

1. INTRODUCTION AND CONSULTATION PROCESS.

PURPOSE OF CONSULTATION PAPER

The Commissioner is considering issuing a Taxation Ruling on the operation of section 73CA of the *Income Tax Assessment Act 1936* ('ITAA 1936'). This consultation paper outlines the Commissioner's existing views on the operation of section 73CA, as well as commenting on some areas that have not been covered previously.

The Commissioner seeks your comments on the views outlined in this paper. Comments will be collated and considered in the preparation of the proposed Taxation Ruling.

STATUS OF THIS PAPER

This paper has been prepared for discussion purposes only and is not binding on the Commissioner, except to the extent to which it describes existing publicly available Tax office views.

Where you rely on a statement in a Tax office publication that expressly states that it is not binding, you will be liable for any tax that would otherwise be payable under the law where the statement is incorrect or misleading and you make a mistake as a result. No shortfall penalty will be imposed, however there is no protection against interest charges.

MAKING COMMENTS

The Commissioner is seeking submissions and comments on this paper for consideration prior to the drafting of the proposed Public Ruling.

You should feel free to address any issue raised in this paper, as well as any further issues you consider relevant.

Submissions should be sent by post, facsimile or email to:

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Please note: Closing date for submissions is 25 July 2008

CONFIDENTIALITY

All submissions received will be treated as public documents unless the author of the submission clearly indicates the contrary by marking all or part of the submission as 'confidential' prior to the submission being lodged.

A request made under the *Freedom of Information Act 1982* for access to a submission marked confidential will be determined in accordance with that Act.

2. BACKGROUND TO SECTION 73CA

BACKGROUND TO THE PROVISIONS

Section 73CA was introduced in 1990¹, predominantly, but not solely, to deal with claims made for the research and development ('R&D') tax concession by companies involved in R&D syndication arrangements. Claimant companies entered into syndicated R&D arrangements to endeavour to remove all or most of the commercial risk to investors by guaranteeing a minimum return.

Section 73CA operates to deny the concessional component to deductions based on expenditure related to R&D activities where the claimant company taxpayer is 'not at risk in respect of the whole or a part of the expenditure' (paragraph 73CA(2)(c)). This is based on the policy that the concession is designed to reward taxpayers who are prepared to take on the additional commercial risks normally associated with undertaking R&D activities, and is not intended to be available where such risk is not present.

3. OPERATION OF SECTION 73CA

TERMS AND BASIC SCHEME

Section 73B of the ITAA 1936 has effect subject to sections 73C, 73CA and 73C of the ITAA 1936.²

Under the heading "Guaranteed returns to investors," section 73CA reads as follows:

- (1) For the purposes of interpretation, this section is to be read and construed as if it were part of section 73B.
- (2) Where:
 - (a) an amount or amounts would, but for this section, be allowable as a deduction or deductions under section 73B, 73BA or 73BH, as affected by section 73C to an eligible company in respect of expenditure incurred in a year of income; and
 - (b) that amount or the sum of those amounts exceeds the amount of the expenditure; and
 - (c) the Commissioner is satisfied that, when the expenditure was incurred, the company was not at risk in respect of the whole or a part of the expenditure;

the following provisions of this section have effect.

- (3) If the Commissioner is so satisfied in respect of the whole of the expenditure, the amount, or the sum of the amounts, referred to in paragraph (2)(a) is taken to be reduced by the amount of the excess referred to in paragraph (2)(b).

¹ Inserted by *Taxation Laws Amendment Act 1990*

² For expenditure incurred after 7 September 1989 – subsection 73B(1AA) of the ITAA 1936.

- (4) If the Commissioner is so satisfied in respect of part of the expenditure, the amount, or the sum of the amounts, referred to in paragraph (2)(a) is taken to be reduced by an amount ascertained in accordance with the formula:

$$\text{Excess} \times \frac{\text{Part of expenditure not at risk}}{\text{The amount of the expenditure}}$$

where:

Excess means the amount of the excess referred to in paragraph (2)(b);

Part of expenditure not at risk means the part of the expenditure in respect of which the Commissioner is satisfied that the company was not at risk when the expenditure was incurred.

- (5) For the purposes of the application of this section in relation to any expenditure incurred by a company, the company is taken to have not been at risk at the time when the expenditure was incurred in respect of so much of the expenditure as does not exceed any consideration that, in the opinion of the Commissioner, because of:

- (a) any act that occurred, transaction or agreement that was entered into, or circumstance that existed, before or at that time; or
- (b) any act that was likely to occur, any transaction or agreement that was likely to be entered into, or any circumstance that was likely to exist, after that time;

the company or any associate of the company could reasonably have expected at that time to receive as the direct or indirect result of the incurring of the expenditure.

- (6) In this section:

agreement means any agreement, arrangement, understanding or scheme, whether formal or informal, whether express or implied, and whether or not intended to be enforceable by legal proceedings;

expenditure does not include core technology expenditure.

The provision operates at the time the expenditure on the relevant R&D activities is incurred. The relevant acts, transactions, agreements or circumstances required to be considered under subsection 73CA(5) are those present before or at that time, as well as any 'likely' to come about after that time.

Subsection 73CA(1) provides that section 73CA is to be read and construed as if it were part of section 73B. Section 73B contains the main R & D tax concession provisions, including those setting out the rates of deduction applicable to expenditure of various types.

Subsection 73CA(2) sets out the conditions for section 73CA to apply. These conditions (all of which have to apply) are that –

- Where, but for section 73CA, a deduction or deductions under section 73B (affected by section 73C) would be allowable in respect of expenditure incurred in a year of income (paragraph 73CA(2)(a));
- the amount of the deduction or the total of the amounts of the deductions exceeds the amount of the expenditure (paragraph 73CA(2)(b)); and
- the Commissioner is satisfied that the company was not at risk, when the expenditure was incurred, in respect of all or part of the expenditure (paragraph 73CA(2)(c)).

Section 73C, referred to in paragraph 73CA(2)(a), provides for the treatment of a grant or recoupment, in relation to expenditure on R & D activities. Section 73C may mean that in some cases there is no need to apply section 73CA, as the relevant deduction has already been reduced to only 100% of the expenditure in question.

Subsection 73CA(3) provides that where the Commissioner is satisfied that the whole of the expenditure was not at risk, the amount of the deduction or the total of the amounts of deductions referred to in paragraph 73CA(2)(a) are to be reduced by the excess referred to in paragraph 73CA(2)(b).

Where the Commissioner is satisfied that part of the expenditure was not at risk, subsection 73CA(4) provides that the amount of the deductions, or the sum of the amounts of the deductions, in relation to the expenditure in the year of income (referred to in paragraph 73CA(2)(a)), is to be reduced by reference to the formula -

$$\text{Excess} \times \frac{\text{Part of expenditure not at risk}}{\text{The amount of the expenditure}}$$

In this formula 'excess' is the amount referred to in paragraph 73CA(2)(b) - that is, the deduction (or deductions) minus the associated expenditure - and 'part of expenditure not at risk' means that part which the Commissioner is satisfied was not at risk when the expenditure was incurred.

The effect of the formula is that as the excess of the deduction or sum of the deductions over the amount of expenditure reduces towards zero the part of the expenditure not at risk increases towards 100 per cent of the expenditure.

Subsection 73CA(5) outlines when a company is to be taken not to have been at risk for the purposes of subsection 73CA(2). The Commissioner is required to form an opinion regarding 'any consideration' that the eligible company 'could reasonably have expected' to receive, 'as the direct or indirect result of incurring' the expenditure in question. This consideration could arise from any act that occurred, transaction or agreement entered into or circumstance that existed, before or at the time the expenditure was incurred (paragraph 73CA(5)(a)). Or the consideration could arise from any act that was likely to occur, transaction or agreement likely to be entered into, or circumstance that

was likely to exist, before or at the time the expenditure was incurred (paragraph 73CA(5)(b)).

For the purposes of the section, the term 'agreement' is defined in subsection 73CA(6) to mean 'any agreement, arrangement, understanding or scheme, formal or informal and whether express or implied and whether or not intended to be legally enforceable'.

4. SECTION 73CA NOT RESTRICTED TO SYNDICATION ARRANGEMENTS

Section 73CA is headed 'Guaranteed returns to investors'. Such returns were a feature of certain R&D syndication arrangements at the time the section was introduced into the ITAA 1936. However the terms of the section do not contain any reference to R&D Syndicates, nor any express limitation indicating that it was intended to be applied only to claims for the R&D tax concession involving R&D syndicate arrangements.

The language of section 73CA also indicates that its purpose is not restricted only to syndication arrangements. That purpose is one of denying the benefit of more than 100% deductibility for certain expenditure where there is reasonably expected to be some reduction in the loss from incurring that expenditure. In other words, the section is intended to apply whenever the risk attached to incurring this expenditure is expected to be materially defrayed in some predictable fashion. Examples of such defrayal are where there is reasonably expected to be some reimbursement, recoupment or recompense received as the direct or indirect result of incurring the expenditure in question.

4.1 Explanatory Memorandum

The Explanatory Memorandum to *Taxation Laws Amendment Act 1990*, which introduced section 73CA, acknowledges that the provision was introduced to deal with claims made by R&D Syndicate arrangements but does not limit its application to these arrangements. At page 30 the Explanatory Memorandum states:

These amendments are to apply to all R & D tax concession arrangements and, in particular, to R & D projects being undertaken by syndicates. (emphasis added)

This is further support for the view that section 73CA was intended to apply to situations outside of R&D syndicated arrangements.

The proper interpretation of section 73CA is one in which its words should be given their ordinary meaning, as understood in the light of the context in which

they are used, including the language of the statute as a whole and the purpose of the section³.

The relevant Explanatory Memorandum shows that syndicated R&D arrangements and the type of 'guaranteed returns' existing in them, were no more than examples of the type of broader policy consideration⁴ section 73CA was aimed at addressing.

4.2 IT 2635

The Commissioner's views on the broad application of section 73CA are reflected in Income Tax Ruling IT2635 *Income Tax: Syndicated Research and Development Arrangements* in the following statement in paragraph 17:

Section 73CA is expressed and defined in the widest possible sense and would therefore apply to all arrangements that guarantee minimum returns on R&D activities undertaken.

4.3 ATO ID 2006/68

Consistent with the above, the Commissioner has applied section 73CA to non syndicated arrangements, specifically, to a reimbursement arrangement for R&D expenditure incurred by an eligible company. The effect of this arrangement was that the conclusion was reached that this expenditure was 'not at risk', as outlined in ATO Interpretative Decision ATOID 2006/68.

³ See *CIC Insurance Ltd v. Bankstown Football Club Ltd* (1997) 187 CLR 384 at 408-5; *Project Blue Sky Inc v. Australian Broadcasting Authority* (1998) 194 CLR 355 at 381; and *FC of T v. Linter Textiles Australia Ltd* (2005) 220 CLR 592 at 612

⁴ Note also that in the Second Reading Speech to the Taxation Laws Amendment Bill (No.6) 1989 the relevant Minister said on p.8 in relation to s 73CA:

... The Government considers that the highest rate of deduction should only be applicable where all of an investor's funds are at full risk.

5 MEANING OF WHEN A COMPANY IS NOT 'AT RISK' IN RESPECT OF EXPENDITURE: SUBSECTION 73CA(5)

5.1 The 'reasonable expectation' test

Subsection (5) sets out the circumstances in which the Commissioner is entitled to conclude that the claimant company is 'not at risk' for the purposes of section 73CA. The company is taken to have 'not been at risk' in respect of certain expenditure at the time that expenditure is incurred, to the extent that the expenditure does not exceed any consideration that, in the Commissioner's opinion, the company (or the company's associate) could 'reasonably have expected at that time to receive as the direct or indirect result of the incurring of the expenditure'.

The phrase 'could reasonably have expected' requires more than a possibility. It involves a reasonable prediction as to what will happen if certain expenditure is incurred, in circumstances where it is a precondition for the operation of section 73CA of the ITAA 1936 that expenditure has been incurred. The prediction must be sufficiently reliable for it to be regarded as 'reasonable'.⁵

In reaching a conclusion about whether this reasonable expectation existed, acts, transactions, agreements and circumstances that occurred, were entered into, or existed before the time when the expenditure was incurred; and those likely to occur, be entered into or exist after that time need to be taken into account.⁶

Consequently, it is not necessarily determinative whether or not the benefit in question has actually been received or not. All that is required is that at the time of incurring the expenditure it was reasonable to expect that it would be received for the required reason. Evidence of actual receipt and why this occurred however, will usually go directly to the reliability of the prediction that the benefit would be received in the required fashion, so that, in practice, there will normally be an amount of actual consideration received which will be under examination.

The relevant Explanatory Memorandum states at page 37:

In applying the section, exploitation of the results of R&D activities on normal commercial terms is not intended to indicate that a company was not at risk.⁷

Our view is that this statement refers to circumstances where a company incurs expenditure on R&D activities that are not recouped or reimbursed, and then subsequently exploits the (already tested and proven) results of that R&D and receives proceeds as a result. In such circumstances there will typically be an insufficient nexus between the receipt of those exploitation proceeds and the earlier incurring of the R&D expenditures to conclude that section 73CA is attracted. The statement is not directed at circumstances

⁵ *FC of T v. Peabody* (1994) 181 CLR 359; *A-G's Dept v. Cockcroft* (1986) 10 FCR 180.

⁶ Paragraphs 73CA(5) (a) and (b).

⁷ Explanatory Memorandum to the *Taxation Laws Amendment Act 1990*, Notes on Clause 9.

where the expenditure itself is reasonably expected to be reimbursed, recouped or recompensed to the claimant company as a result of performing the research and development activities in question, regardless of the ultimate commercial exploitation of the results of the expenditure. Such a restriction on the reasonable expectation would tend to defeat the purpose of section 73CA.

The proper construction of the phrase 'at risk', as outlined in subsection 73CA(5), is that a company will not be 'at risk' in respect of research and development expenditure where the relevant underlying expenditure is reasonably expected to be reimbursed, recouped or recompensed to the company in some way connected to the performance of the activities to which the expenditure relates. This situation is typically to be distinguished however, from any subsequent consideration arising from the exploitation of the results of the expenditure on normal commercial terms.

5.2 'consideration' not confined to contract law meaning

'The term 'consideration' is not defined in section 73CA, although the relevant Explanatory Memorandum states:

Consideration" in this subsection will have the same meaning as it has in section 21 of the Principal Act so that, if paid or given otherwise than in cash the money value will be deemed to have been paid or given.⁸

Section 21 of the ITAA 1936 refers only to 'transactions' and states:

Where, upon any transaction, any consideration is paid or given otherwise than in cash, the money value of that consideration shall, for the purposes of this Act, be deemed to have been paid or given.

A 'transaction' is just one of the things in paragraphs 73CA(5)(a) and (b), that the Commissioner is to have regard to in determining what might be the cause of the consideration flowing to the eligible company. The wording of subsection 73CA(5) also refers to an act, agreement (defined to mean 'any agreement, arrangement, understanding or scheme, whether formal or informal, whether express or implied, and whether or not intended to be enforceable by legal proceedings' or circumstance), and hence is much broader than section 21.

The overall context and purpose of section 73CA does not suggest that the term 'consideration', as used in subsection 73CA(5), is limited to its meaning in contract law (i.e. as a promise given or an act done in exchange for an act or promise of another party⁹) The statements made in the Explanatory Memorandum indicate no more than that where the consideration flowed from a transaction and was not cash, the rule in section 21 would apply. Indeed, the reference to 'agreement, arrangement, *understanding... whether or not*

⁸ Explanatory Memorandum to the *Taxation Laws Amendment Act 1990*.

⁹ Refer *Scully v. Federal Commissioner of Taxation* (2000) 201 CLR 148; [2000] HCA 6; (2000) ATC 4111, at paragraphs 21, 25 and 67.


intended to be enforceable' makes it clear that the concept goes beyond the meaning of consideration in contract law.

In the context of section 73CA, we consider that the meaning of 'consideration' is similar to that determined in *Scully v. FC of T*¹⁰, in that it involves the notion of recompense – a payment or benefit that is made to compensate or reimburse the taxpayer or is in satisfaction and discharge of an obligation owed to the taxpayer.

Accordingly, a company will not be 'at risk' in relation to an amount of expenditure, if at the time of incurring the expenditure, it is reasonable to expect that it would receive some payment or benefit by way of compensation, reimbursement, or satisfaction and discharge of an obligation owed to it by another, in relation to incurring that expenditure.

We consider this meaning best fits the purpose of section 73CA, of reducing the extent of the concessional deduction an eligible company would otherwise obtain, in relation to expenditure it has incurred, but which it may recoup, or be reimbursed or recompensed for in some fashion.

5.3 connection between incurring R&D expenditure and the consideration – meaning of 'as the direct or indirect result of'


By using the words 'direct or indirect'  clear that section 73CA is intended to capture not just those situations where an agreement clearly stipulates that a payment or benefit will be made if R&D expenditure is incurred, but also those circumstances where the connection between incurring the relevant expenditure and receiving some payment or benefit as a result of this, is not so clearly marked out.

This is in keeping with the broad range of things the Commissioner is to have regard to in paragraphs 73CA (5) (a) and (b) about what might reasonably be expected as causing the relevant consideration to flow.

The purpose of section 73CA is to restrict entitlement to concessional deductions for expenditure related to R&D activities, where there is a **reasonable expectation that the burden of that expenditure will be reduced or relieved in some reasonably predictable and discernible way.**

We think whether or not this expectation exists can be examined by asking whether the relevant expenditure can reasonably be expected to be a sufficient or material cause of the relevant consideration being receivable.

Alternatively, approaching the issue from the other direction, can this consideration reasonably be expected to be the consequence or effect of incurring the expenditure in question?

Whether such a causal connection is present or not will be dependent on the facts of each case. 

¹⁰ Above, note 2, at paragraphs 21, 25 and 29.

6. REASONABLE EXPECTATION CONCERNING DIFFERENT TYPES OF 'CONSIDERATION'

In IT 2635, paragraph 8 says:

... Arrangements guaranteeing returns can take many forms. These can range from direct reimbursement of R&D expenditure to the more complex forms encountered in R&D syndication arrangements.


Paragraphs 13 to 17 of IT 2635 indicate that 'guaranteeing returns' was used here to be, amongst other things, a reference to different forms of 'consideration' to which section 73CA might apply.

6.1 'consideration' under various commercial contracts

We consider that section 73CA may apply to various forms of commercial contracts concerning the performance of R&D activities. For example, it would seem reasonably uncontroversial that where an eligible company performs R&D activities for a fee which is not conditional on the outcomes or results achieved from those activities, it can be concluded that there is a reasonable expectation that the incurring of expenditure in the performance of these activities will be a sufficient or material cause of why this fee is receivable.

More controversial are those commercial contract situations where either:

- (a) the contract is argued not to be for the performance of services, but rather for the production of a 'result', such as a product or good. In such cases it has also been argued that any associated R&D activities are undertaken at the company's own cost, and no amount of consideration flows to the company as result of incurring any expenditure on these activities; or
- (b) even if the contract includes a component concerning the performance of services which align with the conduct of activities for which registration as 'research and development activities' is sought, the commercial and/or scientific or engineering risk of successfully performing these services is said to render section 73CA inapplicable.

We consider that the application of section 73CA depends on the facts, and that there may be commercial contract situations of the type described in (a) and (b) above, where it is reasonable for the company to expect to receive consideration as the direct or indirect result of incurring expenditure in relation to R&D activities associated with the performance of the contract. 

This is so notwithstanding the fact that the contract might be predominantly for the production of a product or good, and notwithstanding the possibility that

failure to perform the contract might mean an absence of consideration flowing to the company.

Conversely, we acknowledge that not every commercial contract where there is associated expenditure on R&D activities will attract section 73CA. Much will turn on why these R&D activities are carried out, and the relationship between them and the obligations of the company under the contract. For example, the need for the R&D activities may be entirely unanticipated at the time the contract is entered into (and no variation clause applies, or there is no ability to renegotiate the contract), and the performance of these activities is sufficiently unrelated to the performance of the contract, that it cannot be concluded that the company could reasonably expect to receive consideration under the contract as the direct or even the indirect result of incurring this expenditure.

6.2 Insurance proceeds, guarantees and warranties

Consistently with IT 2635, paragraph 8, we consider it also conceivable that section 73CA may have application to consideration in the form of insurance proceeds, or guarantees or warranty payments. This will be where, as with the commercial contract situations already referred to, the relevant connection exists between the incurring of the expenditure in relation to the R&D activities in question and the reasonably expected receipt of this form of consideration.

For example, rectification or repair in relation to an insured event may involve the conduct of R&D activities by an eligible company, the expenditure on which then becomes fully reimbursable under the company's insurance policy. We consider there is no reason in principle why, if the company seeks to claim this expenditure by way of a concessional deduction, that section 73CA ought not to apply.

6.3 Grants or recoupments

Similarly, where an eligible company is expected to receive a grant or recoupment, say, from an industry body for example, we consider it appropriate to examine whether or not that expectation is connected in the way described above, with the incurring of expenditure on R&D activities, such that section 73CA may apply.

Your feedback

We are interested in hearing your views on the proper construction of section 73CA and the fact situations to which it should and should not apply. However, this is not the first and final round of consultation. We propose releasing a draft public ruling for broader public comment, once we have examined the results of this first round of consultation.