated with preparing detailed design documentation, including descriptions of the performance specifications for the new hardware and software elements, as well as expenditure on testing integration of the elements.
- Year 4 expenditure on the sensor and command system options which were included in the completed vessel.

Date of effect

22. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
4 December 2013

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Explanation

23. Section 355-205 allows an R&D entity to notionally deduct certain types of expenditure for the purpose of calculating any tax offset it is entitled to under section 355-100.[5]

24. The opening words of subsection 355-205(1) relevantly state:

> An *R&D entity can deduct for an income year (the ***present year***) expenditure it incurs during that year to the extent that the expenditure:
>
> (a) is incurred on one or more *R&D activities:
>
> (i) for which the R&D entity is registered under section 27A of the *Industry Research and Development Act 1986* for an income year; and
>
> (ii) that are activities to which section 355-210 (conditions for R&D activities) applies; and …

25. Section 355-225 describes a number of different types of expenditure that cannot be deducted under section 355-205. Paragraph 355-225(1)(b) describes one of these types as:

> expenditure included in the *cost of a tangible *depreciating asset for the purposes of Division 40 (as that Division applies as described in section 355-310 or otherwise)

26. The scope of the exclusion in paragraph 355-225(1)(b) (the **cost exclusion**) is therefore governed by the measurement of 'cost' which applies for the purposes of Division 40, subject only to the qualification that this purpose may be affected by the modifications to Division 40 brought about by section 355-310.[6] Inclusion of the words 'for the purposes of Division 40' within the cost exclusion direct attention to how the cost of a depreciating asset is worked out under this Division. The words provide a clear textual pointer to working out the cost of an asset this way, that is, the same way as it would if Division 40 applied to the asset, rather than Division 355.

27. The cost of a depreciating asset is worked out under Subdivision 40-C. Section 40-175 states that the cost of a depreciating asset held by an entity consists of two elements. The first element is specified in subsection 40-180(1) and is worked out at the time that the relevant entity began to hold the depreciating asset. Paragraph 40-180(1)(b) provides that the first element of cost is the amount the entity is taken to have paid to hold the asset under section 40-185, provided an item in the table in subsection 40-180(2) does not apply. None of the items listed in the table in subsection 40-180(2) are relevant in the circumstances to which this Draft Taxation Determination applies.

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[5] The expression 'notionally deduct' refers to the fact that no actual deduction is allowable for the expenditure if section 355-100 applies (see section 355-715). However, the expenditure is deemed to be a deduction for certain purposes affecting section 355-100, to allow other provisions outside of Division 355 to apply (see section 355-105).

[6] The key modification section 355-310 brings about is to substitute references to '*taxable purpose' in Division 40, to the purpose of conducting one or more 'R&D activities': refer subsection 355-310(2).

28. In this regard it is important to note that there are no express or implied restrictions in Division 40 that confine the working out of the first element of cost of a depreciating asset to only expenditure incurred in the income year in which the asset starts to be held. This observation therefore also applies to the cost exclusion in paragraph 355-225(1)(b).

29. Subsection 40-185(1) relevantly states:

> This Division applies to you as if you had paid, to *hold a *depreciating asset… the greater of these amounts:
>
> …
>
> (b) the sum of the applicable amounts set out in this table **in relation** to holding the asset… [emphasis added]

30. Subsection 40-180(3) can add to the first element of cost so that it includes an amount that the entity paid or is taken to have paid '…in relation to starting to *hold the *depreciating asset **if that amount is directly connected with holding the asset.**[7]' (emphasis added)

31. Subsection 40-180(3) was introduced to the ITAA 1997 by the *Tax Laws Amendment (2006 Measures No.1) Act 2006* and applies to expenditure incurred on or after 1 July 2005. Its introduction was part of a range of amendments to expand the cost of a depreciating asset by increasing the 'range of expenditures included as part of both the first and second elements of cost': refer paragraph 2.124 in the Explanatory Memorandum to the Tax Laws Amendment (2006 Measures No.1) Bill 2006 (the 2006 EM).

32. The phrase 'directly connected' is not defined, and takes its ordinary meaning according to the context in which it is used, as shaped by the purpose of subsection 40-180(3), which is to permit a broader range of amounts incurred in relation to starting to hold a depreciating asset to be included in the cost of that asset. An illustration of the type of connection that was intended to qualify as a direct connection between certain expenditure and starting to hold an asset is provided by Example 2.23 in the 2006 EM:

> Russ wishes to buy a computer for his business that is not available in Australia. After adequate research he concludes he would be able to obtain the computer from a company in Silicon Valley in the United States. Russ travels to Silicon Valley for the sole purpose of purchasing the computer. The travel costs would be included as part of the first element of cost of the computer because they are directed to and result in the purchase of the computer.

33. Example 2.23 suggests that subsection 40-180(3) involves an inquiry into how the asset in question has started to be held and how the particular expenditure is connected with the means by which that occurs. In the circumstances this Draft Taxation Determination is aimed at, this inquiry involves examining the construction process and what that process has led to in terms of the final shape, features and performance of the completed asset.

34. Whether Design Expenditure will be directly connected with an R&D entity holding a tangible depreciating asset will therefore depend on how that asset comes into existence, and the role that the Design Expenditure played in that process. Design Expenditure that is both directed to, and does result in, the final shape, features and performance of the asset will qualify as being directly connected with holding that asset, and hence, come within subsection 40-180(3).

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[7] * denotes a term defined in section 995-1.

35. On the other hand, Design Expenditure which might be part of a project directed to bringing that asset into existence but, for whatever reason, does not result in the asset coming into being (because, for example, it concerns the development of elements not forming part of the final shape, features and performance of the asset) will not come within subsection 40-180(3).

36. The time for testing whether Design Expenditure is included in the asset's cost for the purposes of Division 40 is at the time the R&D entity begins to hold the asset: see subsection 40-180(1). In some cases to which this Draft Taxation Determination applies, that time may be several years after the time when the expenditure was incurred.

37. The operation of the cost exclusion in paragraph 355-225(1)(b) therefore, may require the R&D entity to look back over the course of a project of R&D activities, in order to identify which Design Expenditure that otherwise is able to be deducted under section 355-205, is not eligible as such, because of the cost exclusion.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.

Alternative views

38. An alternative view is that paragraph 355-225(1)(b) requires an entity to consider in each income year whether it has started to hold an asset for the purposes of Division 40. If an entity has started to hold an asset in that income year then the entity will need to identify which Design Expenditure that otherwise is able to be notionally deducted under section 355-205, is not eligible as such, because of the cost exclusion.

39. However, if the Design Expenditure relates to the holding of an asset which is not actually being held at the end of the income year in which that expenditure has been incurred then, under this alternative view, that expenditure is not caught by the cost exclusion.

40. The alternative view rests upon a particular temporal interpretation of the operation of paragraph 355-225(1)(b). Under this interpretation the expression 'included in the *cost of a tangible *depreciating asset for the purposes of Division 40'[8] in paragraph 355-225(1)(b) operates so that Design Expenditure is *only* excluded from being notionally deductible if it is included in the cost of an asset for the purposes of Division 40 in the income year that an entity considers the application of paragraph 355-225(1)(b). That is, the cost exclusion will not exclude Design Expenditure that is incurred by an R&D entity in any income year prior to that in which they start to hold an asset for the purposes of Division 40.

41. We do not agree with the alternative view. The words of paragraph 355-225(1)(b) do not suggest that there should be any change to the ordinary operation of Division 40. The words '…as that Division applies as described in section 355-310 or otherwise' support a conclusion that there is no intention to distinguish between amounts included in the cost of a tangible depreciating asset under Division 355 and those that would ordinarily be included when working out the cost of a depreciating asset under Division 40 as detailed above in paragraphs 26 to 28.

[8] * denotes a term defined in section 995-1.

Appendix 3 – Your comments

42. You are invited to comment on this draft Determination including the proposed date of effect. Please forward your comments to the contact officer by the due date.

43. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- be published on the ATO website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: **24 January 2014**
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- eligible research and development expenditure
- research and development expenses
- research and development notional Division 40 deduction
- research and development tax incentive
- research and development tax offset

Legislative references:

- ITAA 1997 Div 40
- ITAA 1997 Subdiv 40-A
- ITAA 1997 Subdiv 40-B
- ITAA 1997 40-40
- ITAA 1997 40-100
- ITAA 1997 40-105
- ITAA 1997 40-110
- ITAA 1997 Subdiv 40-C
- ITAA 1997 40-175
- ITAA 1997 40-180
- ITAA 1997 40-180(1)
- ITAA 1997 40-180(1)(b)
- ITAA 1997 40-180(2)
- ITAA 1997 40-180(3)
- ITAA 1997 40-185
- ITAA 1997 40-185(1)
- ITAA 1997 Subdiv 40-D
- ITAA 1997 Div 355
- ITAA 1997 355-35
- ITAA 1997 355-100
- ITAA 1997 355-105
- ITAA 1997 355-205
- ITAA 1997 355-205(1)
- ITAA 1997 355-225
- ITAA 1997 355-225(1)(b)
- ITAA 1997 355-310
- ITAA 1997 355-310(2)
- ITAA 1997 355-715
- ITAA 1997 995-1
- Tax Laws Amendment (2006 Measures No.1) Act 2006

Other references

- Tax Laws Amendment (2006 Measures No.1) Bill 2006 Explanatory Memorandum

ATO references

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