



TD 2019/D5 - Income tax: tax incentives for early stage investors: what is an 'expense' that is 'incurred' for the early stage test?

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Draft Taxation Determination

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

1 Relying on this draft Determination

This publication is a draft for public comment. It represents the Commissioner’s preliminary view on how a relevant provision could apply.

If this draft Determination applies to you and you rely on it reasonably and in good faith, you will not have to pay any interest or penalties in respect of the matters covered, if the draft Determination turns out to be incorrect and you underpay your tax as a result. However, you may still have to pay the correct amount of tax.

Ruling

1. Under the expense tests in subparagraph 360-40(1)(a)(ii) of the *Income Tax Assessment Act 1997*¹ and paragraph 360-40(1)(b), the company in which you (the investor) are investing must only take into account ‘expenses’ which have been ‘incurred’ as at the test time.
2. 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.²

Date of effect

3. 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 *Public Rulings*). However, see paragraph 16 of this draft Determination which sets out the Commissioner’s compliance approach.

Commissioner of Taxation
28 August 2019

¹ All legislative references are to the *Income Tax Assessment Act 1997*.

² Paragraphs 360-15(1)(b) and (c) and subsection 360-40(1).

Appendix 1 – Explanation

❶ *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.*

Background – early stage investment

4. 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.³
5. 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.⁴
6. 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.
7. 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.⁵ The company may need to satisfy an additional expense test, depending on when it was incorporated in Australia or registered in the Australian Business Register.⁶

Expenses

8. 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.
9. Expense ordinarily refers to a ‘cost or charge; a cause or occasion of spending’.⁷ 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 states⁸:

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.

³ Section 360-10.

⁴ Paragraphs 360-15(1)(b) and (c) and subsection 360-40(1).

⁵ Paragraph 360-40(1)(b).

⁶ Subparagraph 360-40(1)(a)(ii).

⁷ Macmillan Publishers Australia, *The Macquarie Dictionary Online*, www.macquariedictionary.com.au; viewed 30 May 2019.

⁸ See paragraph 1.64.

10. The expenses reported at item six of a company tax return are the expense amounts taken from the company's financial statements. The Australian Accounting Standards Board (AASB) *Framework for the Preparation and Presentation of Financial Statements* defines expenses as⁹:

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.

11. 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.

12. 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 concepts¹⁰, 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.¹¹

Incurred

13. 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.

14. 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.

15. 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.¹²

⁹ AASB, July 2004, *Framework for the Preparation and Presentation of Financial Statements*, paragraph 70(b).

¹⁰ '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 2004, *Framework for the Preparation and Presentation of Financial Statements*, paragraph 89.)

¹¹ 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 August 2014, *Intangible Assets*, paragraphs 18 to 71.

¹² Taxation Ruling TR 97/7 *Income tax: section 8-1 - meaning of 'incurred' - timing of deductions*.

Appendix 2 – Compliance approach

① *This Appendix sets out a proposed practical administration approach to assist taxpayers in complying with relevant tax laws. When this Determination is finalised, 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.*

16. 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 ordinarily 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.

17. 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.

Appendix 3 – Your comments

18. 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.

19. This draft Determination is being published using a new fast-tracked process designed to accelerate the finalisation of Determinations in certain circumstances.

20. As the issue addressed by this Determination was previously subject to consultation via the ATO's Let's Talk platform and the feedback was taken into account in developing the interpretative view and compliance approach, the comments period is reduced to two weeks.

21. A compendium of comments is prepared for the consideration of the relevant Public Advice and Guidance 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
- be published on the ATO website at ato.gov.au.

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

22. If we receive no comments, the draft Determination will be finalised as soon as possible after the conclusion of the comments period.

Due date: 11 September 2019
Contact officer: Tom Rengers
Email address: Tom.Rengers@ato.gov.au
Telephone: (07) 3213 6955

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10, TR 97/7

Legislative references:

- ITAA 1997
- ITAA 1997 8-1
- ITAA 1997 360-10
- ITAA 1997 360-15
- 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)

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
- AASB 138, Intangible Assets
- The Macquarie Dictionary Online

ATO references

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