IT 2442 - Income tax : concession for eligible research and development expenditure

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TAXATION RULING NO. IT 2442

INCOME TAX : CONCESSION FOR ELIGIBLE RESEARCH AND DEVELOPMENT EXPENDITURE

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PREAMBLE The Income Tax Assessment Amendment (Research and Development) Act 1986 received the Royal Assent on 25 June 1986 (Act No. 90 of 1986). It inserted new section 73B into the Income Tax Assessment Act 1936 ("the Assessment Act") to provide a special tax concession for Australian companies that incur expenditure on qualifying research and development (R & D) activities carried on in Australia during the period from 1 July 1985 to 30 June 1991. The section provides a deduction of between 100% and 150% of an eligible company's qualifying research and development expenditure.

2. A detailed explanation of the new section is contained in the explanatory memorandum that accompanied the introduction of the legislation. This Ruling does not deal with issues already covered in that memorandum. Its purpose is to discuss specific aspects of the provisions of new section 73B under the following headings -

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RULING EXPENDITURE ELIGIBLE FOR CONCESSION
- Contracted expenditure

3. The term "contracted expenditure" (defined in subsection 73B(1) and forming part of "research and development expenditure" which is also defined in that subsection) covers payments by an eligible company to an approved research institute or to the Coal Research Trust Account where the institute performs, or the Trust Account funds the performance of, R & D activities on behalf of the company. Such expenditure is not subject to the general $20,000 threshold which must ordinarily be met before an augmented deduction under the section (shading from 100% of the expenditure to 150% of the expenditure where qualifying expenditure in the year exceeds $50,000) is allowable. While it is possible for an approved research institute to perform R & D activities through an agent, the institute would not be considered to perform those activities where it did not choose the agent, supervise the performance of the activities, or take responsibility to the eligible company for the agent's performance of the activities. Arrangements under which, for instance, an eligible company made payments to an approved research institute for the performance of R & D activities on condition that the institute would have the activities performed by a particular researcher, would have the consequence that the institute could not be said to perform those activities. In such a case, the payments would not be "contracted expenditure".

4. It should be noted, however, that an eligible company is not limited to contracting out its R & D activities to approved research institutes or through the Coal Research Trust Account. It may contract out some, or all, of its R & D activities to any person, company or other body, but if it does so it will be subject to the general threshold (see also the later section on "other expenditure").

5. Where the work on an R & D project is contracted out to an approved research institute, payments made to the institute will generally be deductible in the year of income in which they are made. That will be the case even though the actual R & D activities may not be carried out until a later year of income, provided that the relevant R & D activities are carried out during the deduction period i.e. the activities in respect of which deductions are claimed are completed by 30 June 1991.

6. Some approved research institutes have been established to carry out activities, including R & D activities, that are solely related to particular industries. Often an institute imposes a levy upon industry members as a means of raising the funds to support its various activities. In those circumstances, member companies' levy payments will generally qualify for the 150% rate of deduction to the extent that the moneys are expended on qualifying R & D activities (as defined in section 73B) on behalf of the members. In some instances, an institute's R & D activities are also supported by government grants. Because those grants are received by the

institute and not the member companies, sub-section 73B(8) does not apply to disallow expenditure by such companies on R & D projects funded through such an institute. As a practical matter, it is to be accepted that the full amount of the levies paid by member companies to such an approved research institute is eligible for the 150% concession if the institute's expenditure on qualifying R & D activities in the year of income, other than expenditure on activities performed by the institute under a specific contract and funded from the contracted fees, is equal to, or exceeds, the aggregate of the levies and any government grants received in that year.

7. In a case where such an approved research institute's expenditure on relevant R & D activities during the year of income is less than the aggregate of the levies collected and government grants received, a proportion of the levy paid by a member company will be deductible under section 73B. The deduction allowable will be calculated as follows -

$$\text{relevant R \& D expenditure-government grants} \times \frac{\text{individual levy}}{\text{total levies collected}}$$

- Salary expenditure

8. "Salary expenditure", which also forms part of "research and development expenditure", is comprehensively defined in subsection 73B(1) and provides a basis for apportionment of some salary-related expenses. Subject to the other requirements of the section being met, an eligible company is entitled to a deduction, at the appropriately increased rate, for the remuneration of employees directly (but not necessarily exclusively - see paragraph 10) involved in the R & D activities of the company. Expenditure incurred by an eligible company in respect of employees' annual leave, extended sick leave or long service leave, or in respect of superannuation contributions otherwise deductible under section 82AAC of the Assessment Act, is also eligible for accelerated deduction, on a proportionate basis according to the part of the year's activities of the employee that was taken up in the R & D activities of the company. For example, if during the year an employee had been engaged for 16 weeks on R & D activities for the company and 32 weeks on other activities, 1/3 of the salary paid to the employee during the remaining 4 weeks spent on annual leave would qualify as salary expenditure for the purposes of section 73B.

9. Paragraph (c) of the definition provides for expenditure by an eligible company on pay-roll tax and premiums for workers' compensation insurance to be treated as salary expenditure to the extent that it is reasonable having regard to the proportion of the total salaries and other employee costs specified in paragraphs (a) and (b) (other than superannuation fund contributions) attributable to the company's R & D activities, as well as other relevant matters. Such other matters would include any pay-roll tax exemptions or concessions available to the company. For example, if a company's R & D activities for some reason attracted a

concessional rate of pay-roll tax or an exemption (in whole or part) from liability to pay-roll tax, otherwise deductible salary expenditure on pay-roll tax would need to be adjusted to reflect that concession or exemption. Similarly, in the case of workers' compensation premiums, any increased or decreased rate of premiums applicable to the employees carrying out the company's R & D activities would be taken into account in determining the deductible expenditure.

10. Where a company employee performs services related directly to, but not exclusively on, qualifying R & D activities, subject to the other requirements of section 73B being met, the company would be entitled to an accelerated deduction for the relevant part of the remuneration (paragraph (a) of the definition of "salary expenditure") of that employee. For that purpose as well as for the purposes of paragraphs (b) and (c) of the definition, it is expected that the company would be able to demonstrate - by way of appropriate records such as time sheets or job cards - the extent to which such an employee's services are directly related to qualifying R & D activities. The salaries of company employees whose only connection with R & D activities is clearly indirect - for example, management staff who recruit other company employees for general duties not necessarily related to R & D activities - would not qualify as salary expenditure. Claims for salary expenditure should be based on actual expenditure and not upon standard salary rates that might be developed for internal costing purposes.

11. The provision of fringe benefits is not taken to fall within the definition of salary expenditure. This is because those benefits are not related directly to the company's R & D activities but to the recipient of them. Expenditure on a car provided for the private use of a technician employed on a company's R & D activities would therefore not be eligible to be claimed under section 73B either as salary expenditure or, because the car would not be used by the company exclusively for the purpose of carrying on R & D activities, as plant expenditure for the purposes of the section. Where a car provided as a fringe benefit to a member of the R & D staff of a company is also used partly for purposes directly related to the R & D activities, that part of the running expenses associated with the car that is attributable to the R & D activities would be allowable as research and development expenditure for the purposes of subsection 73B(14).

- Other expenditure

12. Expenditure incurred directly in respect of R & D activities carried on by or on behalf of the company, other than "contracted expenditure", "salary expenditure" or capital expenditure on plant and buildings, also forms part of research and development expenditure as defined in subsection 73B(1). That other expenditure includes amounts paid by a company to another person in consideration for that person carrying on all or part of an R & D project on the company's behalf. It would also include overheads and administration costs that are

directly related to a company's R & D activities - e.g. rent, light and power, property rates and taxes, insurance and leasing costs. Further examples of other research and development expenditure are provided in following paragraphs under specific headings.

13. Where a company is not engaged solely in R & D activities on its own behalf, it will be necessary to apportion any relevant overheads and administration costs between the company's R & D activities and its other activities - an appropriate basis of apportionment is to be established by the company. While it might be expected that, for example, rent would ordinarily be apportioned on a floor area basis, it would be open to a company to use some other basis of apportionment where it can be shown that it produces an allocation of overheads to R & D activities with a reasonable degree of accuracy. A company would, of course, need to be able to show that overheads and administration costs being apportioned are to that extent directly related to its R & D activities. For instance, there would be no apportionment of rent paid by a company for premises that are not to any extent used in R & D activities.

14. It has already been indicated that some expenditure could not be said to have been incurred directly in respect of R & D activities, and therefore will not be treated as research and development expenditure for the purposes of section 73B. Other items in this category would include entertainment expenses (deductions for which are denied by section 51AE of the Act) and fringe benefits.

15. As depreciation of plant and buildings does not represent expenditure incurred, it does not qualify as "research and development expenditure". Nor does it qualify as "plant expenditure" or "building expenditure" (see paragraphs 25 to 33). Accordingly, depreciation allowances are not deductible at an accelerated rate and are not taken into account in determining whether a company has satisfied the $20,000 or $50,000 expenditure threshold.

- Expenditure on overseas activities

16. The definition of "research and development activities" for the purposes of section 73B refers to activities that are carried on in Australia or an external Territory. The section 73B concession is not, therefore, available in respect of expenditure on an R & D project carried on overseas. However, it might be that some ancillary or incidental part of a project that is being carried on in Australia has to be undertaken overseas - for example, where testing facilities are not available in Australia. In those circumstances, it is to be accepted that such expenditure on the overseas activities qualifies as research and development expenditure.

17. Similarly, expenditure incurred by an eligible company in sending R & D staff overseas to observe techniques used in other countries or to attend relevant seminars is to be accepted

as research and development expenditure, where those activities are directly related to the company's R & D activities carried on in Australia. Expenditure incurred in accessing overseas information databases and transferring technology to Australia for the purpose of carrying on R & D activities in Australia would also qualify.

- Finance costs

18. Expenditure incurred by an eligible company on financing R & D activities may also qualify as research and development expenditure. As with other expenditure, the company would be expected to be able to establish the extent to which the expenditure is directly related to the activities. An arbitrary proportion of the total finance costs would not be acceptable. Of course, where arrangements have been entered into specifically to finance R & D activities, the relevant costs, being directly related to the activities, would qualify as research and development expenditure.

19. It may occur that moneys are borrowed by a company specifically to finance an R & D project but the whole of the principal borrowed is not immediately applied to R & D activities, - e.g., part of the moneys may be deposited with a bank until it is needed to pay for particular activities. In such a case, provided that the whole of the principal sum is, within a reasonable time, applied to the R & D activities, the finance costs would be deductible in full, notwithstanding that, in the interim period of deposit, assessable income from interest had been received. What is reasonable in a particular case will depend on its circumstances, including the use to which the moneys are put during the interim period before it is applied to the R & D activities.

- Clinical trials

20. A company might use clinical trials as an integral part of the development of a new product or to determine different uses for a product that is being developed. Expenditure on such clinical trials might qualify as research and development expenditure. On the other hand, clinical trials for purposes of market research, market testing or market development, or to demonstrate compliance with statutory standards, could not so qualify. As the distinction is likely to require technical expertise in the appropriate scientific areas, the question whether particular clinical trials are R & D activities would generally be referred to the Industry Research and Development Board for determination.

- Computer software development

21. The definition of "research and development activities" in subsection 73B(1) has 2 limbs. Paragraph (a) of the definition specifies s experimental activities carried on for the purpose of acquiring
new knowledge or creating new or improved materials, products, etc. Paragraph (b) of the definition specifies other activities

carried on for a purpose directly related to activities of the kind described in paragraph (a).

22. Subsection 73B(2) excludes from the first limb of the definition the development of computer software otherwise than for the purpose of sale, rent, licence, hire or lease. As a result, expenditure on the development of computer software for in-house use will generally not qualify as research and development expenditure.

23. However, where computer software is developed as an integral part of, and for use in, a larger R & D project - i.e., the development of the software is not in itself the objective of the project - related expenditure may qualify as expenditure in respect of R & D activities within the meaning in the second limb of the definition. Similarly, expenditure on the purchase of a software package that is to be used in carrying on an R & D project may qualify as research and development expenditure or, in appropriate circumstances (for instance, where purchased in a package with computer hardware), as "plant expenditure". Where the software package is to be used partly for qualifying R & D purposes and partly for other purposes, an appropriate apportionment would be necessary.

- Cost of patents

24. The costs associated with taking out a patent on the results of an R & D project are not considered to represent expenditure on R & D activities (but rather expenditure incurred after the completion of the relevant R & D activities) and therefore would not qualify for accelerated deduction under section 73B. However, where a company that is carrying on R & D activities acquires an existing patent to facilitate those R & D activities, the purchase price of the patent, to the extent that the patent is used in the company's R & D activities, may qualify as research and development expenditure.

- Plant expenditure

25. Expenditure incurred by an eligible company on the acquisition or construction of plant for use exclusively in R & D activities carried on by or on behalf of the company may be written off in equal instalments over 3 years, commencing with the year in which it is first used. The "plant expenditure" (as defined in subsection 73B(1)) must be incurred under a contract entered into during the period 1 July 1985 to 30 June 1991, except where the plant is constructed by the company itself, in which case the construction must commence during that period. Where the $20,000 threshold is exceeded in a year, the annual deductible amount is increased to up to 150% of the expenditure (subsection 73B(15)). If the plant ceases to be used exclusively in R & D activities in any of the first 3 years of its use, the special rate of write-off will not apply in the year of cessation or any later year, although the part of the cost of the plant not deducted under section 73B is capable of being written off under the ordinary depreciation provisions of the Assessment Act.

26. Deductions in respect of plant expenditure are allowable under section 73B only where the relevant expenditure is incurred during the deduction period 1 July 1985 to 30 June 1991. However, subsection 73B(16) allows for increased deductions in the years of income commencing on 1 July 1991 and 1 July 1992 in respect of plant expenditure incurred during the final two years of the deduction period. The subsection also applies to adjustments on the disposal, loss or destruction of non-pilot plant (paragraph 73B(23)(e)) or on the disposal, loss or destruction of pilot plant (paragraph 73B(24)(e)). In each case, the appropriate accelerated rate of deduction (up to 1.5 times) is calculated by reference to a notional total R & D expenditure as if the deduction period extended to 30 June 1993.

27. For example, an eligible company may have incurred the following expenditure in relation to qualifying R & D activities during the 1989/90, 1990/91, 1991/92 and 1992/93 years of income:

	Building Exp'ture	Plant Exp'ture	Other R & D Exp'ture
1989/90	$120,000	$90,000	$90,000
1990/91	NIL	$60,000	$50,000
1991/92	NIL	$30,000	$40,000
1992/93	NIL	NIL	$10,000

In the 1991/92 year of income the aggregate R & D amount would be $140,000 comprising 1/3 of $120,000 building expenditure plus 1/3 of the total qualifying plant expenditure of $180,000 ($90,000 + $60,000 + $30,000) plus other R & D expenditure of $40,000. The deduction acceleration factor would therefore be 1.5. The 1991/92 deduction allowable in respect of the qualifying plant expenditure of $50,000 (1/3 of $90,000 + $60,000) would thus be $75,000.

In the 1992/93 year of income the aggregate R & D amount would be $40,000 comprising 1/3 of the total qualifying plant expenditure of $90,000 ($60,000 + $30,000 + NIL) plus other R & D expenditure of $10,000. Under the statutory formula, the deduction acceleration factor would therefore be 1.4167 calculated as follows -

$$\frac{(440{,}000 - 100{,}000)}{240{,}000}$$

and rounded to 4 decimal places. The deduction allowable in respect of the qualifying plant expenditure of $20,000 (1/3 of $60,000) would be $28,334.

28. The special write-off provisions for plant are not restricted to cases where the plant is used by the company that owns it. A company could make its plant available to another party undertaking R & D activities on its behalf. Provided the plant was used exclusively for R & D activities on the company's behalf, the company's plant expenditure would still be eligible for the special concession.

29. Some companies may carry on R & D activities on their own behalf and on behalf of other companies - e.g. on behalf of subsidiaries. In such a case, a company's capital expenditure on plant for use both in its own R & D activities and in such activities carried on on behalf of others does not qualify for the special rate of write-off. Sub-section 73B(9) provides that a deduction is not allowable under section 73B in respect of any expenditure incurred for the purpose of carrying on R & D activities on behalf of another person. Moreover, to be plant expenditure, the expenditure must be on plant for use by the company exclusively for the purpose of the carrying on, by or on behalf of the company, of R & D activities.

- Building expenditure

30. In a similar way to qualifying plant expenditure, qualifying building expenditure may be written off in equal instalments over the first 3 years of a building's exclusive use in R & D activities. However, there is no accelerated rate of write-off for qualifying building expenditure (subsection 73B(17)). In addition, to attract write-off under section 73B, the building, extension, alteration or improvement must be used exclusively for R & D activities for 5 years. Where it is disposed of or ceases to be used exclusively for R & D activities within the first 5 years of its use, deductions allowed under subsection 73B(17) are deemed never to have been allowable and the relevant expenditure is deemed never to have been qualifying building expenditure (subsection 73B(28)). As a result, any deduction allowed or otherwise allowable in accordance with section 73B in respect of the building, extension, alteration or improvement will generally (see the following paragraph) have to be disallowed. Assessments may be re-opened for this purpose by virtue of subsection 170(10) of the Assessment Act. It should be kept in mind that, if section 73B deductions are disallowed, deductions may be allowable under another provision of the Act which would otherwise have applied in the absence of section 73B - e.g. under section 124JA in relation to expenditure on timber mill buildings or Division 10 in relation to expenditure on general mining buildings (subsection 73B(30)).

31. Subsection 73B(29) provides for deductions to be maintained even though a building, extension, alteration or improvement has not been used exclusively in R & D activities for 5 years, but only where, having regard to the matters specified in subparagraphs (i) to (iv), the Commissioner is satisfied that disallowance would be unreasonable. For example, a company may have commenced to use a building for non-R & D activities because it had ceased R & D activities completely during the 5 year period. If it could be demonstrated that cessation could not reasonably have been foreseen when the building in question was acquired or constructed , subsection 73B(29) should, in the absence of any evidence suggesting that the company had sought to exploit the provisions of section 73B, be applied to maintain previously allowed deductions. However, the subsection should not be applied to maintain the allowance of a deduction in the year of

income in which a building ceased to be used exclusively in R & D activities.

32. The general adjustment provision (subsection 73B(27)) applies only in respect of the sale or disposal of a building, extension, alteration or improvement after the expiry of 5 years from the date on which a company commenced to use the building, etc. exclusively for the purpose of carrying on R & D activities by or on behalf of the company. For this reason, subsection 73B(29) should not, other than in exceptional circumstances, be applied to maintain the allowance of deductions under subsection 73B(17) where a building is sold or disposed of before the expiry of the 5 year period. To so apply subsection (29) would, in almost all circumstances, be to provide a benefit to a company far in excess of that which is reasonable given the company's effective commitment to usage of the building exclusively for R & D purposes.

33. The provisions of section 73B relating to expenditure on buildings used for the purpose of carrying on R & D activities also apply to expenditure incurred on a part of a building used for that purpose (see the definition of "building" in subsection 73B(1)). Where a part of a building is used exclusively for qualifying R & D purposes and the cost of the acquisition or construction of that part of the building is able to be accurately and separately quantified, the amount of the relevant expenditure may qualify as building expenditure for the purposes of section 73B.

- Leased plant and buildings

34. Lease payments by an eligible company in respect of plant or buildings used in R & D activities carried on by or on behalf of the company would constitute "other expenditure" referred to in paragraph (c) of the definition of R & D expenditure. There is no requirement that such plant or buildings be used exclusively in the R & D activities, but where they are not so used, only the proportion of the expenditure that can be shown to be directly related to the R & D activities would qualify for deduction under section 73B.

35. Similarly, where a company uses leased plant or buildings to carry out R & D activities on its own behalf and on behalf of other persons, the proportion of the relevant lease payments attributable to the company's own R & D <' activities would qualify for deduction under section 73B. The situation is different to that of a company's capital expenditure on plant or buildings because the lease payments (being "other expenditure") are not required to be exclusively in respect of R & D activities and can be apportioned according to the use to which the relevant plant or buildings are put. Subsection 73B(9) does not apply to disqualify the lease payments from deductibility because, to the extent that the payments are attributable to the company's own R & D activities, that expenditure is not incurred for the purpose of carrying on R & D activities on behalf of another person.

R & D ACTIVITIES SUPPORTED BY GOVERNMENT SUBSIDIES

36. The special section 73B deductions are available only in respect of expenditure on an R & D project that is not the subject of some other form of direct government subsidy. In that regard, subsection 73B(8) denies a deduction under the section in respect of an eligible company's expenditure on R & D activities where the company is, or becomes entitled to be, recouped or receives a grant in respect of any of the expenditure by or from the Commonwealth, a State or a Territory or a statutory authority.

37. Examples of such subsidies are the grants made by the Industry Research and Development Board, or its predecessor, the Australian Industrial Research and Development Incentives Board, and those made by various State government authorities to assist particular R & D projects. Expenditure on a subsidised project is outside the scope of section 73B regardless of the level of subsidy provided. None of the expenditure on an Industry Research and Development Board sponsored project is deductible under section 73B even though the grant represents only a small part of the total expenditure or, in the more usual case, 50% of expected expenditure on that project. The fact that actual expenditure on a project exceeded the expected expenditure budgeted for when a grant was made does not mean that the excess expenditure qualifies for deduction under section 73B.

38. The exclusion in subsection 73B(8) is project-related, and therefore does not prevent a company's expenditure on separate non-subsidised projects from qualifying for deduction under section 73B. If a total R & D program is divided into separate stages where each stage has its own separate objective, so that each stage can be identified as a discrete project in its own right and itself involving innovation or technical risk, a company's expenditure on stages that are not the subject of a government subsidy may qualify as eligible expenditure for the purposes of section 73B. For example, an eligible company may receive a commencement grant in respect of the first stage of a lengthy R & D program. Expenditure on that stage would be ineligible for the special concession. However, if the remaining stages of the program are unsupported by Government grants, expenditure on them may qualify for the concession. A project may be regarded as consisting of those activities necessarily undertaken to resolve a defined technical problem.

39. Expenditure by a company on an R & D project that is not deductible under section 73B by virtue of the operation of subsection 73B(8) is disregarded for the purposes of the application of section 73B to the company. The effect is that such expenditure cannot count towards meeting the $20,000 threshold which must be met in a year of income before increased deductions are allowable.

- Bounties

40. The question has been raised as to whether bounty

payments under the various bounty Acts administered by the Australian Customs Service would represent a grant or recoupment for the purposes of subsection 73B(8). Bounties are generally payable in respect of a company's production rather than in respect of its R & D activities, although the eligible production costs may include an R & D component. Where a bounty payment is not directed specifically at a company's R & D expenditure, it is to be accepted as not being a grant or recoupment in respect of that expenditure for the purposes of subsection 73B(8).

- Joint ventures with government agencies

41. Ordinarily, subsection 73B(8) would not operate to deny to an eligible company participating in a joint venture with a government agency the company's entitlement to section 73B deductions in respect of its own expenditure on the particular R & D project. Such a joint venture might be established to carry on an R & D project in an area that is of interest to both parties on the basis that the results would benefit them both. However, if all of the results or benefits of such a project were to flow to the eligible company, the government-provided funds should, as a general rule, be treated as being in the nature of a grant, so that subsection 73B(8) would apply in respect of the company's expenditure on that project.

- The National Teaching Company Scheme

42. The National Teaching Company Scheme administered by the Department of Industry, Technology and Commerce is intended to encourage the participation, in private industry research projects, of researchers attached to tertiary institutions. Under the Scheme, the Department provides a grant to the relevant tertiary institution to cover 50% of the researcher's salary costs. The company actually engaging the researcher is required to pay the remaining 50% of the salary costs to the tertiary institution.

43. Grants under the National Teaching Company Scheme are not paid to the company that engages the particular researcher, and therefore do not affect the company's entitlement to section 73B deductions in respect of its expenditure, including expenditure on the researcher's salary, on an R & D project or projects in which the researcher is involved.

OPERATION OF SUBSECTION 73B(9)

44. Subsection 73B(9) denies deductions under section 73B in respect of a company's expenditure incurred in carrying on R & D activities on behalf of another person. The subsection effectively prevents double deductions in respect of the same program of R & D activities and restricts entitlement to section 73B deductions to the company that bears the financial risk associated with an R & D project and effectively owns the project results. An eligible company's expenditure on R & D activities performed on its behalf by another person may be deductible under section 73B. In those circumstances, the

entity performing the R & D activities would not be at risk and ordinarily would not be entitled to the results of the R & D funded by the eligible company.

45. It might be that a company is approached by a client and asked to develop a project or process which is required by the client for use in the client's business. If the R & D necessary to develop the project was done at the risk of the company - i.e., the client was required to pay for the final product only if the R & D was successful - the company performing the R & D could qualify for the section 73B concession since it would in fact be performing the R & D activities on its own behalf - i.e. to produce a saleable product.

- Inter-company reimbursement

46. It may occur that a particular company in a company group carries on R & D activities, but its expenditure is reimbursed by another group company - for instance, its parent company. In such a case, subsection 73B(9) would operate so that the company performing the R & D activities would not be entitled to section 73B deductions in respect of its expenditure unless it retained ownership of the R & D results. If that was not the case, the performing company would, in effect, be carrying on the R & D activities on behalf of the parent company - the company actually bearing the cost of the R & D. In those circumstances, the parent company would be entitled to deductions for its costs, provided it was entitled to the results of the R & D activities.

SALE OF PRODUCTS OR BY-PRODUCTS OF R & D ACTIVITIES

47. In some cases, there may be a product or a by-product of an R & D project that is saleable - e.g. metal by-products of R & D activities carried out in the mining industry. Another example would be that mentioned in paragraph 45 - where a new product is developed specifically for sale to a client. In each case, the proceeds of the sale of the product or by-product would be included in the company's assessable income. However, their receipt would not affect the company's entitlement to the section 73B concession. The proceeds would not be required to be set-off against the expenditure incurred by the company on the particular R & D activities.

SUBSTANTIATION OF CLAIMS UNDER SECTION 73B

48. There are no statutory rules relevant to the substantiation of claims for deductions under section 73B. A company would, however, be expected to ensure that its ordinary business records are sufficient to verify the amount of expenditure incurred on R & D activities, the nature of the activities which are claimed to be R & D activities, and the relationship of the expenditure to the activities.

49. One particular point relevant to claims for expenditure on R & D activities is the need for some companies to allocate

expenditure between R & D activities and other activities. Where the expenditure (e.g. salary costs) is to be apportioned on the basis of time spent by employees on the different activities, the company would be expected to maintain adequate records for that purpose - e.g. time sheets or job cost cards. As noted in paragraph 10, standard salary rates used for internal costing purposes are not acceptable.

50. Companies will also need to retain documentation such as reports detailing the R & D activities carried on - whether carried on by their own R & D staff or contracted out to another person, including an approved research institute. The documentation should be sufficient to enable a determination to be made of whether the particular activities undertaken by a company, or by some other person on its behalf, are qualifying R & D activities for the purposes of section 73B. That determination would, in appropriate cases, be made by the Industry Research and Development Board as a result of a request made by the Commissioner under subsection 73B(34).

ADDITIONAL TAX AND INTEREST WHERE SECTION 73B CLAIM IS DISALLOWED

51. Under self-assessment procedures, a company's income tax return is not, before an assessment is made, subject to the same degree of technical scrutiny that previously existed. In some cases an amended assessment may be necessary to adjust errors in the original assessment that are detected at the post assessment audit or examination stage. With section 73B claims, adjustments may be required in circumstances such as where -

(a) it has been determined that certain expenditure was not incurred in respect of qualifying R & D activities;

(b) expenditure has been incorrectly allocated or apportioned to R & D activities instead of to other activities of the company; or

(c) the amount in respect of which a section 73B deduction was claimed exceeded the company's actual expenditure on the particular item.

In any of those circumstances, the question arises as to whether the company will incur a liability to any additional tax or interest in respect of the adjusted claim.

52. Broadly, additional tax is payable under Part VII of the Assessment Act where, as far as relevant, a taxpayer makes a statement in respect of a claim which is false or misleading in a material particular or omits from a statement any matter or thing without which the statement is misleading in a material particular, or where a tax avoidance arrangement is involved. Where an eligible company claiming deductions under section 73B makes a full and true disclosure of all material facts surrounding the claim, the additional tax provisions will not apply to any subsequent adjustment to the claim. Those provisions would, however, apply where a section 73B claim is

adjusted and a full and true disclosure was not made.

53. In circumstances where the additional tax provisions of Part VII do not apply, section 170AA of the Act provides for the payment of interest (presently at the rate of 14.026% per annum) where an amended assessment results in an increase in tax payable. The rate of interest payable is the same as that payable under the Taxation (Interest on Overpayments) Act 1983.

COMPANIES WITH SUBSTITUTED ACCOUNTING PERIODS

54. The section 73B concession is available only in respect of qualifying expenditure incurred during the period from 1 July 1985 to 30 June 1991. That may affect companies with substituted accounting periods in two ways. First, in respect of the years of income in which 1 July 1985 and 30 June 1991 occur, R & D expenditure incurred before 1 July 1985 or after 30 June 1991 will not qualify for deduction under section 73B. For instance, a company with a substituted accounting period commencing on 1 January and ending on 31 December may have incurred R & D expenditure of $50,000 in the year of income ended 31 December 1985, with $25,000 of that expenditure having been incurred before 1 July 1985 and $25,000 afterwards. The company's qualifying R & D expenditure in those circumstances would be $25,000.

55. Secondly, expenditure incurred before 1 July 1985 or after 30 June 1991 cannot be taken into account in determining whether a company's R & D expenditure in the relevant year of income exceeds the general $20,000 expenditure threshold. There is no provision for the threshold to be prorated where a company's financial year does not fall entirely within the deduction period. In the example mentioned in the preceding paragraph, the "deduction acceleration factor" (as defined in subsection 73B(1)) in respect of the company's R & D expenditure would be 1.1667 (rounded to 4 decimal places), based on qualifying expenditure in the year of income of $25,000.

FUNDING ARRANGEMENTS FOR R & D ACTIVITIES

56. There have been a number of enquiries relating to arrangements for garnering investment funds from a number of investor companies to finance certain R & D projects, usually chosen by an intermediary. Because of the range and variety of the features of such arrangements, it is proposed to issue a separate Ruling on what is, and is not, considered acceptable for investor companies to be entitled to section 73B deductions in respect of their contributions to the R & D projects.

57. There are, however, some general comments that can be made in relation to these types of investments in R & D projects.

58. In order to meet the requirement that the R & D activities be carried on by or on behalf of an eligible company, it is seen as necessary that the investor company have effective ownership rights in respect of its proper part of the results of the R & D activities - e.g. the intellectual property

or a beneficial interest in that property. The results of R & D activities may not be intellectual property in the formal sense; copyright, a patent or a registered design may not be available. In any event, the question on whose behalf the R & D activities were carried on depends on the substance of ownership and control of the results of those activities, rather than the form. Another factor relevant to that requirement would be the effect of any agreement entered into prior to the completion of an R & D project for the sale or exploitation of the project results. The R & D activities need to be carried on for the benefit of the investor company, and not the purchaser or exploiter of the results. It is also considered implicit that the investor company have control over the conduct of the R & D activities - control would be illustrated by the company, perhaps in conjunction with other investors, being able to appoint the performer of the R & D activities, to direct their course and to terminate the work.

COMMISSIONER OF TAXATION
13 AUGUST 1987