IT 2671 - Income tax: research and development expenses claimed against royalty income of non-residents

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TAXATION RULING IT 2671

INCOME TAX: RESEARCH AND DEVELOPMENT EXPENSES CLAIMED AGAINST ROYALTY INCOME OF NON-RESIDENTS

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Reference no.:	Subject refs:	Legislative refs:
I 1013086	ROYALTIES	51(1)
	- NON-RESIDENTS	73A
	- RESEARCH AND DEVELOPMENT	73B
	EXPENSES	124K
		124Z

OTHER RULINGS ON THIS TOPIC:

PREAMBLE

The purpose of this Ruling is to set out the Commissioner's views on the deductibility of research and development expenses incurred by non-residents who are in receipt of Australian sourced royalties.

2. Royalties derived by non-residents from sources in Australia are included in the assessable income of the non-resident under subsection 25(1) or paragraph 26(f) of the Income Tax Assessment Act 1936. The income is assessed by normal assessment procedures and such deductions as are available under the Act may be taken into account in determining the taxable income. This Ruling examines the deductibility of claims for research and development expenditure under subsection 51(1), section 73A, section 73B and Division 10B of Part III.

3. For purposes of this Ruling, the words 'research and development' are used in the sense of systematic, investigative or experimental activities that involve innovation or technical risk and are carried on for the purpose of either acquiring new knowledge (whether or not that knowledge will have specific practical application), or of creating new or improved materials, products, devices, processes or services (cf. the definition of 'research and development activities' in section 73B). Moreover, in discussing research and development activities, this Ruling is not restricted to activities carried on in Australia.

4. Expenditure on research and development is taken for the purposes of this Ruling to mean all expenses directly related to the research and development activities and includes

salaries of personnel performing the activities (See Taxation Ruling IT 2442, paragraphs 3 to 35).

SUMMARY

5. In brief, this Ruling concludes that expenditure on research and development incurred by non-residents in receipt of Australian sourced royalties will generally not be allowable as a deduction under subsection 51(1). A deduction may be available under section 73A for expenditure incurred in Australia on scientific research or for ex-Australian expenditure to the extent that it relates to a business carried on by the non-resident in Australia. Deductions will not be available to non-residents under section 73B. Deductions may be allowable under Division 10B where the research and development expenditure forms part of the capital cost of inventing, creating or purchasing a unit of industrial property used for the purpose of producing assessable income.

RULING

Subsection 51(1)

6. There are a number of questions that need to be considered in determining whether a deduction is allowable under subsection 51(1) in respect of research and development expenditure, viz:

. Is research and development expenditure deductible under the positive limbs of the subsection?

. Is the research and development expenditure incurred in producing assessable, as distinct from exempt, income?

. Is the research and development expenditure of a capital nature and hence not deductible?

Is Research and Development Expenditure Deductible Under the Positive Limbs of Subsection 51(1)?

7. To come within the positive limbs, it must be shown that the expenditure is of a business or income producing character and is relevant and incidental to the gaining or producing of assessable income, or the carrying on of a business for that purpose.

8. Most research and development activities are conducted for the purpose of developing new or improved products, processes etc for use in the taxpayer's income producing activities, and expenditure on such research and development will generally have a business character. However, where the research and development activities are directed towards the acquisition of knowledge that does not have specific application to the activities by which the taxpayer earns assessable income, the activities may not be relevant and incidental to the taxpayer's business or income producing activities. For example, where the research and development

concerns something which is 'conceptually distinct' from the activities by which assessable income is earned (such as the development of a spectrometer by a taxpayer carrying on an airconditioning business), no deduction will be available under subsection 51(1): Case V141 88 ATC 880. This will of course depend on the factual circumstances of each case.

Is the Research and Development Expenditure Incurred in Producing Assessable Income?

9. The expenditure must be incurred in the production of assessable income of the taxpayer. A non-resident of Australia is assessable only on income derived from sources in Australia, or deemed to be derived from sources in Australia. Income derived from other countries is exempt and does not form part of the non-resident's assessable income. It follows that expenditure by non-residents on research and development that is directed towards activities which give rise to income from sources other than Australia is not incurred in deriving assessable income and is therefore not allowable as a deduction under subsection 51(1). Thus, research and development expenditure on products or processes which are not used in Australia, and which will not be used for the derivation of income in Australia, is not deductible. Where expenditure which is otherwise deductible is incurred on research and development of products, processes and so on which may be used both here and abroad for the derivation of income, the amount is apportionable. To determine whether the expenditure is otherwise deductible one has to decide whether it is of a revenue or a capital nature.

Is the Research and Development Expenditure of a Capital Nature and Hence not Deductible?

10. Expenditure which comes within the positive limbs of subsection 51(1) may nevertheless not be allowable as a deduction if the expense is of a capital nature.

11. Courts have traditionally sought to answer the question of whether expenditure is of a revenue or of a capital nature by considering whether the expenditure relates to the process by which assessable income is earned or whether it relates to the profit-yielding structure; Sun Newspapers Ltd & Associated Newspapers Ltd v. FCT (1938) 61 CLR 337.

12. The products, processes or know-how which give rise to the royalty income are assets of a business or income-producing activity and form part of the profit-yielding structure.
It follows that research and development expenditure directed towards creating such assets from which royalties may be earned also relates to the profit-yielding structure, rather than to the process by which assessable income is earned. Whether or not the research is successful in creating a new or improved product, the expenditure is clearly made with a view to bringing into existence an asset or advantage that will give an enduring benefit (cf Vallambrosa Rubber Co Ltd v.

Farmer (1910) 5 TC 529 per Viscount Cave LC at 192). In an era of rapidly advancing technology, it may be that the product or process sought to be developed has only a very limited commercial life. However, by 'enduring' it is not meant that the asset or advantage should last forever; it is a matter of degree : Herring v. FCT (1946) 72 CLR 543 per Rich J at 547. Expenditure on research and development of this nature is therefore considered to be of a capital nature and not deductible under subsection 51(1) against royalty income.

13. The decision in Goodman Fielder Wattie Ltd v. FCT 91 ATC 4438; (1991) 22 ATR 26 requires comment. That case concerned research and development expenses incurred by a pharmaceutical company in the development of products for sale, and, in these circumstances, Hill J took the view that the expenditure could be seen as part of the regular cost of the company's trading operations and not of a capital nature. His Honour did, however, say at p.4450 of 91 ATC that:

'Research and development may, in a particular case, be directed towards obtaining patentable rights which can be seen as of an enduring kind and may, for that reason, be of a capital nature.'

Where research and development expenditure is directed towards the creation of assets from which royalties may be obtained, the expenses are considered to be akin to expenditure within this latter category described by Hill J and would generally be of a capital nature.

14. Support for this view can be found in Hallstroms Pty Ltd v. FCT (1946) 72 CLR 634. The case involved the deductibility of legal expenses incurred by the taxpayer in opposing the extension of a patent originally obtained by Electrolux Pty Ltd in respect of refrigerators designed to run on electricity or gas. The taxpayer's product ran on kerosene. Dixon J, with whom McTiernan J agreed, thought that the expenditure was of a capital nature.

15. The majority, Latham CJ, Starke and Williams JJ, thought that the expenditure was of a revenue nature. Latham CJ took the view that, since the patent rights had expired, the patent rights were open to the public, and hence the case did not involve a payment for the acquisition of a right. He went on to say that a right enjoyed in common with all persons is not a capital asset of any single person. In his view the taxpayer company 'gained nothing - it merely succeeded in maintaining an existing position.' He did not see the prevention of a loss as tantamount to a gain. He added at p. 641:

'The prevention of subtraction is not the same thing as addition. Occasional legal proceedings are incidental to many businesses. They may result in the acquisition of a new right as, for example, where a person successfully applies for and obtains a patent. But expenditure in defence of a right enjoyed in common with all of His Majesty's subjects is not expenditure incurred in obtaining anything.'

Clearly his Honour saw the fact that the taxpayer did not acquire any right as significant. A similar view was taken by Williams J. If a right had been obtained the clear inference is that the majority would have held the expenditure to be of a capital nature.

16. It was on the question of the significance of the fact that the taxpayer did not acquire any right that the minority differed from the views of Latham CJ and Williams J. Dixon J said at p. 648:

'It is, of course, true that if the acquisition of a proprietary right had been the purpose, as for example the acquisition of the patent, had it been extended, or a licence thereunder, there could have been no question that the cost of acquisition was a capital expenditure: Desoutter Bros, Ltd v. Hanger [1936] 1 All ER 535.'

Later he said:

'The reason why the purchase of an asset such as the patent, if extended, would have been so clearly a matter of capital is, I think, only because of the greater ease with which its character and purpose are recognisable, its duration can be measured and its value estimated.

'Once there is a clear appreciation of the actual place in the business of the company which the existence, expected termination and threatened extension of the patent took, then I think the difference between, on the one hand, gaining or preserving a freedom to use the invention as of common right and, on the other hand, acquiring the exclusive right of user which the extended patent would have conferred ceases to be significant in deciding whether the expenditure belonged to capital or revenue. What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.'

His Honour saw the possibility of the patent being extended as a threat to the total restructuring of the taxpayer's business.

17. It is the view of this Office that it makes no material difference, when considering deductibility of expenditure against royalty income, whether a patent or copyright is acquired by purchase or by research and development. From a practical and business point of view, it is considered that the expenditure is calculated to make new or improved products or processes available to the business, with the attendant

hope of new markets or increased market share and, as a general rule, ought to be seen as going to the profit yielding structure and being on capital account.

18. There will be cases where research and development activities are aimed at developing new applications of an existing product or process. In fact many new discoveries are made in this way. If the end result is a new (albeit derivative) product or process that can be protected by patent or copyright laws, then a new income producing asset has been created and the expenditure, in the view of this Office, ought to be seen as being of a capital nature.

Section 73A

19. Section 73A allows a deduction for certain amounts that are not deductible under any other section of the Act and that have been incurred by a taxpayer carrying on a business for the purpose of gaining or producing assessable income. Such amounts include payments to approved research institutes for scientific research related to the taxpayer's business and expenditure of a capital nature on scientific research related to the taxpayer's business. Where plant is used solely for the purpose of scientific research a deemed rate of depreciation of 33 1/3% may apply. 'Scientific research' is defined in subsection 73A(6) as meaning any activities in the fields of natural or applied science for the extension of knowledge. Thus, most research and development activities of a scientific nature in relation to products or processes not yet in production or use will fall within the meaning of scientific research for purposes of this section.

20. Taxpayers who incur qualifying expenditure in Australia on scientific research related to that business are entitled to a deduction under section 73A in respect of such amounts.

21. Where expenditure is incurred or payments are made outside Australia, and the taxpayer's business is carried on partly in and partly out of Australia, subsection 73A(3) provides that only such part of the amount as the Commissioner considers reasonable is allowable as a deduction. In the context, it seems clear that a judgment has to be made as to the proportion that can fairly be regarded as applicable to the business activities carried on in Australia for the purpose of gaining or producing assessable income.

22. Where the taxpayer does not carry on business in Australia and the expenditure is incurred or the payments are made outside Australia, no deduction will be allowed. Thus, in the case of ex-Australian expenses, the taxpayer must show that the business, or at least a part of the business to which the research and development activities relate, is carried on in Australia. In this regard, the mere receipt of Australian sourced royalties is not of itself considered to amount to the carrying on of a business in Australia unless the royalties are paid in respect of knowledge, information, rights or property effectively connected with a permanent establishment

of the taxpayer.

23. Where a business is being carried on partly in Australia and partly overseas, ex-Australian payments and expenditure which are otherwise allowable under this section will be apportioned. The apportionment will depend on the degree to which the scientific research relates to the Australian business as compared with business carried on worldwide. It would be relevant in making such an apportionment to have regard to the scope and nature of the business operations in each country and the relevance of the research and development to those operations, and the potential use that might be made of any discoveries in each country, including the size of the potential market in each country for any new product or process. Only expenditure on scientific research which relates to the business carried on in Australia will be deductible to a non-resident. Expenditure on research relating to products or processes that will not be used for the derivation of assessable income in a business carried on in Australia will not be allowable as a deduction.

24. On the other hand, where a business is being carried on in Australia and the research relates to a product which will be used solely in Australia in the course of that business, e.g., for the purpose of deriving royalties through licensing the technology developed, then the whole of the expenditure may be allowable as a deduction.

Section 73B

25. A number of concessions in respect of expenditure on research and development activities carried on in Australia or in an external Territory are available under section 73B. The provisions are intended to ensure that Australia obtains a proper return on revenue-subsidised research and development, so the company claiming the deduction must be registered with the Industry Research and Development Board. The Board is empowered to cause the loss of tax benefits where the research and development activities do not have an adequate Australian content or where the results of revenue-subsidised research and development are exploited otherwise than on normal commercial terms and to the benefit of the Australian economy.

26. Deductions under section 73B are available to 'eligible companies', public trading trusts and partnerships of 'eligible companies' or of 'eligible companies' and Registered Research Agencies. The term 'eligible company' is defined in subsection 73B(1) to mean 'a body corporate incorporated under a law of the Commonwealth or of a State or Territory'.

Division 10B

27. Research and development expenditure may be deductible under Division 10B of Part III (sections 124L to 124Z) where the expenditure forms part of the capital cost of inventing, creating or purchasing a unit of industrial property, i.e. an Australian patent, copyright or registered design or an

equivalent right under a foreign law. These provisions allow the "owner" of the unit of industrial property (i.e. the inventor or creator or his assignee, or the purchaser or other person acquiring the property) to amortise the capital cost of the unit over its effective life.

28. The annual deduction allowable is calculated by dividing the unrecouped capital cost of the unit by the number of years of the effective life remaining (section 124M). Under the provisions of section 124U, the effective life of the unit is treated as commencing at the beginning of the first year that the owner of the unit first uses it for the purpose of producing assessable income, and ending in the year in which the right expires or, where the right is purchased for a specified term, the year in which that term expires. In the case of copyright, the right is deemed to have a maximum effective life of 25 years.

29. Where a right wholly or partially lapses, or is disposed of in whole or in part, a balancing adjustment is required to be made. The grant of an interest by way of licence amounts to a disposition of part of a unit of industrial property (section 124V), so that the consideration receivable from the grant of such licence must be brought to account as a balancing adjustment.

30. Section 124Z empowers the Commissioner to reduce the deduction otherwise allowable under the Division where the invention, work etc to which the patent, copyright or registered design relates is also used for the taxpayer's benefit outside Australia. For example, if a patented invention is used for the purposes of a business carried on by the non-resident both in Australia and in another country, the deduction will be reduced to reflect the use of the right otherwise than in the production of assessable income.

COMMISSIONER OF TAXATION
12 March 1992