



ATO Interpretative Decision

ATO ID 2004/871

Income Tax

Research and Development: clawback (section 73C) for grants and recouped expenditure and the Pharmaceutical Industry Investment Program

FOI status: may be released

Status of this decision: Decision Current

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Issue

Must a company apply the 'clawback' provisions of section 73C of the Income Tax Assessment Act 1936 (ITAA 1936) to all or part of the payments received under the Pharmaceutical Industry Investment Program (PIIP)?

Decision

Yes. The clawback provisions of section 73C of the ITAA 1936 apply to the research and development (R&D) component of PIIP payments received, as the requirements of subsection 73C(2) are satisfied.

Facts

The taxpayer is an 'eligible company', as defined in subsection 73B(1) of the ITAA 1936, and was selected to participate in the PIIP.

The PIIP was introduced by the Commonwealth to encourage a sustainable pharmaceutical industry in Australia, increase research and development and production value added activity in relation to the Australian pharmaceutical industry and compensate, in part, the pharmaceutical industry for the impact on the activities of the industry by the Commonwealth exercising its monopsony purchasing power under the Pharmaceutical Benefits Scheme (PBS). The Commonwealth did so by paying higher prices on nominated products supplied by the participating companies in return for those companies agreeing to:

- undertake 'eligible production value added (PVA) and/or eligible R&D activity', and
-

meet 'broad activity commitments' (including those activities which contribute to eligible PVA and/or eligible R&D activity and targets).

A company's 'annual entitlement' in relation to the PIIP, is the maximum amount that the Commonwealth will pay the company in a financial year. In the relevant income year, the R&D component of the taxpayer's 'annual entitlement' was calculated as follows:

$$20\% * (\text{Eligible R\&D Activity Target} - \text{Base for R\&D})$$

Targets in relation to 'eligible R&D activity' refer to the agreed value of 'eligible R&D activity' to be undertaken by the company and the commitments of the company in relation to 'eligible R&D activity' in the relevant year. The taxpayer's agreed value of 'eligible R&D activity' linked back to targets provided to the Commonwealth by the taxpayer in its application for entry into the PIIP, which were comprised of forecasted expenditure in relation to certain identified research and development projects.

The taxpayer incurred expenditure on 'eligible R&D activity' forming particular projects carried on by it in the relevant income year, and reported this information to the Commonwealth in Quarterly and Annual Monitoring Reports.

The definition of 'eligible R&D activity' for the purposes of the PIIP is very similar to the definition of 'research and development activities' in subsection 73B(1) of the ITAA 1936. As a consequence, expenditure on 'eligible R&D activity' incurred by the taxpayer for the purposes of PIIP was also 'relevant expenditure' for the purposes of section 73C of the ITAA 1936 in the relevant income year.

The taxpayer elected to receive PIIP payments as notional price increases and therefore, payments were directly paid to the taxpayer from the Commonwealth on a quarterly basis. These payments were easily divisible into separate components for R&D and PVA. The taxpayer was not entitled to receive these amounts in any earlier income year than the year those payments were received.

The R&D component of the PIIP was calculated by reference to the actual expenditure on 'eligible R&D activity', up to the limit of the company's 'annual entitlement'.

Reasons for Decision

Subsection 73C(2) of the ITAA 1936 determines whether 'clawback' applies, as provided for under the relevant other provisions in section 73C of that Act. The subsection provides that clawback will apply if an 'eligible company' that has incurred 'relevant expenditure' (on or after 1 July 1985), has received or become entitled to receive a 'recoupment of, or grant in respect of' all or part of that relevant expenditure, from certain sources, including the Commonwealth. 'Relevant expenditure' refers to expenditure on 'research and development activities' that formed or form part of a particular project carried on by or on behalf of the company (paragraph 73C(2)(a) of the ITAA 1936).

The taxpayer is an eligible company that incurred relevant expenditure on or after 1 July 1985. The entity also received PIIP payments in the relevant income year from the Commonwealth. The issue to be decided is therefore whether the PIIP payments were a 'recoupment of, or grant in respect of' that relevant expenditure.

'recoupment of...'

The meaning of the term 'recoupment' was considered in *Dampier Mining Co Ltd v. FC of T* 78 ATC 4237; (1978) 8 ATR 835, in relation to former Division 10AAA of the ITAA 1936. In determining that the company was 'entitled to a recoupment' in respect of expenditure concerned, Jenkinson J stated:

I think that recoupment connotes restoration of what has been expended without countervailing detriment to him who incurred the expenditure.

In the present issue, the Commonwealth, was aware that the taxpayer intended to incur expenditure on 'eligible R&D activity' relating to identified projects (which formed R&D activity targets), as provided in the taxpayer's application for entry into the PIIP.

The Commonwealth was notified that the taxpayer incurred expenditure on 'eligible R&D activity' in Quarterly and Annual Monitoring Reports in relation to identified projects and determined the extent of PIIP payments in part by reference to that expenditure. As such, the payments were made to partly reimburse the taxpayer for that

expenditure and were a 'recoupment of that expenditure. To the extent that this expenditure was also relevant expenditure under subsection 73C(2) of the ITAA 1936, there was a recoupment of that 'relevant expenditure' for the purposes of the subsection in the relevant income year.

'grant in respect of...'

'Grant' is not defined in the ITAA 1936, and the meaning of 'grant' found in section 73C of the ITAA 1936 has not been considered judicially. *Osborne's Concise Law Dictionary* (8th edition) defines grant as:

The allocation of rights, money etc by the Crown or Parliament to particular persons or for particular purposes.

In the relevant income year, PIIP payments were made by the Commonwealth Government (or crown) as a form of financial assistance, to encourage a sustainable pharmaceutical industry in Australia. These payments were made for certain purposes, including compensating, in part, the pharmaceutical industry for the impact of the PBS and to increase R&D and PVA activity in the Australian pharmaceutical industry. Hence, PIIP payments received by the taxpayer, in the relevant income year, were a 'grant' for the purposes of section 73C of the ITAA 1936.

The meaning of 'in respect of' has not been considered in the context of section 73C of the ITAA 1936. However, a number of judicial decisions have considered the meaning of the phrase in relation to other areas of the law.

In *FC of T v. Scully* 2000 ATC 4111; (2000) 43 ATR 718, consideration of the words 'in respect of' highlighted the importance of the context in which the phrase appears and resulted in the requirement that there be some 'discernible rational link' between the two subject matters. *J & G Knowles & Associates Pty Ltd v. Federal Commissioner of Taxation* (2000) 96 FCR 402; 2000 ATC 4151; (2000) 44 ATR 22 also supported this interpretation, stating that 'in respect of' requires 'a nexus, some discernible and rational link', which is sufficient for the purposes of the particular legislation.

In the context of the present issue, the incurrance of the relevant expenditure therefore must be a sufficient and material reason for the payment of the grant or recoupment.

The Commonwealth was aware that the taxpayer intended to incur expenditure on 'eligible R&D activity' relating to identified projects (which formed R&D activity targets), as specified in the taxpayer's application for entry into the PIIP and agreed to make payments to the taxpayer which were dependent on the level of its intended and actual expenditure. Further, the actual payment had an identifiable, separate component, calculated by reference to the actual expenditure on 'eligible R&D activity'. To the extent that this 'eligible R&D activity' expenditure was also relevant expenditure, a material link between the PIIP payments for R&D and the relevant expenditure existed in the income year in question. That portion of the PIIP payments relating to this relevant expenditure was 'in respect of' that relevant expenditure for the purposes of subsection 73C(2) of the ITAA 1936.

Therefore, subsection 73C(2) of the ITAA 1936 is satisfied, and the clawback provisions of section 73C of the ITAA 1936, apply to the R&D PIIP payments received by the taxpayer.

Date of decision: 30 September 2004

Year of income: Year ended 30 June 2000

Legislative References:

Income Tax Assessment Act 1936
section 73C
subsection 73C(2)
paragraph 73C(2)(a)
subsection 73B(1)

Case References:

Dampier Mining Co Ltd v. FC of T
78 ATC 4237
8 ATR 835

FC of T v. Scully
2000 ATC 4111
43 ATR 718

J & G Knowles & Associates Pty Ltd v. Federal Commissioner of Taxation

(2000) 96 FCR 402

2000 ATC 4151

(2000) 44 ATR 22

Related ATO Interpretative Decisions

ATO ID 2004/568

Other References

Osborne's Concise Law Dictionary (8th edition)

Keywords

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