Administrative Appeals Tribunal

DECISION AND REASONS FOR DECISION

[2014] AATA 156

Division	**TAXATION APPEALS DIVISION**
File Number(s)	**2013/0322 & 2013/6065**
Re	**Tier Toys Limited**
	APPLICANT
And	**Commissioner of Taxation**
	RESPONDENT

DECISION

Tribunal	**Senior Member C R Walsh**
Date	**20 March 2014**
Place	**Perth**

Decision Summary

1. In relation to Application for Review of Decision (Tribunal Reference: 2013/0322), the Tribunal affirms the Commissioner's objection decision, dated 22 November 2012; and

2. In relation to Application for Review of Decision (Tribunal Reference: 2013/6065), the Tribunal sets aside the Commissioner's objection decision, dated 22 November 2013, and remits the matter to the Commissioner for reconsideration in accordance with the following Reasons for Decision.

...(Sgd) C R Walsh.....

Senior Member C R Walsh

Catchwords

Income tax – research and development tax offset - research and development expenditure – research and development activities — whether expenditure incurred by taxpayer "directly in respect of" registered "research and development activities" – "systematic, investigative and experimental activities" - "objects" provision considered - substantiation of R&D expenditure claimed - whether expenditure "excluded plant expenditure" – whether expenditure on "overseas research and development activities" – whether expenditure on "market research, market testing or market development, or sales promotion" – shortfall penalty imposed on taxpayer for "recklessness" – meaning of "recklessness" considered - reliance by taxpayer on registered tax agent in preparation of income tax return – meaning of "reasonable care" considered - taxpayer's behaviour not "reckless" – taxpayer failed to take "reasonable care" – Commissioner's discretion to remit part of penalty exercised - R&D Objection Decision affirmed - Penalty Objection Decision set aside and remitted to Commissioner for reconsideration in accordance with Tribunal's Reasons for Decision

Legislation

Income Tax Assessment Act 1936 (Cth) – s 73B(1) – s 73B(1AAA) - s 73B(2C)(a) –s 73B(1) – s 73B(12) – s 73B(13) - s 73B(14) – s 73B(15) - s 73(17A) – s 73BA – s 73 BB(1) - s 73I - 73IA(1) – s 73J(1) – s 262A

Taxation Administration Act 1953 (Cth) – s 14ZZK(b) – s 14ZZO(b) – Division 284 of Schedule 1 – s 284-75(4) – s 284-80 – s 284-90(1)- s 298-20

Industry Research and Development Act 1986 (Cth) – s 39ED – s 39J – s 39P

Cases

BP Refinery (Kwinana) Ltd v Federal Commissioner of Taxation (1960) 12 ATD 204; [1961] ALR 52

BRK (Bris) Pty Ltd v Federal Commissioner of Taxation [2001] FCA 164; 2001 ATC 4111; (2001) 46 ATR 347

Dixon (as trustee for Dixon Holdsworth Superannuation Fund) v Federal Commissioner of Taxation 2008 ATC 20-015

Federal Commissioner of Taxation v Burness (as trustee for property of Robert Bottazzi, a bankrupt) 2009 ATC 20-135

Federal Commissioner of Taxation v Turner (1984) 15 ATR 379; 84 ATC 4161

Hadrian Fraval Nominees Pty Ltd v Federal Commissioner of Taxation [2013] AATA 127

Hart v Federal Commissioner of Taxation (2003) 131 FCR 2003; [2003] FCAFC 105
Howard v Federal Commissioner of Taxation [2012] FCAFC 149; (2012) 206 FCR 329
Kajewski v Federal Commissioner of Taxation (2003) 52 ATR 455; 2003 ATC 4375
Ozone Manufacturing Pty Ltd v Commissioner of Taxation [2013] AATA 420
Sent v Federal Commissioner of Taxation [2012] FCA 382
Sent v Federal Commissioner of Taxation [2012] FCAFC 187
Shawinigan Ltd v Vokins & Co Ltd [1961] 2 Lloyd's Rep 153; [1961] 1 WLR 1206; [1961] 3 All ER 396
Traviati v Federal Commissioner of Taxation 2012 ATC 20-321
Zeta Force Pty Ltd v Federal Commissioner of Taxation (1988) 84 FCR 70

Secondary Materials
Australian Taxation Office, "Guide to the R&D Tax Concession", Chapter C1-7
Revised Explanatory Memorandum to the A New Tax System (Tax Administration) Bill (No. 2)
The Macquarie Dictionary, Third Edition (1997)

REASONS FOR DECISION

Senior Member C R Walsh

20 March 2014

INTRODUCTION

1. Tier Toys Limited (formerly 3D Funtimes Limited) (**Tier Toys**) claimed a research and development (**R&D**) tax offset in its income tax return for the year ended 30 June 2007 (totalling $369,999.90) for expenditure on a R&D project, involving the construction of a children's multi-layered "stacker" toy, using the experimental and novel injection moulding manufacturing process, titled "Ark".[1] Following an audit of Tier Toys, the Commissioner issued Tier Toys with a Notice under s 73IA(1) of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**) which stated that the amount of

[1] *Based on the story of "Noah's Ark" in The Holy Bible (Genesis, Chapters 6 -9)..*

R&D tax offset that Tier Toys was entitled to for the 2007 year was $24,916.50 (**s 73IA Notice**). Tier Toys subsequently objected to the s 73IA Notice (**R&D Objection**) and, on 22 November 2012, the Commissioner disallowed Tier Toys' objection (**R&D Objection Decision**).

2. The Commissioner also issued Tier Toys with an assessment of shortfall penalty for "recklessness" in the amount of $172,541.65 (**Penalty Notice**). At the time of commencing its application for a review of the R&D Objection Decision,[2] Tier Toys had not formally objected to the Penalty Notice as it mistakenly believed that it had objected to the Penalty Notice at the same time as it objected to the s 73AI Notice. On 24October 2013 Tier Toys objected to the Penalty Notice (**Penalty Objection**) and on 22 November 2013 the Commissioner issued it with a decision disallowing the Penalty Objection (**Penalty Objection Decision**). On 26 November 2013 Tier Toys applied to the Tribunal for a review of the Penalty Objection Decision.[3]

3. Tier Toys maintains that its R&D tax offset claim for the 2007 year was properly made and that the s 73IA Notice should have been made differently by the Commissioner (namely for a higher amount than $24,916.50) and, further, that no penalty is applicable since there was no misstatement by it of the amount claimed in its 2007 return.[4]

BACKGROUND

4. Tier Toys is an unlisted public company, limited by shares. At the time of its incorporation on 24 March 2006 Tier Toys had two directors - Mr Michael Petrus Romyn (**Mr Romyn**) (managing director and inventor of the "Ark" toy concept) and Mrs Leah Maree Romyn (**Mrs Romyn**) (director). On 15 August 2006, Mr Peter

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[2] *i.e. on 18 January 2013 - Tribunal Reference No 2013/0322*

[3] *Tribunal Reference No 2013/6065*

[4] *Both of Tier Toys Applications for Review of Decision were heard together.*

Roope Woodgate (**Mr Woodgate**) was appointed as a non-executive director of Tier Toys.[5]

5. Tier Toys applied online to AusIndustry[6], using a standard *"Research And Development (R&D) Tax Concession 2006-07 Form for the Registration of R&D Activities"* for the registration of its R&D activities for the 2007 income tax year. Specifically, Tier Toys applied for the registration of the "R&D project" titled "Ark". The "technical objective" of this project was described in Tier Toys' registration application as follows:

> The ark is a multi dimensional toy, which aids hand to eye co-ordination, together with colour recognition, animal recognition, structure and shapes as are apparent in the construction of the item. The item is construction (sic) by the use of injection moulding, toy is multifunctional (sic) and covers a wide age bracket, usage bracket within the arena of childhood development.

6. Under the heading "Activities to be registered in 2006-07" Tier Toys' registration application stated:

> Ark has come from a wooden hand built structure to [a] state of the art structure which makes it easier to handle and gives more learning skill effects.

7. The experimental and novel manufacturing process which formed the basis of Tier Toys' registration of the "Ark" project with AusIndustry was to enable the production of the "Ark" toy and, in particular, plastic figurines with a soft, pliable feel, using an injection moulding process.[7]

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[5] *In the 2007 year Mr Woodgate was (and he currently remains) a registered trade marks and patent attorney.*

[6] *AusIndustry is the Australian Federal Government's specialist business program delivery division in the Department of Industry, Innovation, Science, Research and Tertiary education. AusIndustry delivers programs for businesses and individuals including R&D tax concessions to increase the amount of R&D undertaken in Australia and to encourage innovative, competitive and export-oriented Australian industries. Annual registration of R&D activities with AusIndustry is a prerequisite for companies claiming R&D tax concessions.*

[7] *Mr Romyn's Witness Statement (Exhibit A1), dated 29 August 2013, at [13] – [14], Transcript, Day1, at p 58 and "Respondent's Submissions", dated 5 February 2014, at [6].*

8. On 18 October 2006 Ms Cecilia Hill of AusIndustry conducted an audit of Viewdale Investments Pty Ltd (**Viewdale**) for the 2004/2005 income tax year. Viewdale is a company controlled by Mr Romyn through which Mr Romyn provided contracted services to Tier Toys in relation to the development of the "Ark" toy. Following the audit, AusIndustry produced a *"R&D Tax Concession Monitoring Report"* which noted that the company's R&D project was in a "low" risk category and recommended that no further action be taken in relation to Viewdale's claim for the 2004/2005 year (**AusIndustry Company Monitoring Report**) and a letter stating that AusIndustry did not need to conduct a formal assessment of Viewdale's registered R&D activities.[8]

9. On 12 December 2007 Tier Toy's tax agent Ms Carol Cavill (**Ms Cavill**), then employed by Integrated Accounting Group (WA) Pty Ltd (**Integrated Accounting**), lodged Tier Toys' tax return for the income tax year ended 30 June 2007 (**2007 Tax Return**) on its behalf, reporting interest income of $4,806 and R&D expenditure of $986,666 and claiming a R&D tax offset[9] of $369,999.90.

10. On 29 January 2008 the Commissioner issued Tier Toys with an assessment for the 2007 year showing nil taxable income and attaching a refund cheque for $371,517.80.

11. In early 2009 Tier Toys entered into an arrangement with Intellec Development Group Pty Ltd (**Intellec**)[10] for Tier Toys to purchase the assets of Intellec in return for Intellec receiving cash and shares in Tier Toys.[11] However, on 9 April 2010 Intellec repudiated this agreement by locking Tier Toys' personnel out from its business premises (**Lock-Out**). Tier Toys' assets (including business computers) and documents remained at that business premises in Intellec's possession following the Lock-Out.[12]

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[8] *Mr Romyn's Witness Statement (Exhibit A1), dated 29 August 2013, at pp 23 -29.*

[9] *Under s 73I of the ITAA 1936.*

[10] *Intellec provided Tier Toys with design and tooling services in relation to the development of the "Ark" toy in the 2007 year.*

[11] *Mr Romyn's Witness Statement (Exhibit A1), dated 29 August 2013, at [38].*

[12] *Mr Romyn's Witness Statement (Exhibit A1), dated 29 August 2013, at [39].*

12. On 28 May 2009 the Commissioner initiated an audit of Tier Toys and on 24 March 2010 he sent Tier Toys a draft audit position paper. Tier Toys subsequently engaged solicitors to respond to the draft position paper on its behalf. A response and further documentation was provided to the Commissioner by Tier Toys' solicitors on its behalf on 5 May 2010.

13. In late May 2010 the Commissioner's audit of Tier Toys was completed and a final audit position paper was issued to Tier Toys by the Commissioner on 4 June 2010. The Commissioner determined that Tier Toys' aggregate R&D for the 2007 year was $66,444.17 (as compared to the $986,666 claimed by Tier Toys in the 2007 Tax Return).

14. On 5 July 2010 the Commissioner issued Tier Toys with the s 73IA Notice which stated that the R&D tax offset that Tier Toys was entitled to under s 73I of the ITAA 1936 was $24,916.50 (as compared to the $369,999.90 claimed by Tier Toys in the 2007 Tax Return).

15. On 3 August 2010 the Commissioner issued Tier Toys with a Penalty Notice, assessing it with a shortfall penalty for "recklessness" for the 2007 year totalling $172,541.65.

16. On 11 April 2011 Ms Cavill lodged the R&D Objection on Tier Toys' behalf. The Commissioner treated this objection as raising the question as to whether the Commissioner would allow an amount of R&D tax offset in the 2007 income tax return greater than $24,916.56.

17. On 4 August 2011 the Commissioner wrote to Tier Toys requesting further information to substantiate its claim of entitlement to a greater R&D tax offset and on 8 September 2011 the Commissioner received correspondence from Ms Cavill, dated 5 September 2011, on behalf of Tier Toys, enclosing various documents in response to the Commissioner's request.

18. On 22 November 2012 the Commissioner issued Tier Toys with the R&D Objection Decision, disallowing the R&D Objection, and on 18 January 2013 Tier Toys applied to the Tribunal for a review of the R&D Objection Decision.[13]

19. On 24 October 2013 Tier Toys lodged the Penalty Objection with the Commissioner and on 22 November 2013 the Commissioner issues Tier Toys with the Penalty Objection Decision, disallowing the Penalty Objection, and on 26 November 2011 Tier Toys applied to the Tribunal for a review of the Penalty Objection Decision.[14]

DISPUTED EXPENDITURE

20. The R&D expenditure which the Commissioner determined (in the s 73IA Notice) had been improperly claimed by Tier Toys (wholly or in part) in the 2007 Tax Return falls into the following seven categories (**Disputed Expenditure**):

    - ***Category 1*** **-** Contract payments made by Tier Toys to Viewdale, a company controlled by Mr Romyn through which he provided contracted services to Tier Toys (rather than as an employee);
    - ***Category 2*** **-** Mould making costs paid to Intellec, a company which provided Tier Toys with design and "tooling" services;
    - ***Category 3*** **-** Prototype costs paid to Solid Concepts Pty Ltd, Camerahouse and Photografix Pty Ltd (**Photografix**);
    - ***Category 4*** **-** Consultancy fees paid to the Xenex Group Pty Ltd;
    - ***Category 5*** **-** Legal and patent attorney fees;
    - ***Category 6*** **-** Domestic and international travel expenses; and
    - ***Category 7*** **-** Eligible Apportionable Expenses – comprising "Advertising & Promotion", "Computer Expenses", "Printing & Stationery" and "Telephone".

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[13] *Tribunal Reference: 2013/0322.*
[14] *Tribunal Reference: 2013/6065.*

21. The adjustments made by the Commissioner to the R&D expenditure claimed by Tier Toys in the 2007 Tax Return are set out in the following table[15]:

Expense	Amount Claimed	Adjusted Amount	Difference
Contract Payments	77,184.95	0.00	77,184.95
Mould Making (Quote 51 & 101)	642,818.00	42,000.00	600,818.00
Prototype	29,522.27	17,115.00	12,407.27
Consultancy	24,192.24	0.00	24,192.24
Travel	165,220.82	0.00	165,220.82
Advertising & Promotion	14,678.76	0.00	14,678.76
Computer Expenses	1,428.97	0.00	1,428.97
Legal Fees	20,437.38	7,329.17	13,108.21
Printing & Stationery	8,742.47	0.00	8,742.47
Telephone	2,440.14	0.00	2,440.14
Total	**$986,666.00**	**$66,444.17**	**$920,221.83**

ISSUES

R&D Objection Decision

22. In relation to the R&D Objection Decision, the Tribunal must determine whether the R&D Objection Decision should not have been made or should have been made differently.[16] That is, whether Tier Toys is entitled to a greater R&D tax offset for the 2007 year than that which was allowed by the Commissioner (i.e. $24,916.50).

23. The primary issue for consideration in determining this is whether the Disputed Expenditure was incurred "directly in respect of" eligible "research and development

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[15] *As extracted from the Reasons for Decision attached to the R&D Objection Decision: see T Documents (Exhibit R1), T1 at p 12.*

[16] *See ss 14ZZK(b) and 14ZZO(b) of the Taxation Administration Act 1953(Cth).*

activities" by Tier Toys, such that the Disputed Expenditure was "research and development expenditure" for the purposes of s 73B(1) and (14) of the ITAA 1936[17]. This raises questions of substantiation.

24. Other issues considered in these reasons are:

(i) whether any of the Disputed Expenditure is "excluded plant expenditure" (for the purposes of the definition of "research and development expenditure" in s 73B(1) of the ITAA 1936[18]) because it qualifies as the cost of a "section 73BA depreciating asset" (as defined in s 73BB(1) of the ITAA 1936[19]); and

(iii) whether any of the domestic and international travel expenses claimed relate to activities carried on by Tier Toys outside Australia and the external Territories are precluded from being deductible by s 73B(17A) of the ITAA 1936[20] since Tier Toys did not obtain a provisional certificate in relation to its "overseas research and development activities"[21] under s 39ED of the *Industry Research and Development Act 1986* (Cth) (**IRDA**); and

(iv) whether any of the Disputed Expenditure was incurred on "market research, market testing or market development, or sales promotion (including customer surveys" under s 73B(2C)(a) of the ITAA 1936[22] such that it was not expenditure incurred on "systematic, investigative and experimental activities" and, it follows, "research and development activities" (as defined in s 73B(1) of the ITAA 1936[23]).

Penalty Objection Decision

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[17] *As then in force.*
[18] *As then in force.*
[19] *As then in force.*
[20] *As then in force.*
[21] *As defined in s 73B(1) of the ITAA 1936.*
[22] *As then in force.*
[23] *As then in force.*

25. In relation to the Penalty Objection Decision, the Tribunal must determine whether the Commissioner correctly assessed Tier Toys for an administrative shortfall penalty for "recklessness" under Division 284 of Schedule 1 to the *Taxation Administration Act 1953* (Cth) (**TAA**) in respect of the 2007 year and whether there are any grounds for remission of the penalty (wholly or in part) under s 298-20 of the TAA.

RELEVANT LAW & ANALYSIS

1. R&D OBJECTION DECISION

Entitlement to R&D tax offset

26. For income years commencing prior to 1 July 2011,[24] s 73I of the ITAA 1936 entitled an "eligible company"[25] to claim a tax offset for "research and development expenditure"[26] (i.e. instead of claiming deductions under s 73B of the ITAA 1936), provided the requirements of s 73J of the ITAA 1936 were met. Section 73J of the ITAA 1936 stated:

> 73J(1) An eligible company is eligible to choose the tax offset for the tax offset year if:
>
> (a) it **could**, apart from subsection 73I(4), **deduct an amount under section 73B**, 73BA, 73BH or 73Y for that year; **and**
>
> (b) its aggregate research and development amount for the tax offset year exceeds $20,000; **and**
>
> (c) the aggregate research and development amount for the tax offset year of the company and of taxpayers with which it is grouped (while they are grouped in that year) is not more than $2,000,000; **and**
>
> (d) the R&D group turnover of the company for that year is less than $5,000,000. [Emphasis added]

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[24] The R&D tax "incentive" replaced the R&D tax "concession" as the primary government program to encourage more business expenditure on R&D for income years commencing on or after 1 July 2011. Whilst the R&D tax concessions provisions in the ITAA 1936 referred to in these reasons have been repealed, they remain relevant to the Tribunal's merits review of the R&D Objection Decision as they were in effect in the income tax year concerned, being the year ended 30 June 2007.

[25] As defined in s 73B(1) of the ITAA 1936.

[26] As defined in s 73B(1) of the ITAA 1936.

27. It is not in dispute that in respect of the 2007 income tax year Tier Toys was, for the purposes of s 73J(1) of the ITAA 1936, entitled to choose a tax offset as it was an "eligible company" (as defined in s 73B(1) of the ITAA 1936) with an "aggregate research and development amount" (as defined in s 73B(1) of the ITAA 1936) exceeding $20,000.

28. The key entitlement to a claim under former s 73I of the ITAA 1936 was found in the deduction provisions in s 73B of the ITAA 1936, titled *"Certain expenditure on research and development activities"*. The object of s 73B of the ITAA 1936 is provided in s 73B(1AAA) of the ITAA 1936, which stated:

> The object of this section is to provided a tax incentive, in the form of a deduction, to make eligible companies more internationally competitive by:
>
> (a) encouraging the development by eligible companies of innovative products, processes and services; and
>
> (b) increasing investment by eligible companies in **defined research and development activities**; and
>
> (c) promoting the technological advancement of eligible companies through focus on innovation or high technical risk in **defined research and development activities**; and
>
> (d) encouraging the use by eligible companies of strategic research and development planning; and
>
> (e) creating an environment that is conducive to increased commercialisation of new processes and product technologies developed by eligible companies.
>
> **The benefits of the tax incentive are targeted by being limited to particular expenditure on certain defined activities**. [Emphasis added]

29. It is understood that Tier Toys' R&D tax offset claim under s 73J(1) of the ITAA 1936 for the 2007 year was based solely on it being entitled to a deduction for the expenditure claimed under s 73B(14) of the ITAA 1936 (i.e. and not under any other deduction provision contained in s 73B of the ITAA 1936). Section 73B(14) of the ITAA 1936 stated:

(14) Subject to [s 73B], where:

(a) an eligible company **incurs research and development expenditure** (other than contracted expenditure) **during a year of income**; and

(b) the aggregate research and development amount in relation to the company in relation to the company in relation to the year of income is greater than $20,000;

The amount of expenditure multiplied by 1.25 is allowable as a deduction from the assessable income of the company of the year of income. [Emphasis added][27]

30. The expression "research and development expenditure" was defined in s 73B(1) of the ITAA 1936 as follows:

> ***research and development expenditure***, in relation to an eligible company in relation to a year of income, means **expenditure** (**other than** core technology expenditure, interest expenditure, feedstock expenditure, **excluded plant expenditure** or expenditure incurred in the acquisition or construction of a building or of an extension, alteration or improvement of a building) **incurred by a company during the year of income** being:
>
> (a) contracted expenditure of the company;
>
> (b) salary expenditure of the company, being expenditure incurred on or after 1 July 1985; or
>
> (c) **other expenditure incurred** on or after 1 July 1985 **directly in respect of research and development activities** carried on by or on behalf of the company on or after 1 July 1985
>
> and includes any eligible feedstock expenditure that the company has in respect of the year of income in respect of related research and development activities. [Emphasis added]

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[27] It is not in dispute that the R&D expenditure claimed by Tier Toys was "incurred" by it in the 2007 income tax year. Further, as previously stated, it is not disputed that Tier Toys' "aggregate research and development amount" (as defined in s 73B(1) of the ITAA 1936) for the 2007 year exceeded $20,000.

Directly in respect of research and development activities

31. Tier Toys does not contend that it incurred any expenditure which would satisfy either paragraph (a) or (b) of the above definition of "research and development expenditure" in s 73B(1) of the ITAA 1936 but, rather, that all of the Disputed Expenditure qualifies as "other expenditure" under paragraph (c) of that definition. In such circumstances, to constitute "research and development expenditure" as defined, and for the purposes of deductibility under s 73B(14) of the ITAA 193, all of the Disputed Expenditure must have been incurred by Tier Toys *"directly in respect of"* eligible "research and development activities".

32. The expression "research and development activities" was defined for the purposes of the definition of "research and development expenditure" in s 73B(1) of the ITAA 1936 as follows:

> ***research and development activities*** means:
>
> (a) systematic, investigative and experimental activities that involve innovation or high levels of technical risk and are carried on for the purpose of:
>
> (i) acquiring new knowledge (whether or not that knowledge will have a specific application0; or
>
> (ii) creating new or improved materials, products, devices, processes or services; or
>
> (b) other activities that are carried on for a purpose directly related to the carrying on of activities of the kind referred to in paragraph (a).

33. Tier Toys asserts that all of the Disputed Expenditure is "research and development expenditure". In support of its contention, it relies amongst other things on the fact that AusIndustry considered Tier Toys' R&D project, found that it complied with the relevant statutory requirements and registered it.

34. In Tier Toys submission[28]:

> 14. …….it is outside the purview of the [Commissioner] to question whether a project with its [systematic, investigative and experimental] and directly related activities is eligible for R&D. The Government has given this responsibility to the [Industry Research and Development Board] which has the required expertise to make the assessment.....
>
> 15. ……..It is not incumbent on [Tier Toys] to justify the project and its activities to the Respondent. [Tier Toys] has already satisfied the relevant expert body [i.e. the Industry and Research and Development Board].
>
> …….
>
> 17. ……..The sole business of [Tier Toys] during the 2006-7 financial year was R&D to put [its] project into effect and [Tier Toys] had no other business except for raising capital for the project during the period. Expenditure on [systematic, investigative and experimental] activities and directly related activities are [therefore] claimable expenditure.
>
> 18. The evidence has shown that expenditure as claimed for the 2006-2007 financial year all related to the [systematic, investigative and experimental] and directly related expenditure associated with the project….

35. The Tribunal does not accept Tier Toys' submissions on this issue. Just because a company applies to AusIndustry to have a R&D project registered for a particular year and it is granted that registration that all of its business expenditure in that year will automatically constitute "research and development expenditure" for the purposes of s 73B of the ITAA 1936. As outlined above, s 73B of the ITAA 1936 was intended (as set out in its "objects" contained in former s 73B(1AAA) of the

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[28] *See "Applicants Submissions", filed 7 March 2014.*

ITAA 1936) to be limited in its operation to expenditure on certain "defined activities" (i.e. on certain defined "research and development" activities). This is achieved in s 73B by the inclusion of provisions which expressly exclude particular activities from constituting "research and development activities" for the purposes of the section. It is evident from the statutory scheme of s 73B of the ITAA 1936 that the breadth of eligible R&D activities in s 73B of the ITAA 1936 is not as wide as Tier Toys' (and its directors[29]) contend.

36. Tier Toys does not appear to have understood that only part of its business expenditure in the 2007 year qualifies as "research and development expenditure" for s 73B purposes. For example, it is apparent from the evidence provided by Tier Toys' directors, Mr Romyn (the managing director of Tier Toys and inventor of the "Ark" toy)[30] and Mr Woodgate (a director of Tier Toys and a patent attorney)[31], that their view is that because the vast majority, if not all, of Tier Toys' business in the 2006/2007 income tax year could be described as "R&D", its expenditure in that year was expenditure incurred "directly in respect of" eligible "research and development activities" for the purposes of s 73B(1) of the ITAA 1936.[32]

37. As submitted by the Commissioner, there appears to be a "disconnect" between the activities and expenses which Tier Toys views as "R&D" (as that expression is understood in everyday parlance) and the narrower statutory definition of "research and development expenditure" in s 73B of the ITAA 1936, against which Tier Toys' R&D tax offset claim for the 2007 year must be considered. To represent "research and development expenditure" under paragraph (c) of the definition of that

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[29] *See discussion in next paragraph.*

[30] *See Mr Romyn's Witness Statement (Exhibit A1), dated 29 August 2013, at [54] – [59]. For example, at [54] of Exhibit A1, Mr Romyn stated that "R&D was [Tier Toys] only operating function" and describes the services provided to Tier Toys by him (through his company Viewdale) as being only R&D related.*

[31] *See Transcript, Day 1, at pp 4-5.*

[32] *See also Tier Toys' "Detailed Submissions", dated 26 April 2013, at [12] to [14] and its "Submissions", filed 7 March 2014, at [31] to [50].*

expression in s 73B(1) of the ITAA 1936 (and, it follows, to be deductible under s 73B(14) of the ITAA 1936) all of the Disputed Expenditure must have been incurred by Tier Toys "directly in respect of" its "research and development activities", as defined in s 73B(1) of the ITAA 1936. That is, it is not the case that any expense associated with the development and construction of the "Ark" toy in the 2007 year (being Tier Toys' AusIndustry registered R&D project for the 2007 year) generally, can be claimed.

38. Some of the expenses claimed by Tier Toys are clearly excluded from being eligible "research and development expenditure" as they were not incurred by Tier Toys "directly in respect of" "research and development activities", as required by paragraph (c) of the definition of "research and development expenditure" in s 73B(1) of the ITAA 1936. For example, one of the categories of Disputed Expenditure concerns payments by Tier Toys to Photografix for the production of a DVD.[33] This DVD has no connection with the construction by use of injection moulding, of the "Ark" toy, being the R&D project registered by Tier Toys for the 2007 year.[34] Similarly, in relation to some of the travel undertaken by Tier Toys' directors, a trip to Melbourne to visit a computer games company[35] and a trip to Sydney to visit a computer programming company[36] do not have the necessary connection with Tier Toys registered R&D activities to be deductible under s 73B of the ITAA 1936. Further, some of the Disputed Expenditure is clearly excluded from deductibility under s 73B of the ITAA 1936 (for example, excluded plant expenditure, overseas expenditure and marketing expenditure). This excluded expenditure is discussed in further detail below.

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[33] *See T Documents (Exhibit R1) at pp 458-459, Hadrian Fraval Nominees Pty Ltd v Federal Commissioner of Taxation [2013] AATA 127 at [72], [78] and [114] and Transcript, Day 2, at pp 84 -86.*

[34] *Refer to paragraph 4 above and Transcript, Day 2, at pp 84 -86.*

[35] *See Transcript, Day 1, at p 67.*

[36] *See Transcript, Day 1, at p 67.*

Substantiation

39. The lack of substantiation affects all items of the Disputed Expenditure in this case. In discharging its burden of proof, Tier Toys must prove on the balance of probabilities that its entitlement to an R&D tax offset in the 2007 year is greater than that which was allowed by the Commissioner. This requires Tier Toys to substantiate its entitlement to the R&D tax offset claimed in the 2007 Tax Return. Specifically, Tier Toys must prove that each category of the Disputed Expenditure was incurred by it "directly in respect of" eligible "research and development activities" as required by the definition of "research and development expenditure" in s 73B(1) of the ITAA 1936.

40. There are no statutory rules governing the substantiation of claims for deductions under s 73B of the ITAA 1936. However, Chapter C1-7 of the Australian Taxation Office's *"Guide to the R&D Tax Concession"*[37] provides guidance on the record keeping requirements for companies to substantiate their claims for the R&D tax offset.[38] In Chapter C1-7, the Guide provided that companies intending to claim the R&D tax offset should maintain adequate contemporaneous records that substantiate the carrying on of the claimed R&D activities and the incurring of expenditure in relation to those activities.[39] Further, under s 262A of the ITAA 1936 Tier Toys was, as a person carrying on a business, required to keep records *"that record and explain all transactions and other acts engaged in by [it] that are relevant for any purpose of [the ITAA 1936]."*[40]

41. The Commissioner's primary contention is that the applicant has failed to substantiate that any of the Disputed Expenditure was "research and development expenditure", as defined in s 73B(1) of the ITAA 1936. That is, according to the Commissioner, Tier Toys has been unable to produce adequate records which

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[37] *As it read in the 2007 year.*
[38] *See Exhibit R3.*
[39] *See Exhibit R3.*
[40] *See s 262A(1) of the ITAA 1936.*

demonstrate (for the purposes of paragraph (c) of the definition of "research and development expenditure" in s 73B(1) of the ITAA 1936) that any of the Disputed Expenditure was incurred "directly in respect of" those activities that were registered on its behalf with AusIndustry as "research and development activities". The Commissioner asserts that if there were "systematic, investigative and experimental" activities carried out by Tier Toys in the 2007 year (as required under paragraph (a) of the definition of "research and development activities" in s 73B(1) of the ITAA 1936), Tier Toys has failed to produce adequate records showing what these specific activities were, and how any of the disputed expenditure related to carrying those activities out. Accordingly, it is the Commissioner's view that Tier Toys has not discharged its onus of proving, on the balance of probabilities, that the R&D Objection Decision should not have been made or should have been made differently and the R&D Objection Decision should, therefore, be affirmed.[41]

42. In contrast, it is Tier Toys' position that it did keep adequate records establishing that the Disputed Expenditure was incurred "directly in respect of research and development activities" but that these records were subsequently lost or destroyed in 2010 while in the possession of Intellec as a consequence of the Lock-Out: refer to paragraph 11 above. Further, Tier Toys contends that it has presented evidence to the best of its ability to show that it did maintain adequate records during the 2007 year and in support of this relies in the main on:

    - the evidence of two of Tier Toys' directors, Mr Romyn and Mr Woodgate, concerning the fact that Mr Romyn maintained a very detailed diary and a log book in relation to the development of the "Ark" toy in the 2007 year (which evidence was corroborated by Mr Roy McHutchison: see discussion of this evidence below in paragraph 44); and

    - AusIndustry's Company Monitoring Report, which discussed Tier Toys' record keeping as follows:

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[41] *See Respondent's Statement of Facts, Issues and Contentions, dated 11 October 2013 and Respondent's Submissions, dated 5 February 2014.*

> To demonstrate that they undertook eligible R&D and maintained adequate records, the Company provided a compliant R&D Plan, a description supported by evidence of their record keeping system and a guided tour of their contractor's R&D facilities where prototypes were sighted.

43. In the 2007 year, Tier Toys paid Intellec (a product design, development and manufacturing company) to provide it with design and tooling services in relation to the development of the "Ark" toy. Mr Roy McHutchison, an engineer and a director of Intellec, was summonsed to give evidence at the hearing of these applications.[42] Mr Romyn (the managing director of Tier Toys and the inventor of the "Ark" toy) and Mr McHutchison gave evidence that throughout the 2007 year they worked very closely together ("day in, day out") on the development of the "Ark" toy.[43] Mr Romyn said that he maintained a very detailed daily diary for the 2007 year which, among other things, documented different phases and timeframes of Tier Toys' development of the "Ark" toy, including particular dates on which milestones were met - "what we had achieved [and] what had failed.[44] Mr Romyn referred to this daily diary as his "bible".[45] Mr Romyn said he also kept a logbook which recorded, among other things, the various polymers and colour pigmentations trialled by Tier Toys in respect of the development of the "Ark" toy in the 2007 year.[46] The logbook was, according to Mr Romyn, a timeline reproduction or replication of what he had already recorded in his daily diary but was more broken down tabling, for example, materials used, what days they were used, at what temperature they were used etc. Mr Romyn said that the logbook was really just a summary of his test result data and milestones which, unlike his diaries, he did not fill out daily.[47]

44. The evidence given by McHutchison and Mr Peter Woodgate (a director of Tier Toys and trade marks/patent attorney) corroborates the evidence of Mr Romyn as to Mr

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[42] *Transcript, Day , at pp 4 and 6.*
[43] *Transcript, Day 1, at p 25 and Transcript, Day 3, at p 8.*
[44] *See Transcript, Day1 , at p 39.*
[45] *See Transcript, Day 1, at p 40.*
[46] *See Transcript, Day 1, at p 39.*

[47] *See Transcript, Day 1, at pp 39 and 40.*

Romyn's record-keeping practices generally and as the existence of Mr Romyn's very detailed daily diary and log book in the 2006/2007 income tax year.[48] Mr Woodgate described Mr Romyn's diary as being so detailed that it could be used to "support a timesheet" similar to those used by accountants, lawyers and other professionals.[49] Mr McHutchison described Mr Romyn's record keeping as "pedantic" and noted that he continued, to this day, to use some of Mr Romyn's systems for his own business.[50]

45. Mr McHutchison's evidence does not, however, support a finding that Tier Toys' records (including Mr Romyn's daily diary and log book for the 2007 year) were deliberately withheld or destroyed by Mr McHutchison or any of his/Intellec's employees.[51] Mr McHutchison said that he didn't know what happened to Mr Romyn's diary and log book for the 2007 year and that after the Lock-Out he asked one his/Intellec's employees to box up Tier Toys documents and return them to it.[52]

46. In such circumstances, the only inference available in this case is that certain of Tier Toys' records (including Mr Romyn's diary and log book for the 2007 year) went missing/were simply lost following the Lock-Out. Whilst there is evidence that Tier Toys expended funds, there is insufficient evidence that the expenditure was "directly in respect of" eligible R&D activities, as required by the definition of "research and development expenditure" in s 73B(1) of the ITAA 1936. For example, to substantiate a claim for "Category 1" of the Disputed Expenditure (comprising payments by Tier Toys to Viewdale for Mr Romyn's contracted services in the 2007 year), Tier Toys would need to produce detailed records of the dates Mr Romyn provided services to Tier Toys, the length of time he spent each day on those services, details of the work he did and how his work related to Tier Toys registered "research and development activities". The records would need to be detailed enough

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[48] *Mr Woodgate's Witness Statement (Exhibit A4), dated 29 August 2013, at [12], Transcript, Day 2, at pp 99-100 and Transcript, Day 3, at p 9.*

[49] *Transcript, Day 2, at pp 99-100.*

[50] *Transcript, Day 3, at p 9.*

[51] *Transcript, Day 3, at p 9.*

[52] *Transcript, Day , at p9.*

to distinguish between charges associated with eligible R&D activities and ineligible activities - such as the time Mr Romyn devoted to marketing, attendance of board meetings, company administration, fund raising and the like.[53] Whilst Mr Romyn's diary and log book for the 2007 year may, if they still existed, have been able to provide the necessary detail required to substantiate Tier Toys' claim (for example, in particular, in relation to the "Category 1"/Viewdale expenditure), the fact remains that those records are no longer available as evidence in this case. To properly substantiate the "Category 1"/Viewdale expenses, it is not enough for Mr Romyn to state retrospectively that he attended the business premises nearly every day and that everything he charged Tier Toys for (through Viewdale) was "R&D" related.

47. In the absence of Tier Toys being able to produce adequate records/documentary evidence which demonstrate that the Disputed Expenditure was incurred by it in the 2007 year "directly in respect of" its registered "research and development activities" (even if such records did once exist), the Tribunal finds that Tier Toys has failed to discharge its onus of proof in this case. As such, the Disputed Expenditure cannot be taken into account in calculating deductions that might have been allowable under s 73B(14) of the ITAA 1936 and, therefore, taken into account in any R&D offset calculation under s 73I of the ITAA 1936.

48. Despite the above finding, the Tribunal will now consider some of the Disputed Expenditure which it considers to be excluded from representing "research and development expenditure" for the purposes of s 73B of the ITAA 19i36.

Excluded Plant Expenditure

49. Under the definition of "research and development expenditure" in s 73B(1) of the ITAA 1936, "excluded plant expenditure" was excluded from constituting "research and development expenditure" for s 73B purposes. "Excluded plant expenditure" was defined in s 73B(1) of the ITAA 1936 as:

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[53] *See Ozone Manufacturing Pty Ltd v Federal Commissioner of Taxation [2013] AATA 420 at [135].*

(a) expenditure incurred by an eligible company in:

(iii) the acquisition, or the construction, under a contract entered into at or before 12 pm, by legal time in the Australian Capital Territory, on 29 January 2001; or

(iv) the construction by the company, being construction that commenced at or before 12 pm, by legal time in the Australian Capital Territory, on 29 January 2001;

of a unit of plant or pilot plant; and

(b) **any other expenditure incurred by an eligible company in the acquisition or construction, or that otherwise forms part of the cost, of a section 73BA depreciating asset (as defined by section 73BB)** or a unit of section 73BH plant (as defined by section 73BI). [Emphasis added]

50. The expression "a section 73BA depreciating asset" was defined in s 73BB of the ITAA 1936 (for the purposes of the definition of "excluded plant expenditure" in s 73B(1) of the ITAA 1936) as:

73BB(1) A ***section 73BA depreciating asset*** of an eligible company is an asset for which the eligible company could (ignoring section 73BA) deduct an amount under section 40-25 of the *Income Tax Assessment Act 1997* if the following assumptions were made:

(b) contrary to paragraph 40-30(1)(c) and subsection 40-30(2) of that Act, all intangible assets were excluded from the definition of depreciating asset in section 40-30 of that Act;

(c) subsection 40-45(2) of that Act did not, except in the case of buildings, prevent that Division from applying to capital works to which Division 43 of the *Income Tax Assessment Act 1997* applies, or to which that Division would apply but for the expenditure being incurred, or capital works being started, before a particular day;

(d) the eligible company satisfied any relevant requirement for deductibility under that Division.

51. In *BP Refinery (Kwinana) Ltd v Federal Commissioner of Taxation* (1960) 12 ATD 204 at 207; [1961] ALR 52 at 56, Kitto J described the principle applying to identifying amounts included in the cost of plant for depreciation purposes as:

> ……embracing the whole sum which, according to accepted accountancy practice as applied to the circumstances of the case, ought to be considered as having been laid out by the taxpayer in order to acquire the subject-matter as plant, that is to say installed and ready for his use and for the purpose of producing assessable income.

52. Further, in *Ozone Manufacturing Pty Ltd v Commissioner of Taxation* [2013] AATA 420, the Tribunal said (at [128] – [129]):

> 128. ……..On the evidence, many items referred to as "prototypes" by the applicant were experimental items developed as the object of R&D activities, used in the R&D operations for testing, and were not destroyed, rendered useless or otherwise consumed in those operations. Thus, arguably they were s 73BA depreciating assets and expenditure on their construction was "excluded plant expenditure". The costs associated with the design and construction of those items should have formed a part of the cost bases of those assets, and their decline in value should have been claimed under s 73BA, and not as part of "research and development expenditure" under s 73B(14).
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> 129. The applicant has failed to substantiate the extent to which its disputed expenditure related to the construction and use of various prototypes. Thus, the costs associated with the design and construction of the prototypes should have been accounted for as the cost base of depreciating assets, and not as "research and development expenditure" under s 73B(14).

53. Tier Toys indicates that during the 2007 year:

> Some machining had taken place on two or three tool sets, but this was for investigatory purposes only.[54]

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[54] *See Tier Toys' "Arguments in Support of Review of Decision of Respondent", dated 29 August 2013, at p 9 at [42.1], Transcript, Day, 1 at pp 20 -31 and Transcript, Day 2, at pp 95 – 96.*

54. This work was connected to a project to develop manufacturing of certain "figurines" by an "injection moulding technique".[55] Tier Toys also incurred expenditure on the acquisition of various "prototypes".[56]

55. The above remarks of Kitto J in *BP Refinery* and Senior Member Dunne in *Ozone Manufacturing* apply equally to Tier Toys in relation to its arrangement with Intellec for the provision of design and tooling services and, in particular, to the construction of the relevant tool sets, moulds and prototypes for the "Ark" toy in the 2007 year. That is, the relevant tool sets, moulds and prototypes were tangible "depreciating assets" within the meaning of s 73BA of the ITAA 1936 such that any expenditure incurred on their "acquisition or construction, or that otherwise formed part of [their] cost" is "excluded plant expenditure" under s 73B(1) of the ITAA 1936. That is, to the extent the Disputed Expenditure was directed at, and resulted in, those assets coming to be held by Tier Toys it represented expenditure incurred in the acquisition or construction, or otherwise included in the cost of those assets, within the meaning of "excluded plant expenditure" in s 73B(1) of the ITAA 1936. Consequently, Tier Toys is not entitled to deduct as "research and development expenditure" any amount that qualifies as "excluded plant expenditure". Indeed, based on the evidence, the mould making costs paid by paid by Tier Toys to Intellec in the 2007 year for the provision of design and tooling services were expenses incurred for the supply of goods rather than being expenditure incurred "directly in respect of" eligible "research and development activities", as required by s 73B of the ITAA 1936. However, since the terms of Tier Toys' arrangement with Intellec are not in evidence (i.e. no agreement/contract between Tier Toys and Intellec was produced), any conclusion about the true character of this expenditure is speculative.

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[55] *Mr Romyn's Witness Statement (Exhibit A1), dated 29 August 2013, at [16] – [23]*

[56] *See Tier Toys' "Arguments in Support of Review of Decision of Respondent", dated 29 August 2013, at p 11 at [44.1] – [44.2] and Transcript, Day , at pp 20 – 31.*

Overseas Research and Development Expenditure

56. The Disputed Expenditure includes expenditure by Tier Toys on overseas travel (as part of the total expenditure on domestic and international travel of $165,221).

57. Under s 73B of the ITAA 1936 a deduction was not allowable to an eligible company for a year of income in respect of expenditure in relation to "research and development activities" *unless* the company was registered in relation to the year of income and in relation to those activities under either s 39J of the IRDA or in relation to a project comprising or including those activities under s 39P of the IRDA.[57]

58. Further, s 73B(17A) of the ITAA 1936 provided that an amount is not allowable as a deduction under s 73B(12), (13), (14) or (15) of the ITAA 1936 from a company's assessable income of a year of income in respect of expenditure on "overseas research and development activities" *unless* that expenditure is "certified expenditure".

59. "Overseas research and development activities" was defined in s 73B(1) of the ITAA 1936 as follows:

> ***overseas research and development activities*** means research and development activities that are carried on outside Australia and the external Territories;

and "Certified expenditure" was defined in s 73B(1) of the ITAA 136 as follows:

> ***certified expenditure*** means expenditure that was incurred by an eligible company on overseas research and development activities in respect of which the Board gave a provisional certificate under section 39ED of the *Industry Research and Development Act 1986* before the expenditure was incurred.

[57] *See s 73B(10) of the ITAA 1936.*

60. It is common ground that Tier Toys did not obtain a provisional certificate under former s 39ED of the IRDA in relation to any "overseas research and development activities" carried out by it.

61. Tier Toys claims that it was not informed by AusIndustry of the requirement to obtain a provisional certificate (under former s 39ED of the IRDA) prior to undertaking its overseas travel and claiming expenditure in relation to that travel. Whether that was the case or not, since Tier Toys did not obtain a provisional certificate (under former s 39ED) of the IRDA) it is precluded by s 73B(17A) of the ITAA 1936 from obtaining a deduction under s 73B(14) of the ITAA 1936 on that portion of Tier Toys' total expenditure on domestic and international travel of $165,221 which represents expenditure on "overseas research and development activities", as defined in 73B(1) of the ITAA 1936. It is unclear on the evidence before the Tribunal what that exact portion is. However, this is unnecessary to decide since it has already been found that the Disputed Expenditure is unsubstantiated.

Marketing Expenditure

62. Some of Tier Toys' claim for expenditure on domestic and international travel (totalling $165,221) relates to attendance at the Hong Kong and New York Toy Fairs.[58] This attendance involved the appraisal of products of others, that is, information concerning the global market for toys.[59]

63. Under s 73B(2C)(a) of the ITAA 1936, activities that qualify as "market research, market testing or market development, or sales promotion (including consumer surveys)", are taken not to be activities falling within paragraph (a) of the definition of "research and development activities" in s 73B(1) of the ITAA 1936 such that expenditure on such activities cannot constitute "research and development expenditure" for s 73B purposes. Such activities will only qualify as coming within

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[58] *See Tier Toy' "Arguments in Support of Review of Decision of Respondent", dated 29 August 2013, at p 14 at [47], Mr Romyn's Witness Statement (Exhibit A1), dated 29 August 2013, at [55], Mr Woodgate's Witness Statement (Exhibit A4), dated 29 August 2013, at [15] – [20] and Transcript, Day 1, at pp 68 – 70.*

[59] *Ibid.*

paragraph (b) of this definition, if they are "other activities that are carried on for a purpose directly related to the carrying on of activities of the kind referred to in paragraph (a)".[60]

64. To the extent that Tier Toys' expenditure on domestic and international travel was incurred by it on activities falling within s 73B(2C)(a) of the ITAA 1936 (i.e. "marketing activities"), it was expenditure on activities that do not qualify as "research and development activities", *unless* they were carried on for a purpose directly related to activities which do qualify as such, under paragraph (a) of the definition of "research and development activities".

2. PENALTY OBJECTION DECISION

65. The administrative penalty (of $172,541.65) was assessed by the Commissioner under Division 284 of Schedule 1 to the *Taxation Administration Act 1953* (Cth) (**TAA**) on the basis that Tier Toys' claim for an R&D tax offset in the 2007 Tax Return was false and misleading and gave rise to a "shortfall amount".[61] According to the Commissioner, the 2007 Tax Return was false and misleading because in it Tier Toys claimed an amount of R&D tax offset (of $369,999.90) which was much higher than that which it was entitled.

66. The Commissioner decided that Tier Toys' shortfall amount was caused by the "recklessness" of Tier Toys, or its registered tax agent (Ms Cavill), with regard to the correct operation of a taxation law, such that Tier Toys was liable to a penalty of 50% of the amount of the shortfall.[62]

67. "Recklessness" is not a defined term and accordingly takes its ordinary meaning. In *Hart v Federal Commissioner of Taxation* (2003) 131 FCR 2003; [2003] FCAFC 105

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[60] *Refer to the definition of "research and development activities" set out in [32] above.*

[61] *A "shortfall amount" is the difference between the amount of tax, credit or payment entitlement, calculated on the basis of a taxpayer's statement, and the amount of tax, credit or payment entitlement according to law: s 284-80 of Schedule 1 to the TAA..*

[62] *Under item 2 of s 284-90(1) of the TAA.*

at [33] and [43] the Full Federal Court endorsed the following comments of Cooper J in *BRK (Bris) Pty Ltd v Federal Commissioner of Taxation* [2001] FCA 164; 2001 ATC 4111; (2001) 46 ATR 347 at [77] regarding the meaning of "recklessness" in the taxation law context:

> Recklessness in this context means to include in a tax statement material upon which the Act or regulations are to operate, knowing that there is a real, as opposed to fanciful risk that the material may be incorrect, or be grossly indifferent as to whether or not the material is true and correct, an a reasonable person in the position of the statement-maker would see that there was a real risk that the Act and regulations may not operate correctly to lead to the assessment of the proper tax payable because of the content of the tax statement. So understood the prescribed conduct is more than mere negligence and must amount to gross carelessness.

68. The same approach was taken in *Shawinigan Ltd v Vokins & Co Ltd* [1961] 2 Lloyd's Rep 153 at 152; [1961] 1 WLR 1206 at 1214; [1961] 3 All ER 396 at 403 where Megaw J said:

> Recklessness is gross carelessness – the doing of something which in fact involves a risk whether the doer realises it or not; and the risk being such having regard to all the circumstances, that the taking of that risk would be described as 'reckless'. The likelihood or otherwise that damage will follow is one element to be considered, not whether the doer of the act actually realised the likelihood. The extent of the damage which is likely to follow is another element.

69. Megaw J also noted (at 403) that the degree of the risk, and the gravity of the consequences, need to be considered in reaching a conclusion about whether certain conduct is "reckless", as follows:

> If the risk is slight and the damage that will follow if things go wrong is small, it may not be reckless, however unjustified the doing of an act may be. If the risk is great, and the probable damage great, recklessness may readily be a fair description, however much the

doer may regard the action as justified and reasonable. Each case has to be viewed on its own particular facts and not be reference to a formula.[63]

70. The question of "recklessness" is an objective one.[64]

71. It is now well established that an income tax return that contains a false or misleading statement will expose the taxpayer to penalties under Division 284 of Schedule 1 to the TAA, irrespective of whether or not the taxpayer is guilty of any wrongdoing personally.[65] Further, where a taxpayer's tax agent is taken not to have exercised "reasonable care", or acted with "recklessness", the taxpayer will be held liable for any administrative penalty imposed.[66]

72. The Commissioner submits that the following aspects of Tier Toys' behaviour demonstrate objectively: (i) that it knew that there was a real risk that its R&D tax offset claim for the 2007 year may be incorrect; and (ii) its gross indifference as to the correctness of that claim:

- A failure to prepare an appropriately detailed application for registration of "research and development" activities" (within the definition of s 73B(1) of the ITAA 1936) that would allow for a proper assessment of whether Tier Toys' activities met the statutory definition and whether the expenditure behind its R&D tax offset claim had been incurred "directly in respect of" those activities, as required by the definition of "research and development expenditure" in s 73B(1) of the ITAA 1936;

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[63] *See also Howard v Federal Commissioner of Taxation [2012] FCAFC 149; (2012) 206 FCR 329 at [56].*

[64] *Ibid.*

[65] *See Federal Commissioner of Taxation v Turner (1984)15 ATR 379; 84 ATC 4161; Zeta Force Pty Ltd v Federal Commissioner of Taxation (1988) 84 FCR 70 and Kajewski v Federal Commissioner of Taxation (2003) 52 ATR 455; 2003 ATC 4375.*

[66] *See Sent v Federal Commissioner of Taxation [2012] FCA 382 at [183], which was affirmed on appeal in Sent v Federal Commissioner of Taxation [2012] FCAFC 187.*

- A failure to determine whether Tier Toys had been issued with the relevant provisional certificate in relation to the activities it carried on outside Australia or external territories, as required by s 73B(17A) of the ITAA 1936;

- A failure to determine the extent to which the R&D expenditure claimed by Tier Toys might be precluded from coming within the definition of "research and development expenditure" in s 73B(1) of the ITAA 1936 because it constituted "excluded plant expenditure", as defined in s 73B(1) of the ITAA 1936; and

- A failure to determine the extent to which the R&D expenditure claimed by Tier Toys might be precluded from coming within the definition of "research and development expenditure" in s 73B(1) of the ITAA 1936 because it was related to "marketing" activities under s 73B(2C) of the ITAA 1936.[67]

73. It is clear that Tier Toys relied upon its tax agent at the relevant time, Ms Cavill (then of Integrated Accounting), in calculating and claiming its R&D tax offset in the 2007 Tax Return. Mr Romyn told the Tribunal that he was introduced to Ms Cavill by Mr McHutchison and that she first became involved in Tier Toys' business affairs prior to its R&D tax offset claim for the 2007 year being made.[68] Mr Romyn said that he had regular contact with Ms Cavill during the 2007 year, as her office was nearby Tier Toys' business premises, and that every month throughout the 2007 year he would balance Tier Toys' accounts with its bank statements and then provide Ms Cavill with a spreadsheet summarising that information.[69] Mr Romyn said that when Ms Cavill had completed preparing the 2007 Tax Return he went over the figures and couldn't see any "unforseen problems" and discussed it with Ms Cavill, but didn't "go into [the] ins and outs of the figures" (as he believed Ms Cavill to be a "professional") and then signed the 2007 Tax Return.[70] According to Mr Romyn, at

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[67] *See "Respondent's Submissions", dated 5 February 2014, at [45].*
[68] *Transcript, Day 1, at p 46.*
[69] *Ibid.*
[70] *Transcript, Day , at pp 46 – 47.*

the time he signed the 2007 Tax Return he had, in his possession, adequate records to validate Tier Toys' R&D tax offset claim for the 2007 year.[71] As discussed above, the existence of Mr Romyn's 2007 detailed diary and log book was corroborated by the evidence of Mr Woodgate and Mr McHutchison but that those records went missing following the Lock-Out in 2010 and are consequently no longer available as evidence in this case. In such circumstances, the Tribunal considers that whilst the conduct of Ms Cavill (and it follows Tier Toys) in claiming the R&D tax concession in Tier Toys' 20007 income tax return was objectively negligent, it cannot be described as "gross carelessness" and therefore falls short of amounting to "reckless" behaviour for the purposes of Division 284 of Schedule 1 to the TAA: *Hart* and *Shawinigan.*

74. Where there is a shortfall amount and part or all of it is caused by the failure of the taxpayer or a registered tax agent to take "reasonable care" to comply with a taxation law, the taxpayer is liable to a penalty of 25% of the shortfall (or part thereof) as appropriate under item 3 of s 284-90(1) of Schedule 1 to the TAA. The expression "reasonable care" is an undefined term and so takes its ordinary meaning. "Reasonable" is defined in The Macquarie Dictionary[72] as *"1. endowed with reason. 2. agreeable to reason or sound judgment… 3. not exceeding the limit prescribed by reason, not excessive… 4. moderate…".* "Care" is defined in The Macquarie Dictionary[73] as *"1. worry, anxiety, concern… 2. a cause of worry, anxiety, distress, etc….. 3. serious attention; solitude; heed; caution… 4. protection, charge… 5. an object of concern or attention… 7. to be concerned or solicitous; have thought or regard."* The *Revised Explanatory Memorandum to the A New Tax System (Tax Administration) Bill (No. 2) 2000* states (at [1.69]):

> Reasonable care requires a taxpayer to make a reasonable attempt to comply with the provisions of the ITAA and regulations. The effort required is one commensurate with

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[71] *Transcript, Day 1, at p 47.*
[72] *The Macquarie Dictionary, Third Edition (1997), at p 1776.*
[73] *Ibid at p 334.*

all the taxpayer's circumstances, including the taxpayer's knowledge, education, experience and skill.

75. It follows that in the context of making a statement to the Commissioner within the meaning of s 284-75(4) of the TAA, taking "reasonable care" means giving appropriately serious attention to complying with the obligations imposed under a taxation law. The Tribunal's view is that the behaviour of Ms Cavill (and it follows Tier Toys) in this case demonstrates a lack of "reasonable care" such that, subject to the comments in the following paragraphs (on "Remission of Penalty"), Tier Toys is liable to a penalty of 25% of the shortfall amount under item 3 of s 284-90(1) of Schedule 1 to the TAA

Remission of Penalty

76. The Commissioner has an unconfined discretion to remit an administrative penalty in whole or in part under s 298-20 of Schedule 1 to the TAA, provided it is exercised within the boundaries of the subject matter, scope and purpose of the legislation: *Federal Commissioner of Taxation v Burness (as trustee for property of Robert Bottazzi, a bankrupt)* 2009 ATC 20-135. The question is whether the penalty should be remitted on the basis that the outcome is harsh, having regard to the particular circumstances of the taxpayer. Special circumstances need not be established, and the mere fact that no harm has been done is not of itself a matter that can be taken into account: *Dixon (as trustee for Dixon Holdsworth Superannuation Fund) v Federal Commissioner of Taxation* 2008 ATC 20-015. It is that taxpayer's individual circumstances that are relevant: *Traviati v Federal Commissioner of Taxation* 2012 ATC 20-321.

77. According to the Commissioner, Tier Toys has not shown, by reference to its individual circumstances or mitigating factors, that it is entitled to remission of all or

part of the penalty under s 298-20 of Schedule 1 to the TAA and submits that there are no grounds to remit the penalty in whole or in part.[74]

78. The Tribunal does not accept this submission. Having regard to the evidence of Mr McHutchison concerning Mr Romyn's record-keeping practices generally and as the existence of Mr Romyn's diary and log book in the 2006/2007 income tax year and, it follows, Tier Toys' particular circumstances concerning why it has been unable to produce certain records related to the work performed for it by Intellec, the Tribunal considers that is appropriate to remit that part of the administrative penalty which relates to "Category 1" and "Category 2" of the Disputed Expenditure (see paragraph 20 above), being "Contract payments" and "Mould making".[75]

DECISION

79. For the above reasons, the Tribunal:

(i) Affirms the Commissioner's objection decision, dated 22 November 2012 (Tribunal Reference: 2013/0322); and

(ii) Sets aside the Commissioner's objection decision, dated 22 November 2013 (Tribunal Reference: 2013/6065), and remits the matter to the Commissioner for reconsideration in accordance with the above Reasons for Decision.

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[74] *See "Respondent's Submissions", dated 5 February 2014, at [46].*

[75] *The evidence of Mr Romyn, which was corroborated by Mr Woodgate and Mr McHutchison, was that Mr Romyn maintained a very detailed diary and log book of Tier Toys' business activities in the 2007 year. Whilst those records available at the time Tier Toys' 2007 tax return was prepared and filed, they ceased to exist following the Lock-Out in 2010.*

I certify that the preceding 79 (seventy nine) paragraphs are a true copy of the reasons for the decision herein of Senior Member C R Walsh.

..(Sgd) T Freeman.....
Associate

Dated 20 March 2014

Dates of hearing	**28 & 29 November 2013 & 23 January 2014**
Date final submissions received	**7 March 2014**
Representatives for the Applicant	**Mr P R Woodgate & Mrs L Romyn**
Counsel for the Respondent	**Ms K Clark**
Solicitor for the Respondent	**Ms A McNally** **Senior Principal Lawyer** **Review and Dispute Resolution (WA)** **Australian Taxation Office**