




ATO Interpretative Decision

ATO ID 2013/11

Income Tax

Research and Development - tax incentive - combination of exempt entities

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Issue

Will Item 2 of the table in subsection 355-100(1) of the *Income Tax Assessment Act 1997* (ITAA 1997) apply to a company when two or more exempt entities who are not affiliates, together beneficially own interests in the company carrying more than 50% of the voting rights or rights to a distribution of income or capital?

Decision

Yes. Item 2 of the table in subsection 355-100(1) of the ITAA 1997 will apply to the company where two or more exempt entities, irrespective of their relationship, beneficially own interests in the company carrying more than 50% of the voting rights or rights to a distribution of income or capital.

Facts

The shareholders of the company include a number of tax exempt entities.

Individually, no single tax exempt entity holds more than a 50% shareholding.

Together, the total shareholdings of the tax exempt entities exceed 50%.

The shares carry with them voting rights and rights to distributions of income or capital.

The company incurs research and development expenditure during the income year and claims the tax offset under section 355-100 of the ITAA 1997.

Reasons for Decision

Generally, where an R&D entity has engaged in registered R&D activities, subsection 355-100(1) of the ITAA 1997

allows the entity to claim an R&D tax offset at one of two specified rates. Which rate is applicable depends on certain circumstances as detailed in the table in subsection 355-100(1). One of the circumstances in the table in subsection 355-100(1) is Item 2, which applies when:

an *exempt entity, or combination of exempt entities, would control the *R&D entity in a way described in section 328-125 (connected entities) if:

- (a) references in section 328-125 to 40% were references to 50%; and
- (b) subsection 328-125(6) were ignored.

Note that subsection 328-125(1) provides that an entity is 'connected with' another entity if either entity controls the other entity in a way described in section 328-125 - or both entities are controlled in that way by the same third entity (see paragraph 8 of Taxation Determination TD 2006/68).

Subsection 328-125(2) then sets out how an entity controls another entity 'in a way described in section 328-125', in providing that:

An entity (the **first entity**) controls another entity if the first entity, its *affiliates, or the first entity together with its affiliates:

...

- (b) if the other entity is a company - beneficially own, or have the right to acquire the beneficial ownership of, *equity interests in the company that carry between them the right to exercise, or control the exercise of, a percentage (the **control percentage**) that is at least 40% of the voting power in the company.

Broadly, a company will be controlled by another entity within the meaning of section 328-125, if that other entity, its affiliates, or that other entity together with its affiliates, beneficially own, or have the right to beneficially own shares in the company which carry the right to at least 40% of:

- any distribution of income by the company; or
- any distribution of capital by the company; or
- the voting power in the company.

Under section 328-125, a shareholder of a company will be aggregated with another shareholder if it is an 'affiliate' of the other shareholder. The meaning of 'affiliate' is provided by section 328-130. The aggregation of shareholdings in 328-125 therefore depends on a certain relationship between the shareholders. Multiple shareholders will be included in the test as long as there is one identified shareholder to which each of the other shareholders have the required relationship.

A shareholder of a company will not be included in the section 328-125 control test if it is not an affiliate of another requisite shareholder.

Item 2 in the table in subsection 355-100(1) adopts the control test in section 328-125 with some modifications. Firstly the threshold is increased to 50% (up from 40%). Secondly the requirement for control by an exempt entity is extended to include control by a 'combination of exempt entities'.

Combination of Exempt Entities

'Combination of exempt entities' is not defined in the ITAA 1997.

The High Court stated (per Hayne, Heydon, Crennan and Kiefel JJ) in *Alcan (NT) Alumina Pty Ltd v. Commissioner of Territory Revenue* (NT) (2009) 239 CLR 27; 2009 ATC 20-134 at 47:

"...the task of statutory construction must begin with a consideration of the text itself. Historical considerations and extrinsic materials cannot be relied on to displace the clear meaning of the text. The language which has actually been employed in the text of legislation is the surest guide to legislative intention. The meaning of the text may require consideration of the context, which includes the general purpose and policy of a provision, in particular the mischief it is seeking to remedy."

In consideration of the text itself, *The Concise Oxford Dictionary*, 1987, rev. 7th edn, Oxford University Press, Melbourne, defines 'combination' as a:

"...combined state (in combination with); combined set of things or personsgroup of things chosen from a larger number without regard to their arrangement..."

The Macquarie Dictionary (1997) defines 'combination' to mean '1. the act of combining. 2. the state of being combined. 3. a number of things combined.' 'Combine' is defined in *The Macquarie Dictionary* (1997) to include 'to bring or join into a close union or whole; unite; associate; coalesce.'

Webster's Third New International Dictionary gives the meaning of 'combination' as:

"the result or product of combining: a union or aggregate made of combining one thing with another."

In *Gunn v. Canada* (F.C.A.), 2006 FCA 281, [2007] 3 F.C.R. 57 it was stated that:

"a combination ... in ordinary language implies an addition or aggregation."

These definitions make no reference to a relationship between the things combined and so suggest 'combination' should be interpreted as a singular state. A strict reading of the text using these definitions indicates that, once a set of entities are combined, further enquiry into the existence of any relationship is not required.

Indeed, in the US antitrust decisions of *Gates v. Hooper* (1897) 90 Tex. 563 [39 S.W. 1079]; *Hitchcock v. Anthony* (6th Cir. 1897) 83 Fed. 779; *Padgitt v. Lone Star Gas Co.*, 213 S.W.2d 133, (Tex.Civ.App. 1948); and State of California ex rel. *Van de Kamp v. Texaco, Inc.* (1988) 46 Cal. 3d 1147 [252 Cal. Rptr. 221, 762 P.2d 385]; the courts held that (in this particular context), the word 'combination' applied only to entities that combined in the sense of uniting or associating their otherwise independent, separate and competing status. 'It is aimed at combinations between parties who, having each a separate business with no interest or concern in that of the other, join together to restrict the output or enhance the prices of goods'; *Hitchcock v. Anthony* (6th Cir. 1897) 83 Fed. 779. See also *State v. Fairbanks-Morse & Co.*, 246 S.W.2d 647, 658-59 (Tex.Civ.App.--Dallas 1952; and *Hood v. Tenneco Texas Life Insurance Co.*, 739 F.2d 1012, 1019 (5th Cir. 1984).

Furthermore, if Parliament had intended the words 'a combination of exempt entities' to require an exempt entity to be an affiliate of another exempt entity in order for the two to be combined, that objective would have been achieved by section 328-125 without the inclusion of those words in Item 2 of the table in subsection 355-100(1). Parliament's inclusion of the words 'a combination of exempt entities' supports the view that there was intent for those words to have an effect and serve a purpose. Given the definition and interpretation of the words used, this supports the view that Parliament did not intend for there to be a requirement as to a relationship between combined exempt entities.

In adopting the control test 'in a way described in section 328-125 (connected entities)', Item 2 of the table in subsection 355-100(1) does not require that the (at least) 50% control threshold must be satisfied only by a combination of 'connected' exempt entities. Therefore, exempt entities that are not affiliates of each other are collectively capable of being 'a combination of exempt entities' under subsection 355-100(1) of the ITAA 1997.

The combined shareholdings of the company by the exempt entities exceed 50%. These shareholdings carry the right to more than 50% of the voting power in the company and also the right to receive a percentage of at least 50% of any distribution of income or capital.

Accordingly, Item 2 of the table in subsection 355-100(1) of the ITAA 1997 will apply to the company.

Date of decision: 31 October 2012

Year of income: Year ended 30 June 2012

Legislative References:

Income Tax Assessment Act 1997

section 328-125

section 328-130

subsection 355-100(1)

Case References:

Alcan (NT) Alumina Pty Ltd v. Commissioner of Territory Revenue (NT)

[2009] HCA 41

(2009) 239 CLR 27

2009 ATC 20-134

73 ATR 256

Gates v. Hooper

(1897) 90 Tex 563 [39 SW 1079]

Gunn v. Canada (FCA)

2006 FCA 281

[2007] 3 FCR 57

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(6th Cir 1897) 83 Fed 779

Hood v. Tenneco Texas Life Insurance Co

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Padgitt v. Lone Star Gas Co

213 SW2d 133 (TexCivApp 1948)

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(1988) 46 Cal 3d 1147 [252 Cal Rptr 221, 762 P2d 385]

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State of California ex rel Van de Kamp v. Texaco, Inc

(1988) 46 Cal 3d 1147 [252 Cal Rptr 221, 762 P2d 385]

Related Public Rulings (including Determinations)

TD 2006/68

Related ATO Interpretative Decisions

ATO ID 2010/145

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Keywords

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