

TD 2023/6 - Income tax: tax incentives for early stage investors: what is an 'expense' that is 'incurred' for the early stage test?

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! There is a Compendium for this document: **TD 2023/6EC** .



Status: **legally binding**

Taxation Determination

Income tax: tax incentives for early stage investors: what is an ‘expense’ that is ‘incurred’ for the early stage test?

📌 Relying on this Determination

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

If this Determination applies to you, and you correctly rely on it, we will apply the law to you in the way set out in this Determination. That is, you will not pay any more tax or penalties or interest in respect of the matters covered by this Determination.

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Ruling

- Under the expense tests in subparagraph 360-40(1)(a)(ii) and paragraph 360-40(1)(b) of the *Income Tax Assessment Act 1997*, the company in which you (the investor) are investing must only take into account ‘expenses’ which have been ‘incurred’ as at the test time.
- All legislative references in this Determination are to the *Income Tax Assessment Act 1997*, unless otherwise indicated.
- In these provisions:
 - expenses** are amounts recognised as expenses under general accounting concepts
 - incurred** has the same meaning as for the purposes of the general deduction provisions in section 8-1, and
 - test time** means the time immediately after the company has issued shares to you.¹

¹ Paragraphs 360-15(1)(b) and (c) and subsection 360-40(1).

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Date of effect

4. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will 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 this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation

22 November 2023

Status: **not legally binding**

Appendix 1 – Explanation

❶ *This Explanation is provided as information to help you understand how the Commissioner’s view has been reached. It does not form part of the binding public ruling.*

Background – early stage investment

5. The object of the early stage innovation company (ESIC) regime is to encourage new investment in small Australian innovation companies with high-growth potential, by providing a tax offset and modified capital gains tax treatment to qualifying investors.²

6. To be entitled to a tax offset, you (the investor) must be issued with shares in a company that satisfies the tests in subsection 360-40(1) immediately after the shares are issued.³

7. Subsection 360-40(1) consists of an early stage test and innovation test, reflecting Parliament’s intent that the ESIC regime only apply to investments in recently established, innovative companies.

8. The early stage test includes a requirement that the company issuing the shares, and any of its 100% subsidiaries, incurred total expenses of \$1 million or less in the income year preceding the issue of the shares.⁴ The company may need to satisfy an additional expense test, depending on when it was incorporated in Australia or registered with the Australian Business Register.⁵

Expenses

9. The word ‘expenses’ in the expense tests is not a defined term and so has its ordinary meaning in the context in which it appears. Our view is that in the context of the early stage investor incentive, a meaning consistent with the general accounting concept of expense is the most appropriate.

10. Expense ordinarily refers to a ‘cost or charge ... a cause or occasion of spending’.⁶ Spending conveys the notion of using up or consuming resources. In a business or commercial context, expense would not ordinarily be used to describe the purchase price of a capital asset. An interpretation which adopts the commercial meaning of the word is appropriate in the context of legislation concerned with business activities. This is supported by the Explanatory Memorandum to the Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016, which states⁷:

The ATO’s company tax return requires companies to report ‘total expenses’ at item six as part of the total profit or loss calculation. A company that has submitted a company tax return in the previous income year must rely on the amount reported in item six for the purposes of this test. Alternatively, if the company was not required to submit a company tax return, it may use the amount corresponding to this item.

11. The expenses reported at item 6 of a company tax return are primarily the expense amounts taken from the company’s financial statements. The Australian Accounting

² Section 360-10.

³ Paragraphs 360-15(1)(b) and (c) and subsection 360-40(1).

⁴ Paragraph 360-40(1)(b).

⁵ Subparagraph 360-40(1)(a)(ii).

⁶ Macmillan Publishers Australia, *The Macquarie Dictionary* online, www.macquariedictionary.com.au, accessed 10 November 2023.

⁷ See paragraph 1.64.

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Standards Board (AASB) *Framework for the Preparation and Presentation of Financial Statements* defines expenses as⁸:

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

12. Accordingly, an amount will be an expense where it results in a decrease in the equity of the potential ESIC, otherwise than by way of a distribution to its members.

13. An implication of this interpretation is that an outgoing that has been properly capitalised, and results in the recognition of an asset under general accounting concepts⁹, is not an expense for the ESIC expense tests. In such a case, any outgoing of cash or increase in liabilities will be offset by the recognition of a new asset.¹⁰

Incurred

14. The early stage test is only concerned with expenses which have been 'incurred' at the test time. We consider that the general tax law meaning of incurred is the most appropriate.

15. There is nothing in the ESIC provisions to suggest that incurred in the expense tests means anything other than the usual interpretation of section 8-1, which has already been extensively considered and established by the courts.

16. An expense for accounting purposes is not necessarily incurred for the purposes of the expense tests. In each case it is necessary to consider whether there is a presently existing liability, having regard to the legal nature of the arrangements in question.¹¹

17. The early stage test therefore, would not include certain provisions and reserves that may be recognised as expenses for accounting but which are not incurred, for example, provision for doubtful debts. The test also would not include depreciation expenses, consistent with the statutory context of Division 360.

⁸ AASB, July 2020, *Framework for the Preparation and Presentation of Financial Statements* (Compiled), paragraph 70(b).

⁹ 'An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.' (AASB, July 2020, *Framework for the Preparation and Presentation of Financial Statements*, paragraph 89.)

¹⁰ An entity does not obtain an asset for these purposes merely because it incurs expenditure with the objective of securing future economic benefits. There may be circumstances where it is improbable that such economic benefits will flow to the entity beyond the current accounting period and therefore the expenditure is appropriately accounted for as an expense. Refer to AASB 138, 12 July 2021, *Intangible Assets* (Compilation no. 4), paragraphs 18 to 71.

¹¹ Taxation Ruling TR 97/7 *Income tax: section 8-1 – meaning of 'incurred' – timing of deductions*.

Status: **not legally binding**

Appendix 2 – Compliance approach

① *This Appendix sets out a practical administration approach to assist taxpayers in complying with relevant tax laws. Provided you follow the advice in this appendix in good faith and consistently with the Ruling section, the Commissioner will administer the law in accordance with this approach.*

18. As a practical matter, the Commissioner considers there is low compliance risk in a company and its investors relying on the amount reported as 'total expenses' in the company tax return, without separately identifying whether those expenses have been 'incurred' in the tax sense. Accordingly, the Commissioner would not devote compliance resources to query or adjust the company's incurred total expenses that use the reported amount of total expenses in the company's tax return. However, compliance action may be taken to verify that the amount of total expenses reported in the tax return is correct.

19. For the avoidance of doubt, this compliance approach does not prevent a company and its investors from using an amount worked out to be the correct amount of incurred expenses in determining if the relevant early stage expense tests are met.

20. Also, if the Commissioner is asked to amend an assessment, or required to state a view (for example in a private ruling or in submissions in a litigation matter), the Commissioner will act consistently with the views set out in this Determination.

Status: **not legally binding**

References

Previous draft:

TD 2019/D5

Related Rulings/Determinations:

TR 97/7; TR 2006/10

Legislative references:

- ITAA 1997 8-1
- ITAA 1997 360-10
- ITAA 1997 360-15(1)(b)
- ITAA 1997 360-15(1)(c)
- ITAA 1997 360-40(1)
- ITAA 1997 360-40(1)(a)(ii)
- ITAA 1997 360-40(1)(b)
- ITAA 1997 Div 360

Other references:

- Explanatory Memorandum to Tax Laws Amendment (Tax Incentives for Innovation) Bill 2016
- Australian Accounting Standards Board Framework for the Preparation and Presentation of Financial Statements (Compiled)
- Australian Accounting Standards Board 138 Intangible Assets (Compilation No. 4)
- Macmillan Publishers Australia. *The Macquarie Dictionary* online, www.macquariedictionary.com.au

ATO references

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