Australian Government
Australian Taxation Office

ATO Interpretative Decision

ATO ID 2012/89

Income Tax
Research and Development: feedstock adjustments - creation of a prototype

FOI status: may be released

Issue

Does a 'feedstock adjustment' arise under section 355-465 of the *Income Tax Assessment Act 1997* (ITAA 1997) in relation to expenditure incurred by an 'Research and Development (R&D) entity' in creating a prototype which is a depreciating asset, but not one used in acquiring or producing any 'feedstock inputs'?

Decision

No. A feedstock adjustment does not arise under section 355-465 of the ITAA 1997 where an R&D entity incurs expenditure on constructing a prototype which is a tangible depreciating asset, where that asset is not used in acquiring or producing any 'feedstock inputs'.

Feedstock adjustments depend, among other conditions, on the R&D entity obtaining a tax offset under section 355-100 of the ITAA 1997 for an income year, but only for certain kinds of notional deductions covered by Division 355 of the ITAA 1997. A notional deduction for the decline in value of a depreciating asset which is not used in acquiring or producing any feedstock inputs is not one of these kinds, and so section 355-465 of the ITAA 1997 does not apply.

Facts

The taxpayer is an R&D entity within the meaning of section 355-35 of the ITAA 1997. In an income year to which section 355-100 of the ITAA 1997 applies it incurs expenditure on constructing a prototype. This expenditure is included in the 'cost' of the prototype, as a tangible depreciating asset, for the purposes of Division 40 of the ITAA 1997.

The construction of the prototype involves transforming or processing various goods or materials during the conduct of certain registered R&D activities. It does not include any component relating to expenditure incurred on any energy input directly into the transformation or processing.

The prototype is then held and used by the R&D entity in conducting one or more further registered R&D activities, but not in acquiring or producing any 'feedstock inputs'.

The R&D entity obtains a tax offset under section 355-100 of the ITAA 1997 for the income year, for a notional deduction under section 355-305 of the ITAA 1997 relating to this use of the prototype in conducting registered R&D activities.

Reasons for Decision

(All legislative references are to the *Income Tax Assessment Act 1997* , unless stated otherwise)

Division 355 allows certain taxpayers (being an R&D entity within the meaning of section 355-35) a tax offset based on prescribed percentages of the total of the notional deductions they are entitled to under seven specific sections in the Division, including section 355-205 (R&D expenditure) and section 355-305 (decline in value of R&D assets).

Subsection 355-205(1) allows an R&D entity to notionally deduct expenses incurred on R&D activities, where the conditions of that subsection are met. This is subject to section 355-225 (excluded expenditure): see subsection 355-205(2).

Paragraph 355-225(1)(b) specifically excludes expenditure included in the cost of a tangible depreciating asset for the purposes of Division 40 from being deductible under section 355-205. As note 2 of subsection 355-225(1) identifies, the decline in value of this tangible depreciating asset may be notionally deductible under section 355-305.

Section 355-305 allows an R&D entity to notionally deduct the decline in value of a tangible depreciating asset that falls within the scope of Division 40, where it is held and used by it for the purpose of conducting one or more registered R&D activities, and the conditions of section 355-305 are met.

The expenditure incurred on constructing the prototype is expenditure that falls within the scope of Division 40 and meets the conditions of section 355-305. Therefore the R&D entity can claim, under section 355-305, a notional deduction for the income year equal to the amount of the decline in value of the prototype.

In certain circumstances, the R&D entity may be liable to a 'feedstock adjustment' under Subdivision 355-H where the prototype is then held and used by the R&D entity in conducting one or more further registered R&D activities. Where a 'feedstock adjustment' occurs, an amount is included in the R&D entitys' assessable income as calculated under subsection 355-465(2).

Subsection 355-465(1) specifies three conditions that must be met before an R&D entity is liable to a 'feedstock adjustment':

(1) the R&D entity incurs expenditure in the income year on acquiring or producing goods or materials (referred to as 'feedstock inputs'), transformed or processed during R&D activities in producing one or more tangible products (referred to as 'feedstock outputs');

(2) the R&D entity obtains a tax offset under section 355-100 for one or more income years for its notional deductions:

- **(a)** for the expenditure
- **(b)** for expenditure the R&D entity incurs on any energy input directly into the transformation or processing, or
- **(c)** for the decline in value of assets used in acquiring or producing the feedstock inputs;

and

(3)

during the income year, the R&D entity supplies a feedstock output or a transformed feedstock output, to another entity, or applies it to the R&D entity's own use.

In this case, the first condition is met as the components used to construct the prototype are the 'feedstock inputs', the construction involves transforming or processing those feedstock inputs during R&D activities, and the prototype is the tangible 'feedstock output' produced from those activities.

With regard to the second condition, it might be argued that paragraph (a) is met in relation to the construction expenditure, on the basis that the amount notionally deducted under section 355-305 is 'for' this expenditure. However, for paragraph (a) to apply the 'expenditure' referred to here must be the expenditure on acquiring or producing the goods or materials, namely the 'feedstock inputs' under the first condition. Though the R&D entity obtains a tax offset under section 355-100 in relation to the prototype, it is not for 'the expenditure' under section 355-205 but rather for the 'decline in value' of the tangible depreciating asset under section 355-305, of which such expenditure forms part of the cost. As paragraph 355-225(1)(b) excludes expenditure which is included in the cost of a tangible depreciating asset for the purposes of Division 40 from being deductible under section 355-205, the expenditure does not satisfy paragraph (a). This is consistent with such expenditure being intended to be covered, where applicable, by section 355-305, which allows a notional deduction for the decline in value of the asset.

Paragraph (b) of the second condition does not apply as the construction expenditure does not include any expenditure incurred on any energy input directly into the transformation or processing conducted in creating the prototype.

Paragraph (c) of the second condition is also not met. Although the R&D entity in this case does notionally deduct an amount for the decline in value of the prototype, the prototype is not used in acquiring or producing any 'feedstock inputs'.

Therefore, as the R&D entity has not met all three conditions of subsection 355-465(1), its expenditure on the prototype will not of itself trigger any feedstock adjustment under section 355-465.

Date of decision: 23 October 2012

Year of income: year ended 30 June 2012

Legislative References:
Income Tax Assessment Act 1997
Division 40
Division 355
section 355-35
section 355-100
section 355-205
subsection 355-205(1)
subsection 355-205(2)
section 355-225
subsection 355-225(1)
paragraph 355-225(1)(b)
section 355-305
Subdivision 355-H
section 355-465
subsection 355-465(1)
subsection 355-465(2)

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