




## ATO Interpretative Decision

ATO ID 2008/115

### Income Tax

### Eligibility for Tax Offset: R&D tax offset and exempt entity ownership exception

FOI status: may be released

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## Issue

Does the exception in subsection 73J(2) of the *Income Tax Assessment Act 1936* (ITAA 1936) apply, to prevent an eligible company choosing the tax offset under section 73I of the ITAA 1936, where the less than 25% exempt entity ownership requirement may not be breached if actual and potential future interests are taken into account?

## Decision

Yes. The exception in subsection 73J(2) of the ITAA 1936 applies if the interests actually owned, by an entity or entities referred to in the subsection, carry at least 25% of the voting power in the eligible company or the right to receive at least 25% of a distribution of income or capital by the eligible company. It does not matter that the less than 25% requirement may not be breached if both actual and potential future interests are taken account of.

## Facts

Company A is an eligible company which undertakes research and development (R&D) activities in Australia. All the conditions for Company A to be able to claim the R&D tax offset in section 73I of the ITAA 1936 are satisfied, other than the exception in subsection 73J(2) of the ITAA 1936.

For the 'tax offset year' in question (refer subsection 73I(1) of the ITAA 1936), Company B (an affiliate of an exempt entity for the purposes of subsection 73J(2) of the ITAA 1936), legally owns shares in Company A. These shares carry 27% of the voting power in Company A and the right to receive that same percentage of a distribution of income or capital by Company A.

Company A has issued to Company B and other entities, a number of convertible notes in Company A. These other entities are neither exempt entities nor affiliates of any exempt entity. The convertible notes give the holders the right to acquire shares in Company A in certain circumstances, but they do not carry any voting rights in Company A or rights to a distribution of income or capital by Company A. Both the existing shares and any

shares to be acquired on conversion of the notes, are, or will be, 'interests' in Company A for the purposes of subsection 73J(2) of the ITAA 1936.

If a certain number of the convertible notes held by entities other than Company B are converted into shares, the voting power and the right to distributions of income or capital owned by Company B will fall below the 25% condition in subsection 73J(2) of the ITAA 1936.

## Reasons for Decision

Subsection 73J(2) of the ITAA 1936 prevents an eligible company from choosing the tax offset, instead of a deduction, under section 73I of the ITAA 1936, if an exempt entity, the affiliates of an exempt entity, an exempt entity together with its affiliates, or two or more exempt entities, at any time during the tax offset year, legally or beneficially own, or have the right to acquire, the legal or beneficial ownership of:

interests in the company that carry between them the right to exercise or control the exercise of, at least 25% of the voting power in the company; or

interests in the company that carry between them the right to receive at least 25% of any distribution of income or capital by the company.

In the case in question an affiliate of an exempt entity, Company B, legally owns shares in the eligible company, Company A, which carry the rights described in subsection 73J(2) of the ITAA 1936. However, Company A has also issued convertible notes carrying the right to acquire shares in it to Company B and other entities. If Company B's present interests and its possible acquisition of interests in the future in Company A are taken together, they may not carry between them at least 25% of the voting power in the company or the right to receive at least 25% of any distribution of income or capital by Company A. This is on the presumption that the other holders of the convertible notes convert them into shares and so dilute the shareholding of Company B below the 25% limit.

The question of whether subsection 73J(2) of the ITAA 1936 applies in such a case requires an examination of the purpose and context of the provision.

Subsection 73J(2) of the ITAA 1936 applies where the relevant affiliate 'legally or beneficially owns', or 'has the right to acquire', the relevant interests. The provision therefore has two limbs, which represent two alternatives. The first limb looks at present interests in the eligible company while the second limb is concerned with the possible acquisition of interests in the future. If the relevant affiliate has interests which fall within the first limb of the exception, it will not be necessary to consider the second limb. Conversely, if the first limb is not satisfied, the second limb of the subsection may still apply, to prevent the eligible company from choosing the R&D tax offset.

This interpretation supports the purpose of the provision, which is to prevent an eligible company from being able to choose the tax offset if an exempt entity, or affiliate of an exempt entity, legally or beneficially own interests in the company of the prescribed type, or legally or beneficially owns rights to acquire such interests. An alternative interpretation is that in subsection 73J(2) of the ITAA 1936, the word 'or', as used the second time in the expression, 'legally or beneficially own or have the right to acquire', means 'or, as well' (see for example, *Minister for Immigration and Ethnic Affairs v. Baker* (1997) 73 FCR 187 at 194-5). For present purposes it is not necessary to decide this point as it does not affect the decision.

The R&D tax offset is intended to provide a tax concession to eligible small companies, by enabling them to 'cash out' their otherwise deductible R&D expenditure (refer to paragraphs 5.4 and 5.5 of the Explanatory Memorandum to the Taxation Laws Amendment (Research and Development) Bill 2001).

However, some of these small companies may be owned by exempt entities, such as universities or other tax exempt research bodies, and/or their affiliates. These entities not only receive the benefit of being tax exempt, but may also receive other forms of government support. The purpose of subsection 73J(2) of the ITAA 1936 is to prevent such exempt entities from benefiting from ownership of an eligible company which might otherwise be able to claim the R&D tax offset.

An alternative view of subsection 73J(2) of the ITAA 1936 is that when deciding whether it applies it is necessary to take account of both the interests actually held in the eligible company and those which might be acquired in the future. Testing of whether the less than 25% requirement is met then takes place in relation to the sum of both types of interests.

This view is not accepted. The preferred construction of subsection 73J(2) of the ITAA 1936 is one that supports

the purpose of the exception and does not allow that purpose to be defeated by granting rights to non exempt persons which might never be exercised.

In this case there is an affiliate of an exempt entity which actually owns interests in the eligible company which come within the first limb of the exception. It is not necessary to consider the operation of the second limb. As the first limb is satisfied, subsection 73J(2) of the ITAA 1936 applies to prevent Company A from choosing the tax offset under section 73I of the ITAA 1936.

**Date of decision:** 5 August 2008

**Year of income:** Year ended 30 June 2007

**Legislative References:**

*Income Tax Assessment Act 1936*

section 73I

subsection 73J(2)

**Case References:**

*Minister for Immigration and Ethnic Affairs v. Baker*

(1997) 73 FCR 187

153 ALR 463

**Related ATO Interpretative Decisions**

ATO ID 2003/660

ATO ID 2003/895

ATO ID 2005/23

**Other References**

Explanatory Memorandum to the Taxation Laws Amendment (Research and Development) Bill 2001

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