



ATO Interpretative Decision

ATO ID 2006/68

Income Tax

Research and Development: application of section 73CA of the ITAA 1936 to a reimbursement arrangement - expenditure 'not at risk'

FOI status: may be released

Status of this decision: Decision Current

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Issue

Does section 73CA of the *Income Tax Assessment Act 1936* (ITAA 1936) apply where an eligible company is entitled to reimbursement for expenditure on research and development activities in the form of a fee paid by a related entity?

Decision

Yes. Section 73CA of the ITAA 1936 applies in this case to amounts calculated by reference to the eligible company's own expenditure on research and development activities, as it is possible to conclude, for the purposes of the section, that the company is 'not at risk' in respect of this expenditure.

Facts

Company X is an 'eligible company', as defined in subsection 73B(1) of the ITAA 1936. It registers its research and development (R&D) activities with the Industry, Research and Development Board, (the Board), under section 39J of the *Industry Research and Development Act 1986*, (IR&D Act 1986). The company claims a deduction for its expenditure on these R&D activities, at the rate of 125%, under section 73B of the ITAA 1936.

Company X owns certain intellectual property connected with the conduct of the R&D activities, and has contracted with an associated company, company Y, to allow company Y to use this property for initial market testing and commercial promotion. This occurs under the 'first agreement'.

Under a second, but related, agreement, company X pays amounts to company Y, as and when company Y manages and contracts with third parties in relation to the actual conduct of the R&D activities.

The fees payable under the first agreement exactly match the amounts payable under the second agreement, and whilst there is evidence of the R&D activities being carried out on behalf of company X, there is little evidence in support of the claim that company Y uses the intellectual property in a way consistent with the terms, or commensurate with the fees set under the first agreement.

Reasons for Decision

Subsection 73CA(1) of the ITAA 1936 provides that section 73CA of the ITAA 1936 is to be 'read and construed as if it were part of section 73B' of the ITAA 1936.

The effect of section 73CA of the ITAA 1936 is to limit the research and development deduction available under section 73B of the ITAA 1936 based on the extent that an eligible company claiming the deduction is 'at risk' in relation to its research and development (R&D) expenditure.

Subsections 73CA(2), 73CA(3) and 73CA(4) of the ITAA 1936 provide that where the Commissioner is satisfied that, at the time the expenditure was incurred, the eligible company was 'not at risk' with respect to the whole or a part of its R&D expenditure, then the amount of the deduction available to the company under section 73B of the ITAA 1936 will be proportionately reduced. Where the eligible company's expenditure is 'not at risk' at all, the deduction reduces to the amount of its actual expenditure on the R&D activities.

In this respect, subsection 73CA(5) of the ITAA 1936 sets out the basis for how the Commissioner is to be satisfied that when the expenditure in question was incurred, the eligible company (in this case, company X), was 'not at risk in respect of the whole or a part of that expenditure.

Broadly, under subsection 73CA(5) of the ITAA 1936 the Commissioner is required to identify what, if any, is the 'consideration' which in his opinion the company (or an 'associate') could reasonably have expected to receive, at the time of, and because, directly or indirectly as the result of, incurring that expenditure. Under paragraphs (a) and (b) of the subsection, the Commissioner is entitled in this process, to examine matters present before or at the time of incurring the expenditure, as well as matters present after this time.

In Taxation Ruling IT 2635, paragraph 18 says in respect of section 73CA of the ITAA 1936:

Where a claimant [company] has received (or become entitled to receive) a recoupment or grant in respect of its R&D expenditure, then to the extent of such grant or recoupment the claimant is not at risk for the expenditure.

At paragraph 19 of IT 2635 mention is made of the fact that whether or not certain matters 'result in a recoupment should involve a substance approach with regard to the economic realities and not just contractual form: see *Dampier Mining Co. Ltd. v. FCT* 78 ATC 4237 at 4249; (1978) 8 ATR 835 at 848'.

In the case to hand the Commissioner identifies the consideration relevant to subsection 73CA(5) of the ITAA 1936 as the amounts company X is entitled to receive from company Y under the first agreement. Having regard to the circumstances in which both the first and second agreements were entered into, and carried out, he concludes that the substance of the arrangement is that company Y is fully reimbursing or recouping company X in respect of company X's expenditure on the relevant R&D activities. He concludes these reimbursement amounts are consideration company X could reasonably have expected to receive at the time of incurring its expenditure on the R&D activities, directly as the result of incurring this expenditure.

Therefore, the Commissioner concludes for the purposes of subsection 73CA(2) of the ITAA 1936, that company X is 'not at risk' in respect of the whole of this expenditure. The practical effect of this is that company X's deduction in relation to this expenditure is reduced to 100% of the expenditure.

Date of decision: 24 February 2006

Year of income: Year ended 30 June 2002

Year ended 30 June 2003

Year ended 30 June 2004

Legislative References:

Income Tax Assessment Act 1936

section 73B

subsection 73B(1)

section 73CA
subsection 73CA(1)
subsection 73CA(2)
subsection 73CA(3)
subsection 73CA(4)
subsection 73CA(5)

Industry Research and Development Act 1986
section 39J

Case References:

Dampier Mining Co Ltd v. FC of T
78 ATC 4237
(1978) 8 ATR 835

Related Public Rulings (including Determinations)

Taxation Ruling IT 2635

Keywords

Deductions & expenses
Research & development expenses
Section 73CA guaranteed returns to investors

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