FEDERAL COURT OF AUSTRALIA

Commissioner of Taxation v Desalination Technology Pty Limited [2015] FCAFC 96

Citation:	Commissioner of Taxation v Desalination Technology Pty Limited [2015] FCAFC 96
Appeal from:	Commissioner of Taxation v Desalination Technology Pty Limited [2014] FCA 1120
Parties:	**COMMISSIONER OF TAXATION v DESALINATION TECHNOLOGY PTY LIMITED**
File number:	NSD 1159 of 2014
Judges:	**EDMONDS, LOGAN AND PAGONE JJ**
Date of judgment:	3 July 2015
Catchwords:	**INCOME TAX** – research and development ("R&D") expenditure – whether taxpayer eligible for tax offset under Div 3 of Pt III (repealed) of *Income Tax Assessment Act 1936* (Cth) – whether relevant expenditure "incurred" for purposes of s 73B(14)(a) – competency of appeal from Tribunal's decision – whether that appeal was on a question of law – whether contingencies to which obligation was subject went only to timing of payment or

	to the existence of the obligation itself – whether taxpayer was definitively committed to the obligation
Legislation:	*Income Tax Assessment Act 1936* (Cth) ss 73B, 73I, 73J *Income Tax Assessment Act 1997* (Cth) s 8-1 *Administrative Appeals Tribunal Act 1975* (Cth) s 44
Cases cited:	*Belton v General Motors-Holden's Ltd (No 1)* (1984) 58 ALJR 352 cited *Birdseye v Australian Securities and Investments Commission* (2003) 76 ALD 321 cited *Brookton Co-operative Society Limited v Commissioner of Taxation of the Commonwealth of Australia* (1981) 147 CLR 441 cited *Coles Myer Finance Limited v Commissioner of Taxation of the Commonwealth of Australia* (1993) 176 CLR 640 cited *Commissioner of Taxation of the Commonwealth of Australia v CityLink Melbourne Limited* (2006) 228 CLR 1 cited *Haritos v Commissioner of Taxation* [2015] FCAFC 92 cited *Hope v The Council of the City of Bathurst* (1980) 144 CLR 1 cited *Manzi & Ors v Smith & Anor* (1975) 132 CLR 671 cited *New Zealand Flax Investments Limited v Federal Commissioner of Taxation* (1938) 61 CLR 179 cited *Price Street Professional Centre Pty Ltd v Commissioner of Taxation* (2007) 243 ALR 728 cited *TNT Skypak International (Aust) Pty Ltd v Federal Commissioner of Taxation* (1988) 82 ALR 175 cited *Vetter v Lake Macquarie City Council* (2001) 202 CLR 439 followed
Date of hearing:	7 May 2015
Place:	Sydney
Division:	GENERAL DIVISION
Category:	Catchwords

Number of paragraphs:	47
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IN THE FEDERAL COURT OF AUSTRALIA

NEW SOUTH WALES DISTRICT REGISTRY

NSD 1159 of 2014

GENERAL DIVISION

ON APPEAL FROM THE FEDERAL COURT OF AUSTRALIA

BETWEEN: **COMMISSIONER OF TAXATION**
Appellant

AND: **DESALINATION TECHNOLOGY PTY LIMITED**

Respondent

EDMONDS, LOGAN AND PAGONE JJ

JUDGES :

DATE OF ORDER: **3 JULY 2015**

WHERE MADE: **SYDNEY**

THE COURT ORDERS THAT:

1. The appeal be allowed.

2. Order 1 made on 21 October 2014 in NSD 2571 of 2013 be set aside.

3. The decision of the Administrative Appeals Tribunal made on 29 November 2013 in [2013] AATA 846 be set aside.

Note: Entry of orders is dealt with in Rule 39.32 of the *Federal Court Rules 2011*.

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BETWEEN: **COMMISSIONER OF TAXATION**
Appellant

AND: **DESALINATION TECHNOLOGY PTY LIMITED**

Respondent

JUDGES: **EDMONDS, LOGAN AND PAGONE JJ**

DATE: **3 JULY 2015**

PLACE: **SYDNEY**

REASONS FOR JUDGMENT

THE COURT:

INTRODUCTION

1. This is an appeal from a judgment of a judge of this Court: *Commissioner of Taxation v Desalination Technology Pty Limited* [2014] FCA 1120, dismissing an appeal by the appellant ("Commissioner") from a decision of the Administrative Appeals Tribunal ("Tribunal"): *Desalination Technology Pty Limited* [2013] AATA 846, setting aside the Commissioner's objection decision disallowing the respondent's ("taxpayer" or "DST") objection to its amended income tax assessment for the year of income ended 30 June 2009 ("year of income") and allowing the objection in full.

2. In the Tribunal, before the primary judge and before this Court, the ultimate substantive issue was whether the taxpayer is eligible for a tax offset for the year of income in respect of research and development ("R&D") expenditure under provisions previously contained in Div 3 of Pt III of the *Income Tax Assessment Act 1936* (Cth) ("1936 Act"), in particular ss 73B, 73I and 73J, all repealed effective 8 September 2011 (Act No 93 of 2011). The amount claimed by the taxpayer as a tax offset was $363,281. Of that amount, the Commissioner allowed only $56,236: Tribunal's Reasons for Decision ("TR") at [5].

STATUTORY CONTEXT

3. Section 73B(14) provided:

> Subject to this section, 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 year of income is greater than $20,000;

the amount of that expenditure multiplied by 1.25 is allowable as a deduction from the assessable income of the company of the year of income.

4. There is no issue that the taxpayer is an "eligible company" as defined (s 73B(1)); that the expenditure in question is properly classified as "research and development expenditure" as defined (s 73B(1)); and that the amount of expenditure ($968,750) exceeds $20,000.

5. As the primary judge observed at [7] and [8] of his Reasons for Judgment ("JR"):

> [7] Frequently those involved in R&D activity [would] have no income against which a deduction might be claimed under s 73B and instead only an expectation of profit lying in the future. This reality [was] reflected in a set of provisions which provide for immediate tax relief in the form of an offset against the tax (not the income) which would otherwise be due. This was achieved, relevantly for this case, by s 73J(1) ... which provided:
>
> '(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 (except subsection 73B(14C)), 73BA, 73BH or 73QA for that year; and
>
> (b) either:
>
> (i) all or part of the amount that the company could, apart from subsection 73I(4), have deducted is contracted expenditure; or
>
> (ii) 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 persons with which it is grouped (while they are grouped in that year) is not more than $1,000,000; and
>
> (d) the R&D group turnover of the company for that year is less than $5,000,000.'

> [8] By force of s 73I(3) the offset was fixed at 30 cents for each dollar of expenditure. In practice, the operation of s 73B(14) and s 73J(1) was to provide a taxpayer who incurred R&D expenditure a choice between claiming a 125% deduction against its assessable income or a 30% offset against its tax liability. Plainly enough, a taxpayer making little or no income would usually take the latter course and in those cases where a taxpayer's liability to pay income tax in a year of income is less than the offset it will receive a refund. Indeed, in those years in which a taxpayer has no liability to pay income tax at all it [would] receive a refund equal to the offset. The generosity of this arrangement will be apparent.

THE ISSUES

6. The substantive issue between the parties at all levels from the Tribunal to this Court is whether the taxpayer "incurred" the relevant expenditure for the purposes of s 73B(14)(a).

7. Before the Tribunal, there was also a question of administrative penalty, which the Commissioner assessed at the rate of 50%, having concluded that the taxpayer had a tax shortfall that resulted from recklessness as to the operation of a taxation law: see TR [2]. By virtue of the Tribunal's decision on the substantive issue, there was no tax shortfall, and as a result the administrative penalty fell away: TR [27].

8. Before the primary judge and before this Court, the taxpayer relied on notices of contention, contending that the jurisdiction of this Court under ss 44(1) and (3) of the *Administrative Appeals Tribunal Act 1975* (Cth) ("AAT Act") was not enlivened by the notice of appeal filed by the Commissioner against the decision of the Tribunal on 29 November 2013 because it did not raise a question of law. At JR [46], the primary judge said:

> In view of the result, it is not necessary for me to deal with the taxpayer's notice of objection as to the competency of the appeal.

THE TRIBUNAL'S RELEVANT FINDINGS

9. The Tribunal made the following findings of primary fact:

> 6. The circumstances surrounding the tax offset claim were explained by Mr Garth Davey and Mr Colin Kofoed. Mr Davey is perhaps best described as an inventor; Mr Kofoed is an accountant and a registered tax agent. Mr Davey has been a director of the taxpayer since 29 June 2007. Mr Kofoed was a director from incorporation in June 2007 until January 2008. Since then he has been an alternate director. At all relevant times he has been the accountant and tax agent for the taxpayer.
>
> 7. Mr Davey has been involved in R&D activities for over 45 years. In that time he has explored and developed new technologies in relation to diesel engines, power generators, and the transportation of large equipment items including mobile transformers and substations. As he explained in his affidavit sworn on 7 March 2013 (Exhibit A1):

[24] As the number of research and development projects with which I was involved grew and became more complex from about 1996 onwards it became necessary for me to have access to more very expensive computers and other equipment ...

[25] In order to better facilitate the financing of these items, to segregate them from the companies actually conducting research activities and to better manage and allocate the cost [of] their usage to various projects, I was advised by Kofoed to establish a new structure in which to hold them. To this end STR Developments Pty Ltd (STR) was registered to act as the trustee for the Davey Family Trust which was to own these assets and equipment. ...

8. Mr Davey appears to have been constantly looking for what he described as "the best way to conduct research and development activities". In around July 2006 Mr Kofoed suggested to him a structure that he had apparently used for other clients and which he said was in common use where R&D activities were involved. Mr Davey's affidavit continues:

[32] Broadly, the structure involved establishing a new company to act as the project manager for all of the various projects being undertaken in the group. That company would also coordinate the use of labour and equipment for the various projects and to ensure suitable premises were available.

[33] Another company would be formed to hold the technology and patents and to carry out research and development using the labour and equipment to be provided through the project manager. I commented that this is what was already happening ...

[34] A separate company also would be formed with a view to it exploiting the technology under license. And also a Unit Trust would be established so that investors would have a direct interest (as opposed to an interest in a company) in the successful exploitation of the technology.

[35] When external investors subscribed moneys to particular projects the funds were split into allotments of shares and units amongst these bodies. The moneys subscribed to the unit trust and the exploitation company were to be made available to the technology company for it to use in meeting its expenses, including costs associated with the filing for patents and to pay the project management company.

> *[36] I was happy with this structure as it offered protection for the patents and I thought that separating the different technologies into different (sic) would make it easier to borrow. I also thought that each technology would appeal to a different type of investor and separating them would make it easier to attract investors.*
>
> *[37] This structure was used for subsequent inventions and was also incorporated into the manner in which earlier inventions were held. ...*

9. The structure was put into effect with the registration of Innovative Design Technologies Group Pty Limited (IDTG) on 6 July 2007. IDTG shared the same business address as the taxpayer and in the relevant income year it also had the same directors as the taxpayer. IDTG was "to act as a project manager for all research and development projects and to coordinate the use of labour and equipment for the various projects". One of the projects related to the development of a flash evaporator desalination unit for the purpose of combating salinity problems in the Murray Darling Basin and elsewhere. The taxpayer, DST, which had been registered on 7 June 2007, applied for a patent over the evaporator.

10. Mr Davey prepared an R&D Plan setting out the research that DST needed to conduct in relation to the evaporator. Soon afterwards, in July 2007, according to Mr Davey, DST "contracted with IDTG so as to obtain the labour and equipment it required to complete the [R&D] Plan".

11. The R&D work itself was carried out by Mr Davey and others as employees of Davey Technology Pty Ltd, a company established by Mr Davey. The workers recorded the number of hours they spent undertaking R&D activities. The value of the time they charged became the basis of the fee invoiced by IDTG to the taxpayer, generally on a monthly basis.

12. During the relevant year, IDTG issued monthly invoices totalling $1,065,625 to DST. Of the total amount invoiced, DST paid $149,964. The balance of $915,661 was debited to an inter-company loan account between IDTG and the taxpayer. To this day the balance has not been paid.

13. The arrangement between DST and IDTG, referred to by Mr Davey as a "contract", was not initially in writing. At that time, he said, it was a "verbal agreement". The detail of the arrangement, he said, is reflected in a "Service Agreement" dated 14 May 2010 which was provided to the Australian Taxation Office (ATO) when the Commissioner raised queries about the taxpayer's tax offset claim. Mr Kofoed, responding to the queries on behalf of the taxpayer, explained in a letter dated 30 November 2010 to the ATO:

The agreement was dated 14 May 2010. This agreement simply evidenced in writing the long standing and clear agreement between the parties which had operated for some years. The effects of the agreement are obvious from the way in which the parties had operated in the past. ...

14. The Service Agreement reads as follows:

Service Agreement

This Service Agreement is dated the 14th day of May 2010. It is executed this day to formalise the agreement between the parties which has been understood and operating between the parties since the inception of the project. This agreement is made between

Innovative Design Technologies Group Pty Ltd (ACN 126 418 657) of 19 Speedwell Street, Somerville, Victoria.

(IDTG)

and

Desalination Technology Pty Ltd (ACN 125 846 996) of 19 Speedwell Street, Somerville, Victoria.

(DST)

IDTG has coordinated and sub contracted Research and Development work on behalf of DST and continues to do so on an ongoing basis.

IDTG has rendered monthly invoices for that work, and will finance that work on behalf of DST on an ongoing basis.

The nature of the research and development project precludes DST making full settlement of monthly invoices as they are rendered.

The purpose of this agreement is to define the terms of trading between DST and IDTG, and to define the remedies available to IDTG should DST breach those terms of trading.

Terms of Trading

IDTG will continue to finance research and development work on behalf of DST. IDTG will render detailed monthly invoices to DST setting out work done and the monthly amount due.

DST will make such reductions in the total amount outstanding as funds received from investors, loan funds received, and any amounts DST may receive from other sources will prudently allow.

IDTG has the option at its absolute discretion to convert all or any part of monies outstanding under this agreement to an interest free loan, or to take equity in the project equivalent to any part of those outstanding

monies. Any equity in the project will be valued at the current price sought from investors at the date of conversion.

Neither DST nor IDTG shall assign, further subcontract or delegate its rights or obligations under this agreement without the prior consent of the other party.

Termination

This agreement may be terminated by either party given 30 Days notice in writing.

Upon termination all amounts payable under the terms of this agreement will become payable in full.

This agreement will be protected from termination and demand for immediate payment in the event that IDTG becomes bankrupt, unable to pay its debts, insolvent, or enters into an arrangement with its creditors.

Disputes

Any dispute under this agreement which cannot be resolved within 30 days shall be submitted to third party arbitration. Failing resolution at arbitration the matter will be resolved by the courts in the State of Victoria.

This agreement shall be construed, governed and enforced on accordance with (sic) the laws of the State of Victoria and shall take effect as a sealed instrument within that state.

[Signed and executed for and on behalf of IDTG by Anthony Vernon Scott Gall, Director;

Signed and executed for and on behalf of DST by Garth Davey, Director]

15. Also relevant is a minute of a meeting of directors of DST which took place on 16 July 2007. That minute is as follows:

> *It was noted that a new company Innovative Design Technology Group Pty Ltd had been created to facilitate and co ordinate and finance Research and Development for the group.*
>
> *It was noted that IDTG would render Monthly invoices to each member of the group for R&D work carried out on their behalf.*
>
> *It was further noted that cash flow for the company would be uncertain for the foreseeable future with funds incoming from R&D tax offsets and investors being received on an uncertain and irregular basis.*

It was further noted that to simply treat invoices from IDTG as trade creditors would reflect badly to potential investors and lenders as no normal trading terms could be adhered to with any certainty.

It was therefore resolved that any invoice received from IDTG, after verification, be charged to a come and go loan account with that company. The invoices will be treated as fully paid as at the date it is rendered and the payment due to IDTG be more properly treated as a longer term borrowing for financing purposes. Investors and financiers would be therefore (sic) of the nature of funding received, and the company would avoid the risk of being considered insolvent due to its inability to meet trade credit commitments.

Funds received from investors and R&D tax offsets will be paid to IDTG in reduction of the loan account balance until exploitation of the technology enables payment in full.

[Signed as a correct record by Garth Davey.]

[Footnotes omitted.]

10. The Tribunal reasoned and made the following findings of secondary fact:

> 22. True it is that the timing of the payments by DST to IDTG is conditional on two things – first, that DST receives funds from investors, lenders or other sources; and second, that even if it has the funds, DST considers it "prudent" to make a payment to IDTG. Mr Davey conceded as much in cross-examination. But the truth of that proposition does not render impossible the entirely different proposition that DST was definitively committed to IDTG in respect of the R&D expenditure.
>
> 23. The DST directors' minute acknowledges DST's obligation to meet the charges invoiced to it by IDTG. It speaks of the "payment due" to IDTG. It notes that each invoice will be "treated as fully paid as at the date it is rendered". There is no reason to treat them that way if there was no obligation to meet the expenditure in the first place. While it might be said against the taxpayer that the minute is unilateral and therefore does not speak for IDTG in relation to the arrangement, that argument ignores the fact that Mr Davey, who signed the minute on behalf of DST as a "correct record", was also a director of IDTG.
>
> 24. The Service Agreement, entered into on 14 May 2010 but said to reflect "the agreement between the parties which has been understood and operating between the parties since the inception of the project", is consistent with the directors' minute. While it is not the most tightly drafted agreement of its kind, it acknowledges

> that IDTG will "finance" the R&D work. In context, that can only mean that DST has a debt to IDTG for the value of the R&D work invoiced – IDTG has "financed" the work by lending the invoiced amount to DST so that the invoices are not outstanding. The balance sheet for DST as at 30 June 2009 shows an inter-company loan of just over $1 million to IDTG, which is a proper reflection of the situation as documented in the directors' minute and the Service Agreement. [Footnotes omitted.]

THE TRIBUNAL'S PROCESS OF REASONING

11. The Tribunal noted (at TR [16]) that it was common ground between the parties that the cases dealing with the word "incurred" in the context of s 51(1) of the 1936 Act or the corresponding s 8-1(1) of the *Income Tax Assessment Act 1997* (Cth) ("1997 Act") are relevant to the question arising under s 73B(14) of the 1936 Act.

12. The Tribunal said (at TR [17]) that those cases established that:

> [17] ...There must be a "presently existing liability" [*Nilsen Development Laboratories Pty Ltd v Federal Commissioner of Taxation* (1981) 144 CLR 616 at 627] to which the taxpayer is "definitively committed" and "completely subjected" [*Federal Commissioner of Taxation v James Flood Pty Ltd* (1953) 88 CLR 492 at 506].

13. The Tribunal referred (at TR [18]) to what was said by Dixon J (as his Honour then was) in *New Zealand Flax Investments Limited v Federal Commissioner of Taxation* (1938) 61 CLR 179 at 207 :

> "Incurred" does not mean only defrayed, discharged, or borne, but rather it includes encountered, run into, or fallen upon. It is unsafe to attempt exhaustive definitions of a conception intended to have such a various or multifarious application. But it does not include a loss or expenditure which is no more than impending, threatened, or expected.

14. The Tribunal then referred (at TR [19] and [20]) to what was said by Deane J in *Coles Myer Finance Limited v Commissioner of Taxation of the Commonwealth of Australia* (1993) 176 CLR 640 at 670 as to the weight of authority supporting the conclusion that a liability to pay money can constitute a "loss or outgoing" which is "incurred" notwithstanding that the money is not payable until a future time and that the obligation to pay it is theoretically defeasible or contingent, and to the fact that this passage was referred to by Crennan J (with whom Gleeson CJ, Gummow, Callinan and Heydon JJ agreed) in *Commissioner of Taxation of the Commonwealth of Australia v CityLink Melbourne Limited* (2006) 228 CLR 1 at 37–38 .

15. The Tribunal concluded its analysis at TR [25] and [26] in the following terms:

> 25. The Commissioner concedes in his written submissions that the lack of a fixed date for payment of a liability will not prevent a liability from having been incurred. Referring to *Citylink Melbourne* at 228 CLR page 40 [136], he provides an example by which a date for payment can be specified but subject to provision for early or

late payment. He then submits that if no date (or range of dates) is provided at all, this will contribute to a conclusion that there is no presently existing obligation.

26. It seems to me, however, that DST's liability to IDTG was *created* during the 2009 income year (in the sense that DST was definitively committed and had completely subjected itself to the expenditure), notwithstanding the fact that there were conditions affecting the timing of the discharge of that liability. I do not read the directors' minute and the Service Agreement as leaving in any sense "contingent" the obligation placed on DST to pay the amounts that were invoiced to it. As Crennan J said in *Citylink Melbourne* at 228 CLR pages 40-41 [137]:

> ... *A condition affecting the timing of the discharge of a liability (but not the creation of the liability) does not render the liability contingent in any business or commercial sense*. (Footnote omitted)

BEFORE THE PRIMARY JUDGE

16. After referring to the minute of the meeting of directors of the taxpayer held on 16 July 2007, reproduced at TR [15] (see [9] above), the primary judge, at JR [17]–[19], said:

> [17] It is apparent that the intent of this arrangement was to transform the terms upon which the services were provided by IDTG to the taxpayer from ordinary trade terms to a long term debt account of uncertain duration for which, unless the flash evaporator desalination unit was a commercial success, there was very little chance of it ever being settled.
>
> [18] Pursuant to this arrangement IDTG invoiced the taxpayer on a monthly basis in the relevant year for some $1,065,625 and from that amounts totalling $149,964 were paid but, as contemplated in the directors' minute, the remaining balance was paid by then debiting the running account between the taxpayer and IDTG. As at the date of the hearing, that balance remained outstanding.
>
> [19] In 2010 a written service agreement was entered into between IDTG and the taxpayer purporting to set out the terms of the relationship. As the Tribunal correctly observed, its terms were not materially different for present purposes to those contained in the minutes of the directors' meeting. It may, therefore, be put aside and with it the question of whether such a subsequent document can have more than evidentiary effect for tax purposes.

17. Putting to one side for the moment whether any obligation or liability on the part of the taxpayer to Innovative Design Technologies Group Pty Limited ("IDTG") was created or come into existence upon the rendering of the invoices by IDTG to the taxpayer, it is not clear what the learned primary judge meant when he said at JR [18]:

> [T]he remaining balance was **paid** by then debiting the running account between the taxpayer and IDTG.
>
> (Emphasis added.)

The mere accounting entry, debiting the running account, could not constitute payment of "the remaining balance" at least in the absence of the agreement or assent of IDTG: *Manzi & Ors v Smith & Anor* (1975) 132 CLR 671 at 674 per Barwick CJ, with whom Mason and Jacobs JJ agreed; *Brookton Co-operative Society Limited v Commissioner of Taxation of the Commonwealth of Australia* (1981) 147 CLR 441 at 455 per Mason J.

18. What is clear is that the primary judge had some difficulty in comprehending, from the Tribunal's findings, what actually occurred. His Honour described the Tribunal's approach as "a trifle ambiguous" (at JR [24]): "that separate parts of its reasons are arguably consistent with" two different ways of looking at what occurred. His Honour characterised the two ways at JR [21] and [23]:

> [21] ... The first, which for reasons to which I will return seems to me preferable, was to characterise the debt arising from the delivery of each invoice as being created pursuant to the agreement under which the services were provided to the taxpayer by IDTG. On this view, this first debt was then discharged by the taxpayer incurring a second debt liability to IDTG which was added to the running account. Whilst the original invoice and the subsequent running account resulted in debts which were identical in amount, the terms under which those debts were owed were different; in particular, the debt arising under the invoice was an ordinary trade creditor's debt and, therefore, as I understood the argument, payable within a reasonable time. The quantum-identical debt due under the running account was, by contrast, subject to the two contingencies to which reference has already been made and might, in fact, never be repaid.
>
> ...
>
> [23] An alternate view, which I do not share, is that the debts arising under the invoice and the running account were all part of the same transaction so that whatever the contingencies to which the latter was subjected were applied to the former too. The reason I do not share this view is that it elides what appears to me to be two distinct transactions – incurring a trade debt and debiting a running account – into one.

19. The learned primary judge thought that what the Tribunal said at TR [24] was consistent with his preferred first view, but that other parts of its reasons, for example, at TR [26], appeared to embrace the idea that the original debt obligation arising from the invoices was subject to the same contingencies as the loan account (i.e., the second view): JR [24] and [25].

20. The learned primary judge went on to observe at JR [27] that the Tribunal accepted the taxpayer's case on the facts, and that case was:

> [T]hat there was in fact an agreement by both parties [i.e., the taxpayer and IDTG] which could only be inferred from:
>
> (a) the minute of the taxpayer; and
>
> (b) the fact that Mr Davey was a director of both the taxpayer and IDTG.
>
> (At JR [28]).

In his Honour's words (at JR [29]):

> [G]iven the structure of Mr Davey's group of companies (of which the taxpayer was but one) this inference was available as a matter of fact. As such, there can be no challenge to it in this Court where the grounds are limited to questions of law.

21. The learned primary judge then addressed the four points the Commissioner pressed on the appeal from the Tribunal.

22. The first, that the Tribunal erred in law in concluding that the taxpayer was definitively committed to the expenditure when it found at TR [22] that it was subject to the two contingencies – the first, that the taxpayer receive funds from investors, lenders or other sources; and second, that even if it has the funds, the taxpayer considers it "prudent" to make a payment to IDTG.

23. The learned primary judge's response to this starts at JR [31] and finishes at JR [35]. His Honour relevantly said:

> [31] It is … true that the first sentence of [TR [22]] is arguably consistent with a reading under which it is assumed that the original obligations arising from the invoices were subject to the two contingencies. This is a little difficult to reconcile, however, with the last sentence of [22] and even more difficult to reconcile with the passage at [24] which I have quoted above. On balance, therefore, I do not think that the Tribunal actually found that the payment of the invoices was subject to the two contingencies. Instead, what I think is being referred to in the first line of [22] are repayments of the running account.
>
> [32] That being so, the Tribunal's conclusion in the last sentence of [22] that the taxpayer was definitively committed to paying for the R&D expenditure makes perfect sense. Once the Tribunal found as a fact that the taxpayer was thus committed then the application of established (and not disputed) principle inevitably led to the conclusion that the R&D expenditure had been 'incurred' and hence was deductible. Once it was found that the transactions constituted by the issue of the invoice and the debiting of the running account were separate transactions then the issue of contingencies became irrelevant. Whilst it is true as Sweeney and Gummow JJ explained in *Hooker Rex Pty Ltd v Commissioner of Taxation* (1988) 79 ALR 181 at 191 that a future outgoing which is 'no more than contingent, pending, threatened or expected' is not incurred the fact, in this case, that it might be possible to say that the running account was not an expenditure which had been incurred did not matter since the taxpayer was not suggesting that it was. The Commissioner's argument impermissibly ignores the separate nature of the transactions. Nor is that separate nature to be glossed over by asking what, as a 'practical matter', the taxpayer was required to do (c.f., *CityLink Melbourne* at 37 [125]). That test no doubt requires a realistic assessment of the nature of any contingency involved but it is not a licence to ignore the legal form of the transactions.
>
> …

> [34] The Tribunal did not find that the issuing of the invoice and the debiting of the running account were a single transaction …

24. We would make the following observations on his Honour's response:

    (1) As to JR [31]: Putting to one side whether it is possible to reconcile the first sentence of TR [22] with the last sentence of TR [22], it is clear to us that the conclusion in the last sentence of TR [22] is inconsistent with the finding in the first sentence; indeed, absent the learned primary judge's *ex post facto* rationalisation at JR [31] of what the Tribunal found at TR [22], the conclusion in the last sentence of TR [22] is wrong, for the reasons given by the primary judge at JR [38] (see [26] below).

    (2) As to JR [32]: The analyses here is totally dependent on the learned primary judge's *ex post facto* rationalisation of what the Tribunal found in fact occurred: that there were two separate transactions – a liability incurred on the issue of the invoice and its discharge as an equivalent amount being debited to the running account.

    (3) As to JR [34]: It is true that the Tribunal did not in words find that the issuing of the invoice and the debiting of the running account was a single transaction, but nor did the Tribunal in words find that each was a separate transaction.

25. The second point pressed by the Commissioner on the appeal from the Tribunal was that accepting, as *CityLink Melbourne* suggests one must, that a contingency as to the timing of a payment does not mean that expenditure has not been incurred, the two contingencies in this case – that the taxpayer was not bound to pay IDTG unless it came into funds to do so and, even then, only if it regarded it prudent to do so – did not bear that character.

26. The learned primary judge's response to this starts at JR [36] and finishes at JR [40]. His Honour relevantly said:

> [38] … It was only at [TR [26]] … that the Tribunal seemed to reach a view on what kind of contingencies were involved, concluding that they were contingencies as to timing. I cannot agree. The contingencies were not theoretical in any way and were not about timing. In a very real sense it was quite possible that the desalinator might not succeed and the running account might never be paid off.
>
> [39] For that reason I am inclined not to accept the correctness of the very last part of the analysis at [TR [26]] …

27. The third point pressed by the Commissioner on the appeal from the Tribunal was that the Tribunal erred in finding at TR [24] that the statement that IDTG would "finance" the R&D work "can only mean that [the taxpayer] has a debt to IDTG for the value of the R&D work invoiced". The submission was that "an undertaking that one party will finance work is not an agreement that the other party will pay the first party the 'financed' amount".

28. The learned primary judge's response at JR [42] and [43] was that resolution of that submission acutely depends on the facts of the particular financing (at JR [42]). At JR [43] his Honour relevantly said:

> Under the agreement which the Tribunal found to exist the taxpayer was immediately bound to pay the invoices and did so by means, in effect, of supplier finance. The submission therefore fails on the facts.

29. His Honour's response undoubtedly reflects what the Tribunal said at TR [24] (see [10] above), but the difficulty with what the Tribunal said at TR [24] is that there is absolutely no evidence that IDTG "financed the work by lending the invoiced amount to [the taxpayer]"; it is common ground that there were no such loans from IDTG to the taxpayer. Indeed, had IDTG lent money to the taxpayer, even subject to the two contingencies as to repayment, and the taxpayer had used the proceeds of such loans to pay the invoices, there would be no doubt that the invoices had been paid and the expenditure incurred.

30. The fact that the taxpayer's balance sheet showed a "proper reflection" of "an inter-company loan" of just over $1 million to IDTG" does not elevate the taxpayer's argument. This was the Commissioner's fourth point pressed on the appeal to the learned primary judge: see JR [44], [45].

CONSIDERATION AND ANALYSIS

Competency of the Commissioner's Appeal from the Tribunal's Decision

31. The taxpayer put in issue, both before the primary judge and before this Court, the competency of the Commissioner's appeal from the Tribunal's decision. A substantial part of the taxpayer's argument before the learned primary judge was devoted to this issue but, as indicated at [8] above, his Honour at JR [46] said:

> In view of the result, it is not necessary for me to deal with the taxpayer's notice of objection as to the competency of the appeal.

32. The arguments put to the primary judge by the taxpayer on this issue were repeated in this Court and need to be addressed.

33. The Commissioner's notice of appeal from the Tribunal dated 19 December 2013 states that the appeal is from the whole of the decision of the Tribunal, on the following questions of law:

> 1. If under a contract payment is conditional on (1) the payer receiving funds from investors, lenders or other sources; and (2) the payer considering it prudent to make the payment, can the payment nonetheless be "incurred" for the purposes of s 73B(14) of the [1936 Act] at the time of entry into the contract?
>
> 2. Does the contract referred to in Question 1 only involve a contingency as to the timing of the payment, or is there a contingency as to whether payment will be made at all?

3. Does a contract for work which states that the service provider will "finance" the work necessarily mean that the other party incurs a debt to the service provider for the value of the work?

4. Does the intercompany loan described in the Minute of 16 July 2007 necessarily lead to the conclusion that there was a loan from IDTG to the Applicant (either in or before the year ended 30 June 2009)?

34. In *Vetter v Lake Macquarie City Council* (2001) 202 CLR 439 at [27] , Gleeson CJ, Gummow and Callinan JJ said:

> In *Hope v Bathurst City Council* [(1980) 144 CLR 1 at 8], Mason J pointed out that when it is necessary to engage in a process of construction of the meaning of a word (or phrase) in a statute a question of law will be involved, but that the question may be a mixed one of fact and law. His Honour's reasons make it clear that a question exclusively of law arises ... if, on the facts found only one conclusion is open [*Hope* (1980) 144 CLR 1 at 9 . See also *Collector of Customs v Agfa-Gevaert Ltd* (1996) 186 CLR 389].

35. If one or more of the "questions of law" set out in [33] above are truly questions of law and one or more of the grounds of appeal engages that question, or those questions, the appeal on that ground or those grounds will be competent: *Belton v General Motors-Holden's Ltd (No 1)* (1984) 58 ALJR 352 at 352, 353 . In our view, on the test as articulated by the plurality in *Vetter* , question 1 clearly involves a question of law, and it is undoubtedly engaged by grounds 1 and 2 of the notice of appeal. These grounds read:

> 1. The Tribunal erred in finding at paragraph 22 that its finding that payment under the contract was conditional on (1) the Respondent receiving funds from investors, lenders or other sources; and (2) the Respondent considering it prudent to make the payment, does not render impossible the proposition that the Respondent was definitively committed to the contract counterparty (**IDTG**) in respect of the R&D expenditure at the time of contracting.
>
> 2. The Tribunal ought to have found that these two conditions in the contract meant that the Applicant was not definitively committed or completely subjected to the outgoing (and therefore the outgoing was not "incurred" for the purposes of s 73B(14) of the ITAA 1936) at the time of contracting, at which time these conditions had not been satisfied.

36. Even if a question of mixed fact and law is not sufficient to enliven the jurisdiction of this Court under s 44(1) of the AAT Act because it is not a pure question of law (see *Birdseye v Australian Securities and Investments Commission* (2003) 76 ALD 321 at [18] per Branson and Stone JJ), we are of the view that question 1 is sufficient to enliven the jurisdiction of this Court either because ground 1 makes question 1 "the subject matter of the appeal itself" (to use the words of Gummow J in *TNT Skypak International (Aust) Pty Ltd v Federal Commissioner of Taxation* (1988) 82 ALR 175 at 178) or because question 1

is a question exclusively of law; as Mason J reasoned in *Hope v The Council of the City of Bathurst* (1980) 144 CLR 1 at 9, on the facts found, only one conclusion is open.

37. It follows, in our view, that the notice of objection to competency cannot be sustained, and the appeal, at least on the ground or grounds that engage question 1, is competent.

38. The reasons set out in [31]–[37] above were written prior to a Full Court of this Court delivering its judgment in *Haritos v Commissioner of Taxation* [2015] FCAFC 92 earlier this week (30 June 2015). Nothing said in that judgment, in particular in the summary of the Court's conclusions in relation to s 44 of the AAT Act at [62] of the Court's reasons would cause or require us to alter our conclusions in [36] and [37] above. On the contrary, especially insofar as the prevailing view is now that "s 44 should not be read as if the words "pure" or "only" qualified 'question of law'", they fortify the conclusions there expressed.

Substantive Issue – Did the Taxpayer Incur the R&D Expenditure?

39. The critical findings of primary fact by the Tribunal are to be found at:

(1) TR [12]:

> During the relevant year, IDTG issued monthly invoices totalling $1,065,625 to DST. Of the total amount invoiced, DST paid $149,964. The balance of $915,661 was debited to an inter-company loan account between IDTG and the taxpayer. To this day the balance has not been paid.

(2) TR [14]: The Service Agreement, in particular what appears under the heading "Terms of Trading":

> IDTG will continue to finance research and development work on behalf of DST. IDTG will render detailed monthly invoices to DST setting out work done and the monthly amount due.
>
> DST will make such reductions in the total amount outstanding as funds received from investors, loan funds received, and any amounts DST may receive from other sources will prudently allow.

(3) TR [15]: The minute of 16 July 2007:

> It was further noted that to simply treat invoices from IDTG as trade creditors would reflect badly to potential investors and lenders as no normal trading terms could be adhered to with any certainty.
>
> It was therefore resolved that any invoice received from IDTG, after verification, be charged to a come and go loan account with that company. The invoices will be treated as fully paid as at the date it is rendered and the payment due to IDTG be more properly treated as a longer term borrowing for financing purposes...

40. The critical findings of secondary fact are those set out in TR [22] to [24] (see [10] above).

41. The difficulty we have with the learned primary judge's approach, namely, that there are two different ways of characterising what occurred and that the preferred way involved two distinct transactions (see JR [21]) – incurring a trade debt and debiting a running account – as against the alternate view that they were all part of the same transaction (see JR [23]) – is twofold:

    (1) First, the Tribunal, in its findings of primary fact, did not refer to what occurred as two transactions or one transaction; that dichotomy is the creation of the learned primary judge; an *ex post facto* rationalisation of the Tribunal's subsequent process of reasoning, first at TR [22]–[24] and subsequently, at TR [25] and [26].

    (2) The learned primary judge's preference for the two distinct transaction characterisation is not supported by the Tribunal's findings of primary fact.

42. In this area, particularly where the learned primary judge had described the Tribunal's approach as "a trifle ambiguous" (see [18] above), "it is not open to the court to second guess the tribunal's factual findings": *Price Street Professional Centre Pty Ltd v Commissioner of Taxation* (2007) 243 ALR 728 at [29] per Kenny J.

43. As to the Tribunal's findings of primary fact, the minute of the meeting of directors of the taxpayer on 16 July 2007 makes it clear that invoices received from IDTG were not to be treated as trade creditors, but each was to be treated as "fully paid as at the date it is rendered" and "charged to a come and go loan account with that company". It is common ground that that "come and go loan account" was subject to the contingencies which the learned primary judge found (JR [38] and [39] – see [26] above), contrary to the finding of the Tribunal (TR [26]), went not to timing of payment but to the very existence of the obligation itself. Nothing in the Service Agreement of 16 May 2010 detracts from this conclusion. Indeed, the extract from the "Terms of Trading" referred to by the Tribunal at TR [14], and reproduced in [39(2)] above, is totally consistent with that conclusion.

44. There was no evidence before, or finding by, the Tribunal that the taxpayer first debited the IDTG invoice to trade creditors and then, as a separate transaction, credited trade creditors and debited an equivalent amount to the "come and go loan account" with IDTG. And that was not done because there was no need for it to be done; the parties treated each invoice "as fully paid as at the date it is rendered", but debited the amount of the invoice directly to the "come and go loan account" with IDTG.

45. No obligation of the taxpayer to IDTG came into existence on the rendering of each invoice because of the contingencies attaching to the come and go loan account to which the amount of the invoice was debited; and if, contrary to that conclusion, some obligation did come into existence, it was so infected by those contingencies that it was not open to the Tribunal to conclude that the taxpayer was definitively committed to the obligation. On either view, the taxpayer did not incur the relevant expenditure in the year of income for the purposes of s 73B(14) of the 1936 Act.

46. So concluded, it is unnecessary to consider whether there is a discharge of some anterior obligation by reason of an assumption of a subsequent obligation, first because there is no anterior obligation and second, if there is, there is no subsequent obligation, because of the contingencies attaching to it, assumed by the taxpayer which discharges the anterior obligation.

47. The appeal on the substantive issue should be allowed. The issue of the administrative penalty, and any further review of that penalty, should, in default of agreement, be remitted to the Tribunal for further review.

I certify that the preceding forty-seven (47) numbered paragraphs are a true copy of the Reasons for Judgment herein of the Court.

Associate:

Dated: 3 July 2015