



## ATO Interpretative Decision

ATO ID 2010/37

### Income Tax

### Deductions: tax indemnity payment

FOI status: may be released

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## Issue

Is a deduction available under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) for a tax indemnity payment made to an investor pursuant to an obligation in a research and development syndicate (R&D syndicate) arrangement, if the giving of such indemnities and entering into such arrangements is a regular part of the taxpayer's business operations as a developer/supplier of technological products and holding company?

## Decision

Yes, the taxpayer is entitled to a deduction under section 8-1 of the ITAA 1997 for a tax indemnity payment made to an investor where the giving of tax indemnities was a regular feature of the R&D syndicate arrangements entered into by the taxpayer and it is a regular part of the taxpayer's business operations to enter into such arrangements.

## Facts

The taxpayer is a developer and supplier of technological products.

The taxpayer has a number of subsidiaries. One of these subsidiaries, 'Researcher', owned core technology that is able to be licensed to other parties.

Research and Development (R&D) was a vital part of the business conducted by the taxpayer and its subsidiaries. It was a regular part of the taxpayer's business operations, as a developer/supplier of technological products and a holding company to its subsidiaries, to enter into R&D syndication arrangements (as a lender, licensor, contractor or indemnity provider).

In this particular case, two of the taxpayer's subsidiaries other than Researcher formed a R&D syndicate with a subsidiary of a financial institution. The taxpayer, Researcher, the financial institution, and its subsidiary, entered

into a principal agreement which included the following relevant features:

- the R & D syndicate consisted of the two subsidiaries of the taxpayer and that of the financial institution.
- the R & D syndicate would pay Researcher an amount for the right to use the core technology. The R&D syndicate would also pay Researcher a fee to undertake contract work to develop the core technology to commercialisation stage. The contract fees were to be paid to Researcher in instalments over the research period;
- the research results were the property of the R&D syndicate.
- the principal agreement contained a number of agreed assumptions as to the tax treatment of the various payments to be made under the agreement.
- the taxpayer undertook to indemnify the financial institution against any tax payable under an assessment, where that tax would not otherwise have been payable if the agreed assumptions were correct.

Tax indemnities were a regular feature of the R&D syndicate arrangements entered into by the taxpayer as the taxpayer could only attract investors by ensuring that a minimum return to investors in R&D syndicates was maintained. This was done by compensating the investor in the event that expected tax benefits (such as the availability of R&D tax concessions) were disallowed and protecting investors from any additional tax liability. In the absence of the tax indemnity, the investor (financial institution) and its subsidiaries/associates would not have entered into the particular R&D syndication.

The Commissioner disallowed a portion of the core technology expenditure contrary to an assumption in the agreement. In accordance with the principal agreement, the taxpayer was obliged to make the tax indemnity payment to the financial institution.

## Reasons for Decision

Subsection 8-1(1) of the ITAA 1997 allows a deduction for any loss or outgoing to the extent that (a) it is incurred in gaining or producing assessable income or (b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. However, subsection 8-1(2) of the ITAA 1997 provides that a loss or outgoing is not deductible to the extent that it is capital or of a capital nature; of a private or domestic nature; incurred in relation to gaining or producing exempt income or non-assessable non-exempt income; or a provision of the ITAA 1997 prevents its deduction.

A loss or outgoing is 'incurred in gaining or producing assessable income' or 'necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income' if the occasion of the loss or outgoing is found in whatever is productive of the assessable income, or in the carrying on of a business for the production of assessable income (see Mason J in *A.G.C (Advances) Ltd v. Federal Commissioner of Taxation* (1975) 132 CLR 175; 75 ATC 4057; (1975) 5 ATR 243 citing *Ronpibon Tin NL and Tongkah Compound NL v. Federal Commissioner of Taxation* (1949) 78 CLR 47; 8 ATD 431; 4 AITR 236). Where the tax deductibility of an indemnity payment is being considered, the occasion for the outgoing is to be found in the giving of the indemnity and not the payment of the indemnity itself ( *FC of T v. Email Ltd* (1999) 42 ATR 698; 99 ATC 4868 ( *Email* )).

In *Email* , the issue before the Full Federal Court was whether an indemnity payment was capital or of a capital nature (the parties having agreed that the outgoing was necessarily incurred in carrying on a business). In determining whether the indemnity payment is capital or of a capital nature, the Full Federal Court said that

it is the character of the advantage sought which will generally provide the greatest guidance for it tells most about the essential character of the outgoing itself and that it is the character of the advantage which the indemnity was calculated to effect, not directly the character of the payments themselves which must fall for consideration.

The Full Federal Court also said in *Email* that the identification of what expenditure is calculated to effect

involves both a consideration of the character of the expenditure and in many cases an examination of the business structure and the operations of the business in the course of which the expenditure has been incurred.

In that case, in considering the character of the advantage which the indemnity was calculated to effect, the Full Federal Court focussed on the immediate advantage which the giving of the indemnity was designed to effect (in that particular case, it was the sale of the shares at the maximum possible price) rather than the 'ultimate' advantage (which was the expected dividend flow from the subsidiaries to the taxpayer). Consequently, in *Email*, the Full Federal Court concluded that the advantage was not of a revenue nature.

The Full Federal Court in *Email* indicated that the provider of a guarantee/indemnity will be able to claim a deduction where the guarantee/indemnity is given in a context which has a sufficient nexus with the income producing activities of the provider. Thus, it considered that the Court in *Morley v. Lawford and Company* (1928) 14 TC 229 (*Morley*) was correct in holding that moneys paid under a guarantee by a firm of contractors to ensure preference in the allotment of contracts for work at an exhibition was deductible because it was wholly and exclusively laid out for the purposes of the taxpayer's trade. In particular, the Full Federal Court stated the following in relation to the *Morley* case:

No doubt that case was correctly decided and would probably be decided in the same way in Australia under subsection 51(1). The guarantee was so much a part of the taxpayer's trading operations that it was properly to be regarded as a revenue outgoing.

The required connection between the giving of a guarantee and the taxpayer's income producing activities was also found in *Case A58* (1969) 69 ATC 330; (1969) 15 CTBR (NS) *Case 33*. In that case the giving of guarantees were a regular and normal incident of the taxpayer's income earning activities as it was part of the ordinary business of a holding company to guarantee bank overdrafts of tenants of its hotels as an inducement to the tenant to continue to purchase its liquor supplies from the taxpayer's subsidiaries. Accordingly, the No. 2 Board of Review held, by majority, that the payment of the guarantee was incurred in the course of the gaining of the taxpayer's assessable income and was not of a capital nature.

In this case, entering into R&D syndication arrangements (as a lender, licensor, contractor, and indemnity provider) was a regular part of the taxpayer's business operations as a developer/supplier of technological products and a holding company to its subsidiaries. The giving of tax indemnities were a regular feature of the R&D syndicates entered into by the taxpayer and, for this particular R&D syndicate, was a condition of the investor and its subsidiaries/associates' participation in the syndicate arrangement. The immediate advantage which the giving of the indemnity by the taxpayer was designed to effect was to induce the investor and its subsidiary to enter into the R&D syndicate arrangement thereby producing income and new products (for their current markets) for the taxpayer's subsidiaries. The tax indemnity payment is thus incurred in the course of the gaining of the taxpayer's assessable income and is not of capital or of a capital nature

The indemnity is also not private or domestic in nature, was not incurred in relation to the gaining or producing of exempt income or non-assessable non-exempt income and a provision of the Act does not prevent the taxpayer from deducting it.

Therefore, a deduction for the indemnity payment is allowable to the taxpayer under section 8-1 of the ITAA 1997.

**Date of decision:** 18 July 2007

**Year of income:** Year ended 30 June 2007

**Legislative References:**

*Income Tax Assessment Act 1997*

section 8-1

subsection 8-1(1)

subsection 8-1(2)

**Case References:**

*AGC (Advances) Ltd v. Federal Commissioner of Taxation*

(1975) 132 CLR 175

75 ATC 4057

(1975) 5 ATR 243

*Ronpibon Tin NL and Tongkah Compound NL v. Federal Commissioner of Taxation*

(1949) 78 CLR 47

(1949) 8 ATD 431

(1949) 4 AITR 236

*Federal Commissioner of Taxation v. Email Ltd*

(1999) 42 ATR 698

99 ATC 4868

*Morley v. Lawford and Company*

(1928) 14 TC 229

## Case A58

69 ATC 330

(1969) 15 CTBR (NS) Case 33

**Related ATO Interpretative Decisions**

ATO ID 2004/657

**Keywords**

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