TD 94/D83 - Income tax: can research and development expenditure incurred by a business be deductible under subsection 51(1) of the Income Tax Assessment Act 1936 (the Act)?

This document has been finalised by TD 95/44.

Draft Taxation Determinations (TDs) represent the preliminary, though considered, views of the ATO. Draft TDs may not be relied on; only final TDs are authoritative statements of the ATO.

Draft Taxation Determination

Income tax: can research and development expenditure incurred by a business be deductible under subsection 51(1) of the *Income Tax Assessment Act 1936* (the Act)?

1. Yes. In general terms, the expenditure is deductible under subsection 51(1) if it is both relevant and incidental to the income producing activities of the business, and not of a capital nature.

2. Deductions for research and development ('R&D') expenditure are specifically provided for under sections 73A and 73B of the Act. If the criteria for deductibility under section 73B are not satisfied, the application of the general deduction provision, subsection 51(1), may be relevant. Section 73A allows a deduction for expenditure on scientific research only if the expenditure is not deductible under any other provision of theAct, including subsection 51(1).

Connection to the business

3. The requisite connection will generally exist if the R&D activities are conducted for the purpose of developing new or improved products, processes or know-how for use in the income producing activities of the business. However, the R&D expenditure must be undertaken in and for the purposes of carrying on an existing business. Accordingly, R&D expenditure is not deductible if incurred:

(i) to enable a taxpayer to commence to carry on a business or a new branch of a business; or

(ii) on developing a new product prior to establishment of commercial development and manufacturing facilities for that product (see *Goodman Fielder Wattie Ltd v. FC of T* 91 ATC 4438; (1991) 22 ATR 26); or

(iii) on developing a new product which is not in the same general area as products the taxpayer already manufactures (see *AAT Case 4595* (1988) 19 ATR 3847; *Case V141* 88 ATC 880).

4. Whether the R&D activities are successful or not in producing profitable results is not directly relevant to the deductibility of the expenditure. Provided the requisite connection to a business carried on for income-producing purposes exists, subsection 51(1) does not require expenditure to have actually produced income. Thus, for example, expenditure on developing an improved product which is never actually manufactured and sold may be deductible.

Capital/revenue aspects

5. Distinguishing capital from revenue expenditure is a question of fact and degree. Relevant considerations include: whether the expenditure relates to the business structure itself or the process of operating it; the nature of the asset or advantage sought (including its lasting qualities); and the degree of recurrence (see *Sun Newspapers Ltd & Associated Newspapers Ltd v. FC of T* (1938) 61 CLR 337; 5 ATD 87).

6. To be deductible under subsection 51(1), the nature of the business should require ongoing R&D activities as a necessary part of that business, so that recurring outlays on R&D are a part of the continual flow of working or operating expenses. This is most easily established where business is carried on in a field of high or rapidly advancing technology with a continuous need for R&D in order to carry on the business (see *Goodman Fielder Wattie*, supra). It may also be the case where the taxpayer undertakes continuous R&D activities whose results are available for the purposes of producing products which are trading stock of the business (see 15 CTBR *Case 24*).

7. If the R&D expenditure creates an asset or advantage of a lasting nature for the business, this may indicate that it is on capital account. An example would be if the R&D is directed to obtaining patentable rights of a lasting kind.

Example:

Happy Orchards Ltd carries on a business of processing fruit juices. An outbreak of food poisoning is traced to a restaurant which is one of the company's customers. All of the restaurant's suppliers are requested to check that their processing facilities are free of bacteria. Happy Orchards hires a researcher to conduct tests and to ascertain the potential for contamination of its products. The expenditure on hiring the researcher is deductible under subsection 51(1).

Commissioner of Taxation
4/8/94

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Related Determinations:

Related Rulings: IT 2671

Subject Ref: research and development; deductible expenses

Legislative Ref: ITAA 51(1); ITAA 73A; ITAA 73B

Case Ref: Goodman Fielder Wattie Ltd v. FC of T 91 ATC 4438, (1991) 22 ATR 26; Sun Newspapers Ltd & Associated Newspapers Ltd v. FC of T (1938) 61 CLR 337, 5 ATD 87; AAT Case 4595 (1988) 19 ATR 3847, Case V141 88 ATC 880; 15 CTBR Case 24

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