# *IT 2451 - Income tax: Investor funding of research and development activities*

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# TAXATION RULING NO. IT 2451

## INCOME TAX : INVESTOR FUNDING OF RESEARCH AND DEVELOPMENT ACTIVITIES

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RELATED RULINGS: IT 2442

PREAMBLE Taxation Ruling No. IT 2442 addressed specific aspects of the interpretation of section 73B of the Income Tax Assessment Act 1936 which provides a special tax concession for Australian companies in respect of their expenditure on certain qualifying research and development (R&D) activities. Paragraphs 56 to 58 of that Ruling discussed some general issues relating to investments in R&D projects and foreshadowed this separate Ruling.

2. This Ruling discusses in more detail the general principles governing investment in R&D projects and explores the application of these principles to several particular situations. Specific aspects are discussed under the following headings:


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GENERAL PRINCIPLES

3. Expenditure by a company can qualify as R&D expenditure, building expenditure or plant expenditure (as defined in

subsection 73B(1)) only if incurred in respect of R&D activities carried out by or on behalf of the company. Moreover, subsection 73B(9) precludes any deduction under the section for expenditure incurred for the purpose of carrying on R&D activities on behalf of any other person.

4. For R&D activities to be carried out by or on behalf of a company, there must be a close and direct link between the company and the work undertaken; the concept is that the work is being undertaken directly, either by the company itself or by another party on its behalf. It is implicit that the company effectively own its proper part of the result of those activities. It is also implicit that the company have proper control over the conduct of those activities. Arrangements which in substance abdicate either ownership or control could compel the conclusion that R&D activities were not being carried out by or on behalf of the company.

5. On the other hand, expenditure incurred by a company for the purpose of carrying on R&D activities on behalf of another person does not imply that the other person must effectively own the results of the R&D activities undertaken. The concept is broader and extends to a more indirect effective benefit to the other person. For example, agreements for the sale or exploitation of R&D results entered into before those results are known may be on such terms that the R&D activities are, in substance, carried on for the benefit of the purchaser or exploiter rather than for the company undertaking the R&D activities and incurring expenditure in doing so.

EFFECTIVE OWNERSHIP

6. Where R&D activities are carried out by or on behalf of a company, they generally give that company results which it can effectively own. This does not necessarily mean that the company must be the proprietor of a piece of intellectual property in any formal sense. First, the relevant formal regimes of intellectual property - copyright, patent, or registered design - may be unavailable to protect the results. Second, it is possible for the formal owner of any resulting intellectual property to hold it on such terms that the company has all the advantages of ownership. For instance, a company could have the right to use a patent, to require the patent to be licensed, to restrict or direct further development based on the patent, all without further fee or payment, and yet not be formally the holder of the patent. In most such cases, a company with all those rights would have sufficient equity in the ownership of the patent and of the results embodied in it that the R&D activities could be said to have been carried out on its behalf.

7. Some theoretical rights of ownership may be given to others without denying this effective ownership to a claimant under section 73B. For instance, a company having R&D carried out on its behalf might completely control commercial use of the results of that R&D, including further development of those results for commercial purposes, yet permit the researcher certain exclusive rights of scientific publication. The company would nevertheless

be the effective owner of the results in the ordinary case. Similarly, actual use of particular results may only be possible in limited ways or for limited purposes, so that apparently limited rights can really amount to full effective ownership. For instance, exclusive rights of commercial use and development for only a few years might amount to full ownership in a particularly ephemeral area of R&D.

8. A special case can arise where a company incurs expenditure on R&D that builds on existing research results belonging to another person. It may be proposed that the company take an interest in the overall results, rather than being the owner of, but only of, the further R&D it has paid for. Provided the company's interest is appropriate to its contribution to the overall research, it could be said that the further research was carried out 'by, or on behalf of' the company. The question of partnership situations, discussed later in this Ruling, is still relevant.

WHAT IS A PROPER INTEREST IN R&D RESULTS?

9. Where several companies fund a project of R&D together on their behalf, if each is to claim expenditure under section 73B, each must have a proper and effective interest in the R&D results. Apart from special agreement, co-owners of results of R&D will be tenants in common, holding undivided interests in the results. Such co-owners can use the results individually for their own benefit without accounting to each other, can enforce rights over the results and obtain damages without joining their co-owners. However, such co-owners can license or assign their R&D results only by joint agreement. These principles extend to the statutory schemes of copyright, registered designs and patents, although in the latter cases a statutory method of resolving disputes between co-owners is provided.

10. Co-owners who can, as a practical matter, make use of their results in their individual activities often do not make any specific agreements about their rights as between themselves. For instance, members of industry associations (discussed at paragraphs 6 and 7 of Taxation Ruling No. IT 2442) are effectively co-owners of the R&D results obtained on their behalf. Free individual use of those results is practical for them. Co-ownership of this kind is consistent with the R&D having been carried out on behalf of the individual co-owners, each of whom has a proper and effective separate interest in the results. Where each such co-owner makes a contribution, even if the contributions vary somewhat, those contributions would not usually be regarded as having been made for the purpose of carrying out R&D activities on behalf of the other co-owners.

11. Co-owners who cannot make use of their results in their individual activities are more likely to make special agreements covering the use of their results. In cases where they must effectively share the results or their use, the question will be whether their individual share in those results is commensurate with their contribution. This is a question of fact, which may depend on the circumstances of the case. What is required is a

comparison of the contributions of the co-owners to the R&D activities.

12. Contributions to R&D activities take many forms; for example, money, services (provided free, or to the extent that remuneration is clearly less than a proper fee), or plant or premises. The key to comparing contributions in money and in kind is that contributions in kind are valued when contributed. In other words, the value of contributions in kind is not assessed in hindsight, after these contributions have been used in the R&D activities. An item of plant is not less valuable because further R&D activities ceased to use it to the extent expected. In the example given in paragraph 8 above, a contribution may take the form of existing research results. The worth of existing results does not increase because the further R&D results successfully build on them, nor does it decrease because the further R&D activities fail.

13. It is sometimes argued that a co-owner has received an appropriate share of R&D results because the value of their interest in the results of the completed R&D exceeds the cost of their contribution. This is not so. A co-owner must have a proper share in the results, and what that share is does not depend on the ultimate value of the R&D results.

14. Valuation of existing research results brought to a further project of R&D may present some problems. Existing results of obvious commercial application can often be valued at a market price, as being clearly saleable. Where existing results may have a commercial value which is more indirect, a market price may prove to be below the cost of obtaining the results. In such a case, a valuation at cost may be reasonable, so that the shares of further project results going to each co-owner may be fairly allocated.

CONTROLLING THE CONDUCT OF R&D ACTIVITIES

15. When R&D activities are carried out by or on behalf of a company, it would be expected that the company should have and exercise proper control over the conduct of those activities. Yet, as a practical matter, R&D activities will usually be carried on by experts in a particular field, whether an outside researcher engaged to carry out R&D on behalf of the company, or expert employees working within the company. In many cases, the company's management will be less expert than the research workers. In that context, there can be some question what the requisite level of control can entail.

16. Essential elements of control of the conduct of R&D activities are the ability to choose the project of R&D; the capacity to decide on major changes of direction in those activities; the ability to stop an unproductive line of research; the scope to follow up (or not) an unexpected result; and, ultimately, the power to end a project. What these elements will involve depends necessarily on the circumstances of each case. For example, a research team may enter into a project of R&D activities on a 'take it or leave it' basis, where there are

several companies interested in having the work done for them but only one research team able to carry out the work. Nevertheless, the company which decides to fund the work may be treated as having selected the project of R&D activities, and, if the other elements of control are satisfied, it may be seen to have proper control of the R&D activities.

17. Special difficulties can arise where a company has R&D activities performed by some other party on its behalf. It may be argued that an independent researcher will not contract to carry out R&D activities for a company unless the company binds itself to continue the work to completion or for a substantial period. A researcher may not be able to obtain staff and facilities, or to plan ahead, without a firm commitment. There is less force in this argument where the scope of the project of R&D activities is broader, or where the work involves several related projects over a longer period.

18. In such cases, the greater the detail with which the program of R&D activities has been specified in advance, and the less the scope for changes of direction in the course of the program, the fewer decisions there are over which the company may exercise control. The program may be so carefully defined and so limited in scope that there could be no usable results at all short of completing the whole program. In that case, the independent researcher might well insist that the company be bound to complete the program. But, in that case, the company has not abdicated control; it has merely made its choices in advance in the contract. Even then, if the company had control of the R&D activities, it would be entitled to check that the program was being carried out and compel performance by the researcher according to the contract.

19. In cases where contract between the researcher and the company has defined a looser or more wide-ranging program of R&D activities, the company must retain more substantial control. A researcher working on the company's behalf still has a need for security; but that security cannot be achieved by denying the company its control of its program.

20. These requirements also apply where a researcher carries out a program of R&D activities on behalf of several companies. As a group, those companies must still have control over the conduct of the R&D activities, on the same basis as outlined above in paragraph 16. Any terms of the arrangement between the companies and the researcher which regulate how they can exercise their control must not be such as to preclude the exercise of the companies' control in practice.

ARRANGEMENTS FOR R&D ON BEHALF OF ANOTHER

21. Subsection 73B(9) precludes a company claiming a deduction under section 73B for expenditure for the purpose of carrying on R&D activities on behalf of any other person. It is not necessary that the company be acting as an agent of the other; the question is whether, in all the circumstances, the R&D is to be carried out in substance for the other. This will be a

question of fact in each case, and a theoretical answer depending only on the formal legal relationship between the company and the other cannot be given.

22. An example at one extreme can be given. A company may undertake a program of R&D activities, on terms that another would reimburse all costs incurred by the company, and that all results would only be available for commercial use by the other. The company would be ineligible to claim any of its expenditure on the program under section 73B - the expenditure was incurred on behalf of the other.

23. At the other extreme, a company might enter into a contract to supply a new product meeting certain specifications, which cannot be met at present. The buyer and the company both know that a program of R&D will be needed for the company to fulfil its contract. Even if the buyer is the sole purchaser, or one of only a few potential purchasers, of the intended product, it is the company alone on whose behalf the R&D activities are carried out, as it alone controls and uses the R&D results. So the company could be eligible to claim its expenditure on the program of R&D under section 73B.

24. Between these examples fall many practical possibilities. Often these arise because of the conflict between a company's desire for a secure return and its desire for R&D results of its own. It should be remembered that a company which has bartered away the effective benefit (and risk) of the R&D activities it pays for is precluded from claiming deductions under section 73B, regardless that there are good commercial reasons for letting the R&D activities be conducted on behalf of another.

25. A feature of many prearrangements between companies seeking to claim deductions under section 73B and other parties is a sale, option, or irrevocable and exclusive commercial licence of the results of a program of R&D activities, entered into before those results are known. Where a price or royalty percentage is fixed in advance, R&D activities are carried on for the benefit of the buyer, option-holder or licensee because the company's reward does not reflect the value of the actual R&D results; even in the percentage royalty example, the fixing of the percentage does not reflect the bargaining power of the holder of successful R&D results.

26. Prearrangements under which a claimant company's price or royalty percentage is determined only after the result of R&D activities are known will be considered on their own circumstances.

CONDUCT OF R&D ACTIVITIES IN PARTNERSHIP

27. Section 73B deductions can only be claimed by companies. Where R&D activities are conducted by or on behalf of a partnership, even a partnership of companies, no deductions under section 73B can be claimed. This is not because of a specific exclusion, like that of trustee or nominee companies in subsection 73B(3). It is because partnership expenditure on R&D

activities is not as such R&D expenditure by the individual partners; and, even where the partners do directly expend money on R&D activities, those activities are carried out on behalf of the partnership, not of the partners individually. For this reason, where several companies wish to fund a program of R&D activities on their behalf, it is essential that they avoid a partnership at general law.

28. Where companies can make use of their results in their individual activities and do not contemplate joint exploitation of their results, the avoidance of partnership presents few difficulties. Their arrangements will commonly follow the example of the co-owners considered at paragraph 10 above.

29. The position of companies who can, as a practical matter, contemplate only some form of joint exploitation of their R&D results presents some difficulty. Where such companies limit the use they can make of their results to joint sale or joint licensing for commercial use, they may be partners in law even though they seek to avoid that status by assuming only several liability for their individual shares of expenditure, by denying that they have the rights or liabilities of partners and by providing for a division of gross proceeds, on the authority of Brian Pty. Ltd. v UDC Ltd. [1983] 1 NSWLR 490 (CA); UDC Ltd. v Brian Pty. Ltd. (1985) 157 CLR 1 (HC). Companies should therefore consider arrangements under which their individual interests are not limited to shares of the proceeds of joint sale or licensing.

30. It is considered that companies associated in a joint venture that is not otherwise a partnership need not be regarded as partners only because they require jointly funded R&D results to be used in their joint venture activities. For instance, if companies associated in a joint venture for the smelting of mineral ore funded R&D activities on their behalf of use in their ore smelting venture, the use of results in the venture would not convert it into a partnership. If the venture was not a partnership, it could be accepted that the companies each funded R&D on their own behalf and no-one else's, subject to the tests set out in paragraphs 9 to 14 above.

APPROVED RESEARCH INSTITUTES AS CONDUITS

31. Taxation Ruling No. IT2442 at paragraph 3 considered the status of payments made to an approved research institute (ARI) on condition that the institute would have the activities performed by a particular researcher unconnected with the ARI. That was a particular instance of arrangements under which an ARI is paid to expend money in a particular way.

32. Such arrangements would have the consequence that the payments would not be made in consideration of the approved research institute performing R&D activities on behalf of the payer. Rather, the payments would be made in consideration of the institute doing no more than act as a conduit for the particular expenditure. It follows that the payments are not contracted expenditure as defined in subsection 73B(1).

33. It has been suggested that the elements of control by an eligible company required if R&D activities are to be carried out by it or on its behalf are incompatible with the responsibility of an ARI for the performance of R&D activities for which it received contracted expenditure. In particular, it has been suggested that an eligible company's control of R&D activities performed for it by an ARI means that the company ought to be able to compel the institute to subcontract performance of R&D activities to a researcher chosen by the company.

34. This is not so. Section 73B implies control by companies over the R&D activities performed by them or on their behalf; however it does not imply control of all administrative aspects of the performance of those activities. Hence, the suggestion that a company can compel an ARI to serve as a conduit is unacceptable.

CASHBOX RESEARCHERS

35. Under some commonly proposed arrangements, an agent or entrepreneur is to collect contributions from eligible companies and is to enter into contracts on their behalf for the performance of R&D activities. From the fund of contributions, the agent or entrepreneur will make payments required by the contracts as they fall due. The question is whether the funding companies are entitled to deductions under section 73B for their contributions to the fund.

36. Funding companies cannot obtain deductions under section 73B from the mere fact of making such contributions. The contributions do not themselves amount to expenditure of any of the kinds to which deductions under section 73B relate. Deductions under section 73B may be available when the companies incur expenditure through, not to, their agent. Expenditure through an agent may be expenditure met by the agent from the fund of contributions.

37. The position is the same where companies make direct contributions to a researcher to provide a fund from which R&D expenditure will be met as it falls due. Such companies do not incur expenditure for the purposes of section 73B until the researcher draws upon the fund for its fees and expenses. The fund on which the researcher can draw is not itself the researcher's fee; such a fee may be used as the researcher sees fit, whereas the fund may be drawn on only for the companies' expenditure.

38. Under other arrangements also colloquially known as cashbox arrangements, companies establish another company in which they are the shareholders. This jointly owned company engages in R&D activities, or has them carried out. Those activities are funded from money provided by the shareholder companies, whether by way of share capital, premium or loan. The shareholder companies do not seek deductions under section 73B themselves. It is the jointly owned company itself which retains the deductions for its R&D expenditure.

39. It is essential to such arrangements that the jointly owned company's R&D activities be carried out on its own behalf and not on behalf of its shareholders. In applying the general principles already discussed, it should be remembered that the mere fact that shareholders expect an indirect benefit by way of dividends does not mean that the company in which they hold shares conducts its R&D activities on their behalf.

40. Deductions under section 73B can contribute to losses. Those losses are transferable in the same circumstances, and subject to the same conditions, as any other losses. Where shareholders can claim a subsidiary's losses, this does not of itself mean that the subsidiary conducts its R&D activities on their behalf, even though the losses are attributable to R&D expenditure by the the subsidiary.

COMPANY GROUPS

41. Company groups often see advantages in concentrating the performance of R&D activities in a single member of the group. There are two ways in which this is commonly done; they have different consequences for claims under section 73B, and may not always be conveniently combined.

42. Under one arrangement, a group company is selected to be the researcher for the group. Other group companies pay the researcher to undertake R&D activities on their individual behalf; the researcher carries out the work (or, in circumstances and on terms of its own choosing, subcontracts it). The researcher has no expenditure deductible to itself under section 73B; no research is carried out on its own behalf. The other companies may claim individually for the fees they pay to the researcher. They may also claim for plant or buildings for use by the researcher exclusively on their individual projects of R&D.

43. The other type of arrangement again selects a group company as the researcher for the group. However, this researcher conducts its R&D activities on its own behalf. Projects may be suggested by, or by the needs of, other group companies; but the researcher controls and profits by its results, and claims for its expenditures under section 73B. The other group companies have no section 73B claims.

44. Combining the two kinds of arrangement can lead to problems. A researcher may have section 73B claims for its own plant or building expenditure precluded if it also uses the plant or buildings in carrying out R&D activities on behalf of other group companies. It is also easy to conduct R&D activities without considering on behalf of which company they are being performed. These risks should be borne in mind.

45. It should also be remembered that subsections 73B(31) and (32) require expenditure claimed under section 73B to be no greater than an arm's length basis would support and require plant and buildings to be sold for consideration no less than an

arm's length basis would support. Related companies should therefore be careful to ensure that they deal with each other on an arm's length basis.

RESEARCHERS' RIGHTS

46. Eligible companies often wish to pursue arrangements in which they fund a program of R&D activities, to be carried out on their behalf by a researcher, in which the researcher is given a substantial share of the results. Such arrangements are often sought by research bodies associated with academic institutions. Often, all patents, registered designs, copyrights and the like are to be held by the researcher. Such arrangements could jeopardise claims by the companies under section 73B.

47. On examination, however, the substance of the proposed arrangements is often rather different. The researcher may be the holder of its own research results which suggest a further line of R&D activity. Commercial exploitation would require use of the researcher's existing results, as well as the results of the further R&D activities. The researcher's interest would actually reflect this contribution. In such a case, the principles stated in paragraph 8 above would apply.

48. Difficulty can arise in considering such arrangements where the agreements between the parties do not set out the true substance of the case. It is good practice for agreements to set out clearly the basis for the shares the parties will take in results of R&D.

PROMOTERS' SHARES

49. Arrangements have been suggested under which promoters would manage R&D activities on behalf of investor companies, on terms generous only to themselves. For instance, one promoter offered to collect fees from investor companies in advance, select projects of R&D activities on behalf of the investors, pay for those activities from the fees held (with a 10% management fee to itself), and accept a 50% interest in the results of the R&D activities; all on terms that any results would be exploited by, or through, a further company the shareholders of which would be the promoter and the investors. There is little difficulty in applying the principles discussed in this Ruling to conclude that the investors are unlikely to be able to claim deductions under section 73B.

50. It is often suggested that R&D activities are being carried on by or on behalf of investor companies who pay for those activities, merely because they hold shares in another company that is to be the owner or only authorised commercial user of the results of those activities. This is not so. The investor companies do not have any direct interest in the results of the R&D activities; they have only shares in a company which has those results. Nor can investor companies claim where they do not pay for the R&D activities directly, but only by subscribing capital for the company that does carry on the R&D activities or has them performed on its behalf. Such subscription of capital

is only indirectly related to any R&D activities, and in any case the investor companies do not have the R&D activities carried out on their behalf.

51. Similarly, it is often suggested that investor companies have control of the conduct of R&D activities, because these are overseen by a committee appointed to look after their interests. This is not necessarily so. Where companies have R&D activities carried out on their behalf, they may be able to exercise proper control over the conduct of those activities through a committee they have freely chosen. A committee appointed before the investor companies are involved has no representative character, however, and does not become satisfactory merely because at some stage, possibly after all significant decisions have been taken, the investors may be able to replace a promoter's appointees with their own.

PARTICULAR CASES

52. The requirements of section 73B cannot be satisfied in form only. The tests of when a company has R&D activities carried out by it or on its behalf, and when it incurs expenditure for the purpose of carrying on R&D activities on behalf of another, are tests which are determined on the facts. Each depends on the substance of arrangements and on the particular circumstances of the case. It follows that general conclusions about arrangements of a particular form cannot always be drawn. Cases will ultimately be considered on their individual circumstances.

OTHER PROVISIONS

53. Companies should bear in mind the possible application of subsection 73B(33). Deductions otherwise allowable under the section may be clawed back if the Industry Research and Development Board certifies that results capable of commercial exploitation have not been exploited on normal commercial terms, or have not been exploited in a manner that is for the benefit of the Australian economy. The requirements of subsection 73B(33) are additional to the principles outlined above, and will be the subject of a public statement by the Board in due course.

54. The general anti-avoidance provisions of the income tax law may apply to arrangements for the conduct of research and development. Nothing in Section 73B excludes their operation.

COMMISSIONER OF TAXATION
26 November 1987