

R&D tax incentive: quarterly credits

Exposure Draft Consultation Guide
April 2013

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CONSULTATION PROCESS

Request for feedback and comments

The Australian Government seeks your feedback and comments on the proposals outlined in this consultation paper.

All information (including names and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in - confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

Closing date for submissions: 10 May 2013

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FOREWORD

We are very pleased to release exposure draft legislation and explanatory materials on the Australian Government's proposed arrangements for implementing quarterly credits under the Research & Development (R&D) tax incentive. The draft legislation has been developed in light of feedback on the consultation paper that we released in August 2012.

The purpose of this guide is to provide the community with a plain-English overview of the design of the quarterly credits system reflected in the draft legislation and how aspects of this design are similar or different to what was set out in the consultation paper.

R&D quarterly credits will be an opt-in element of the R&D tax incentive available to eligible companies with aggregated turnover of less than \$20 million. It will allow these companies to access their benefits sooner, improving their cash flow and incentives to invest in R&D, while minimising additional compliance obligations for companies.

The R&D tax incentive is a key element of the Government's support for Australia's innovation system. In conjunction with other programs, including those launched in the \$1 billion Industry and Innovation Statement, *A Plan for Australian Jobs*, the Incentive helps small and medium sized companies to grow, creating further business opportunities and jobs for the future.

The Australian Government wants to encourage more companies to undertake more R&D — this is good for business and good for the economy. *A Plan for Australian Jobs* sets out the Government's vision and strategic framework for driving business growth and creating new high-skilled jobs.



The Hon David Bradbury MP
Assistant Treasurer
Minister Assisting for Deregulation



The Hon Greg Combet AM MP
Minister for Climate Change, Industry and Innovation

1. BACKGROUND

The Australian Government provides the R&D tax incentive to encourage industry to conduct R&D activities that might not otherwise occur because the benefits 'spill over' to the rest of the community and the return to the individual company is uncertain.

Under the R&D tax incentive, eligible companies are entitled to an R&D tax offset for expenditure on eligible R&D activities. For eligible companies with an aggregated turnover under \$20 million, this is a 45 per cent refundable tax offset.

On 15 June 2011, the Government announced its intention to introduce quarterly credits for companies entitled to the R&D refundable tax offset.

On 3 August 2012, the Government released a consultation paper outlining the proposed design of the quarterly credits system. Twenty one submissions were received in response to the consultation paper. The majority of submissions viewed the proposed receipt of the R&D refundable tax offset through quarterly credits as positive. Submissions raised some issues around policy design and delivery.

Feedback on the consultation paper has been valuable in further development of the quarterly credits system. Changes have been made to improve and streamline the application process. The proposed draft legislation aims to minimise the administrative burden on taxpayers and maintain the integrity of the tax system.

This paper outlines some of the mechanisms the proposed legislation will employ to deliver the quarterly credits system. It discusses key features of the design and key views put forward by stakeholders. This paper is intended to guide readers through the draft legislation, which is now available for public comment. Submissions are requested by 10 May 2013.

2. POLICY SUMMARY

The purpose of R&D quarterly credits is to allow eligible companies to anticipate the R&D refundable tax offset for the current income year on a quarterly basis. R&D quarterly credits will be a new, important part of the R&D tax incentive for small and medium businesses.

The R&D refundable tax offset is normally provided annually as part of a company's income tax assessment. Providing a quarterly credit in advance of that process will improve company cash flow and enhance incentives to invest in R&D.

R&D quarterly credits will be an opt-in element of the R&D tax incentive available to eligible companies with an annual aggregated turnover of less than \$20 million. Quarterly credits will be accessible for each quarter commencing on or after 1 January 2014.

An end-of-year process will then reconcile a company's expected income tax position with its actual income tax position. The annual end-of-year registration and claiming process for the R&D refundable tax offset has not changed and will still need to be completed by companies.

The legislation employs a more generalised approach that sets up a framework for quarterly credits. This has been done to minimise the need for re-writing provisions should the government decide to utilise the provisions for another refundable tax offset. However, there are no current plans to do so.

3. POLICY DESIGN

3.1 ADMINISTERING QUARTERLY CREDITS

3.1.1 Policy design in the draft legislation

The ATO and Innovation Australia (through AusIndustry) will be responsible for the administration of quarterly credits. This is consistent with the administration of the R&D tax incentive.

A company must opt-in

Quarterly credits is an opt-in system. That is, a company has a choice whether or not to apply to participate.

Eligibility requirements need to be met in order to opt-in to the quarterly credits system (see 3.2 Access to quarterly credits). Companies self-assess their eligibility under quarterly credits, consistent with the existing approach to the R&D tax incentive.

The company must advise the Commissioner of Taxation (the Commissioner) of its intention to receive quarterly credits. This should be done before the 15th day after the end of the quarter in which it would like to receive the first payment.

Exposure draft legislation	Section 48-5 Section 48-15
Explanatory memorandum	Paragraphs 1.47-1.53 notification of intention to enter the system Paragraph 1.127 self-assessment to enter system

3.1.2 Changes since the consultation paper

A streamlined application process

The consultation paper indicated that a company would need to separately notify Innovation Australia and the ATO of their intention to participate in the quarterly credits system.

Submissions indicated that the administrative burden on companies for quarterly credits could be minimised and that the application process should facilitate timely payments. To make these improvements the application process for quarterly credits has been streamlined. Under the proposed quarterly credits system, companies will apply to the ATO only. There will be no requirement to submit a separate application to Innovation Australia for quarterly credits.

Information sharing between the ATO and Innovation Australia will ensure that both administrators can perform their administrative functions. Consequently, the draft legislation includes amendments

that provide clarity about the powers for information to be shared between the ATO and Innovation Australia.

The annual registration and claiming process has not been changed. Companies will still need to register annually with Innovation Australia. This ensures that appropriate risk management and compliance activities can still occur as part of the end of year process.

Exposure draft legislation	Item 47
Explanatory memorandum	Paragraphs 1.128 information sharing powers

Timeliness

The consultation paper did not provide specific timeframes around all matters relating to the administration of quarterly credits. Submissions requested that these timeframes be included in the draft legislation. Timeframes have been included in the draft legislation to remove uncertainty around how the system will operate.

Timeliness and the role of Innovation Australia

Submissions in response to the consultation paper commented on the importance of clear processes to facilitate timely payments of quarterly credits to companies. Transparency about administrative processes is also important for companies.

The draft legislation includes amendments to ensure that Innovation Australia has appropriate powers and responsibilities in relation to eligibility of R&D activities so that the quarterly credits system can operate effectively. This includes the ability of Innovation Australia to:

- (i) initiate a finding about activities before registration; and
- (ii) request information from companies.

If a company does not provide the requested information, or Innovation Australia is justified in refusing to make a finding, this will affect its eligibility for quarterly credits.

Exposure draft legislation	Item 28
Explanatory memorandum	Paragraph 1.126 role of Innovation Australia

Guidance material from ATO and AusIndustry

Submissions requested that the ATO and AusIndustry provide clear, concise, and easily obtainable explanatory materials to encourage companies to opt into the quarterly credits system. The ATO and AusIndustry plan to issue guidance material before quarterly credits takes effect.

3.2 ACCESSING QUARTERLY CREDITS

3.2.1 Policy design in the draft legislation

There are three eligibility tests for participation in the quarterly credits system. As quarterly credits are provided as an advance payment, eligibility tests are required to ensure that the integrity of the

tax system is upheld. Having appropriate eligibility tests means that the compliance burden for companies to participate in the system is less than it otherwise would need to be.

A company that does not meet the requirements to access quarterly credits will retain its normal entitlement to register for and claim the R&D refundable tax offset through its end-of-year income tax return.

Reasonable receipt test

To opt-in to the quarterly credits system a company must reasonably expect to receive the R&D refundable tax offset.

This means a company expects to:

- be an R&D entity;
- have aggregated annual turnover of less than \$20 million;
- not be controlled by an exempt entity; and
- undertake eligible R&D activities.

A company that does not expect to receive the R&D refundable tax offset will generate a debt that will need to be repaid. Quarterly credits are not intended for such companies. This test aims to minimise the instance of this occurring.

Exposure draft legislation	Section 48-105
Explanatory memorandum	Paragraphs 1.20-1.25 reasonable receipt test

Complying taxpayer test

As quarterly credits are payments in advance of a company's annual income tax return lodgement, such payments should only be open to companies that have complied with its taxation and lodgement obligations.

The complying taxpayer test requires a company to comply with its obligations under:

- taxation laws; and
- for the R&D tax incentive, Part III of the *Industry Research and Development Act 1986*.

This test applies to the income year in which it receives quarterly credits and over the previous five years. The compliance histories of affiliated and connected entities are considered when applying the complying taxpayer test.

The draft legislation allows a company to apply to the Commissioner to be excused from compliance breaches that would otherwise result in a failure of the complying taxpayer test. This allows the Commissioner the flexibility to overlook minor breaches where the breach does not indicate the likelihood of future non-compliance, or infractions by related companies do not bear on the suitability of the main entity to participate in the quarterly credits system.

Exposure draft legislation	Section 48-110 Section 48-115 & 48-120 exemption
Explanatory memorandum	Paragraphs 1.26-1.42 complying tax payer test

History test

In order to meet the history test, a company must have been entitled to, and have claimed, the new R&D tax incentive in at least one of the last 5 income years. The history test will be met regardless of whether the R&D tax offset received was refundable or non-refundable.

Applying a history test will assist in maintaining the integrity of the tax system by, for example, reducing the risks that may arise through the activities of phoenix companies. Having a history with the R&D tax incentive will also increase the likelihood that companies have a clear understanding of the definition of eligible R&D activities.

Exposure draft legislation	Section 48-100
Explanatory memorandum	Paragraphs 1.44-1.46 history test

3.2.2 Changes since the consultation paper

The history test has not been extended

The three tests outlined above are the same as those detailed in the consultation paper.

Submissions in response to the consultation paper expressed the view that the history rule would unfairly exclude start-up companies that, in the early stages of operation, could not have established a history under the R&D tax incentive. The draft legislation does not provide an exemption for start-up companies from the history test, ensuring that the risk of non-compliance is managed. Altering the history test to provide an exemption for start-up companies would require the compliance burden for businesses to be increased to levels that are considered impractical.

It is important to note that start-up companies may be eligible for the R&D refundable tax offset received at the end of the year, just not on a quarterly basis. When such a company has established at least one year of R&D tax incentive history, it can opt-in to quarterly credits (providing all other eligibility tests are met).

Submissions also noted that the history test should be expanded so that having a history under the previous R&D tax concession in one of the last five income years qualifies a company for quarterly credits. The draft legislation does not expand the requirements to include the R&D tax concession. From previous patterns of R&D registration, very few companies are likely to be affected by not including the R&D tax concession. In addition, including the R&D tax concession would add additional complexity to the design without significant benefit.

3.3 QUARTERLY CREDIT AMOUNT

3.3.1 Policy design in the draft legislation

The standard amount

To ensure quarterly credits are available in a timely way, and to minimise additional compliance obligations, the Commissioner will advise a company of a ‘standard amount’¹. This amount is calculated on the basis of the latest year for which a company’s income tax has been assessed.

Using the standard amount provides a safe harbour that protects a company from any liability for the general interest charge (GIC) if the amount paid under quarterly credits exceeded what it was actually entitled to. The standard amount limits the liability to repaying the excess amount at the end of the year.

If a company chooses to receive the standard amount for each quarter in the income year following its entry into the quarterly credits system, then no further action is required in order for it to receive quarterly credits until the end of year reconciliation.

For a net refund company, the standard amount for each quarter will be that net refund amount attributable to the R&D refundable tax offset, divided by four.

For a tax payable company (for the most recent income year), the standard amount will be zero.

The standard amount will be paid on the 28th day after the end of the quarter in which it has applied to receive quarterly credits (except for a quarter ending in December, in which case it will be paid on 28 February). If a more recent tax assessment becomes available, the Commissioner will notify a company of a new standard amount. The new amount will apply to the current and future quarters for that year.

Exposure draft legislation	Section 48-205
Explanatory memorandum	Paragraphs 1.54-1.55 overview of amounts Paragraphs 1.56-1.60 the standard amount

Variation of the quarterly credit amount

A company also has the ability to vary the standard amount so that it better anticipates its expected refund of the R&D refundable tax offset for that income year. It is therefore possible for a company that had been tax payable in a previous year to receive quarterly credits for the current year despite the Commissioner having advised a zero standard amount.

If a company wishes to vary the standard amount then it will have to notify the Commissioner. A company can notify the Commissioner as late as 14 days after the quarter has ended.

If a company chooses to vary, it is required to specify the varied amounts for the remaining quarters and will continue to receive the varied amounts for the rest of the income year unless it notifies the Commissioner otherwise. It is possible for a company to vary further in future quarters in the income

1 In the consultation paper, this amount was known as the ‘safe harbour’ amount.

year that it is eligible for quarterly credits. However, there are no 'catch-up' payments for missed quarters throughout an income year.

The Commissioner can disallow a variation that, having regard to the likely end of year tax outcome, would be excessive. However, if this does eventuate, the standard amount or previous variation will still be paid.

Exposure draft legislation	Section 48-210 choosing a varied amount Section 48-220 notification of wish to vary amount Section 48-215 for disallowing variations
Exposure draft legislation	Paragraphs 1.60-1.66 varied amounts Paragraphs 1.67-1.75 disallowing a varied amount Paragraphs 1.84-1.86 paying negative varied amounts

3.3.2 Changes since the consultation paper

Number of interactions reduced

The consultation paper noted that a company would have to notify the Commissioner quarterly if it wished to receive the standard amount or a varied amount. The draft legislation only requires a company to notify the Commissioner in the first quarter in which it applies to enter into quarterly credits and subsequently, only if it wishes to vary during the income year. This removes unnecessary interactions and reduces the burden on companies.

Timely payments

The consultation paper noted that a company was required to apply to enter quarterly credits, or apply to vary a quarterly credit amount by the 28th day after the end of the quarter (except for a quarter ending in December, in which case it will be paid on 28 February). Submissions were concerned that this may result in the delayed payment of quarterly credits which might mitigate the benefit of receiving them.

In the draft legislation, the deadline to apply or vary has been changed to the 14th day after the end of the quarter so that the quarterly credit amount can be paid by the 28th day after the end of the quarter. This will help to ensure that companies receive timely payments of quarterly credits.

If payment is not paid by the 28th day after the end of the quarter, the Commissioner is required to pay interest on late payments. The due date for payment may change if the Commissioner or Innovation Australia request the company to provide information in relation to its participation in quarterly credits.

Exposure draft legislation	Section 48-225
Explanatory memorandum	Paragraphs 1.76-1.79 payment date Paragraphs 1.80-1.83 interest on late credit payments

Continuation of payments if under review

Submissions commented that if a company was under review, and that such a review resulted in the halting of quarterly credit payments, this would disadvantage that company if the finding was

positive. Consequently, the draft legislation provides that if the ATO does not make a payment to a company by the date specified in the legislation, then the ATO will be required to compensate that company through interest payable.

Varying to a nil or negative quarterly credit amount

The draft legislation makes it clear that a varied quarterly credit amount can be nil or a negative amount. This means that if a company's circumstances change and it now expects a smaller refund that year than previously anticipated, it can reduce its exposure to penalties. For example, if a company wishes to pay back some of the quarterly credit amounts it has received, it can request to vary to a negative quarterly credit amount.

Allowing negative payments will enable entities to reduce their exposure to GIC in the event they receive excessive quarterly credits in a quarter. Additionally, it will reduce the potential for a company to be in a repayment position come the end-of-year reconciliation process.

Exposure draft legislation	Section 48-210
Explanatory memorandum	Paragraphs 1.84-1.86 vary to nil or negative amounts

3.4 END-OF-YEAR RECONCILIATION

3.4.1 Policy design in the draft legislation

The quarterly credits system provides payments in anticipation of a company's refund of the R&D refundable tax offset for the current income year. An end-of-year process is required to reconcile a company's anticipated income tax position with its actual income tax position.

Entitlement to quarterly credits does not replace the normal process for claiming the R&D refundable tax offset. A company must still register its R&D activities with Innovation Australia and claim its R&D refundable tax offset in its income tax return. Failure to register and claim the R&D refundable tax offset will result in a requirement to repay any quarterly credits claimed and may result in penalties.

The company income tax return will also incorporate a reconciliation process for quarterly credits. Quarterly credit amounts paid to a company in respect of the income year will be debited against its income tax assessment to determine whether it has an amount due or refundable.

Repayment of excess quarterly credit payments

Where a company (for whatever reason) is paid a total amount of quarterly credits that exceeds the refund of the R&D refundable tax offsets, it will be required to repay any excess quarterly credits received. These payments will be due on the same day as any amount payable as a result of a company's income tax assessment for that year.

Exposure draft legislation	Section 48-230 quarterly credit amounts payable Section 48-300 reconciliation Section 48-305 repaying excess quarterly credits Section 48-355 calculation of reconciled amount for the variation quarter
Explanatory memorandum	Paragraphs 1.87-1.90

GIC payable on excessive varied amounts

GIC applies where a company has varied upwards its quarterly credit for a quarter and the amount received is excessive. It does not matter if the total credits for the year are not too high; it only matters if the credits are excessive for that quarter. A variation will be considered excessive where the total of the amounts that should have been received up to and including the quarter is less than 85 per cent of what a company did receive. In simple terms, the amount that a company should have received for the quarter will be the greater of the standard amount that would have applied for the quarter or 25 per cent of their actual end-of-year entitlement.

In general, the GIC is payable for the period from the time the credit for the quarter was paid until the next time a credit amount is paid for a quarter in the year (or until the time the year's assessment is made if the entity has withdrawn from the system for all later quarters).

However, if a company seeks to alter the variation from the previous quarter by varying down significantly the next quarter, the GIC will only apply to the quarter in which it varied up too much. On the other hand, if a company varies downwards from the standard amount, that company will not incur GIC because it did not vary down enough.

The Commissioner may remit the GIC in the case of special circumstances.

Exposure draft legislation	Section 48-350 GIC liability on varied amounts Section 48-355 Section 48-360
Explanatory memorandum	Paragraphs 1.91-1.101 GIC payable (examples included)

3.4.2 Changes since the consultation paper

GIC payable

The consultation paper stated that, where a company has over-estimated its total quarterly credits for the year, the GIC would not apply to the excess quarterly credits paid if the excess was repaid on time. However, a variation penalty might apply if there was a sufficiently large margin between the total amount of quarterly credits paid and the refund of the tax offset. No further details were provided in the consultation paper. Stakeholders requested further detail on the penalty and interest arrangements that might apply to over-estimated variations and/or for overpayments.

The draft legislation operates on an annual reconciliation process, for integrity reasons and to reduce the administrative burden on companies. As a result, the draft legislation states that the GIC will apply to excessive quarterly payments (that have been varied from the standard amount) from the point of payment until a company varies down far enough so as to mitigate the over-payment or until the end of year assessment date. The GIC does not apply to standard amounts.

Remission of the GIC in special circumstances

The consultation paper did not specify whether or not the GIC might be waived in special circumstances. This was a key point of feedback in submissions. Consequently, in the draft legislation the Commissioner is able to partially or wholly remit the GIC through an application of special circumstances. The Commissioner has published guidelines on the exercise of this remission power.

Making variations and penalties balanced and workable

In the consultation paper (as in the draft legislation), the standard amount is calculated on the previous year's tax assessment. Submissions indicated that this may result in an underestimation of the amount of R&D refund that a company will undertake in the current income year but that the application of the GIC will act as a deterrent in the uptake of the variation option.

In response to these concerns, the draft legislation recognises that a company's circumstances can change during the year and that companies should have mechanisms to make appropriate adjustments and lessen their exposure to GIC. This includes the option for companies to vary their quarterly credit amount to a negative amount, so they can repay excess amounts before the end of the year. In this situation the GIC would only apply in respect of the quarters in which that company varied too high and will not continue until the date of assessment. Additionally, if a company's quarterly credits have been 'too low', the system allows a company to vary up in later quarters to account for this.

Catch up payments

The consultation paper stated that a company could enter into the quarterly credits system at any point in an income year and that it could access quarterly credits for the remaining quarters. The standard amount would still be calculated as if there were four quarterly payments being made for the income year, that is, there is no 'catch up' of the standard amount for quarters prior to when a company entered the quarterly credits system. This is still the case in the draft legislation.

The draft legislation clarifies that there is no catch up for missed quarters when a company seeks to vary its quarterly credit amount. Allowing variations to catch up for quarters when a company was not participating in the quarterly credits system would add complexity to the system. In addition, it will not always be certain that an entity was eligible to participate in quarterly credits in respect of the earlier quarters.

3.5 ENDING PARTICIPATION

3.5.1 Policy design in the draft legislation

It will sometimes be appropriate for a company's participation in quarterly credits to be ended. A company's circumstances can change during the year and could affect its decision to participate in quarterly credits or eligibility for quarterly credits. A company is able to end its participation by withdrawing from quarterly credits. If needed, the Commissioner is also able to end a company's participation in some circumstances.

Notification to ATO of intention to withdraw participation

A company that is participating in quarterly credits can voluntarily withdraw from participation at any time during the year (or up to 14 days after the end of the income year). Once a company withdraws it will not receive quarterly credits for any future quarters in that income year.

If a company wishes to re-enter quarterly credits during that same income year, it will need to submit another application to participate. If a company withdraws for previous quarters and has received payments for those quarters, it will need to repay those amounts.

If a company fails one of the eligibility tests it must withdraw from quarterly credits for the affected quarters. This will usually mean a company has to withdraw for all quarters because the complying taxpayer test and the history test relate to the whole year. There are penalties for not withdrawing within 28 days of failing a test.

Exposure draft legislation	Section 48-400 notifying to withdraw Section 48-420 repayment for quarters withdrawn Section 48-425 recovering excess payments made on leaving the system
Explanatory memorandum	Paragraphs 1.102-1.1047 withdrawing from the system Paragraphs 1.108-1.112 penalty for not withdrawing Paragraphs 1.119-1.121 recovering excess payments made on leaving the system

Removal from quarterly credits for failure to qualify

A company can be removed from the quarterly credits system by the Commissioner if it fails one of the three eligibility tests (and has not yet withdrawn from quarterly credits) or if it does not lodge its income tax return for the year on time. If a company's participation is revoked by the Commissioner, it will need to repay quarterly credit amounts for the relevant quarters.

Exposure draft legislation	Section 48-405 for test failure Section 48-410 revoking participation in the case of default event
Explanatory memorandum	Paragraphs 1.113-1.118 removal for failure to qualify

3.5.2 Changes since the consultation paper

The matter of ending participation was not covered by the consultation paper or in submissions.

3.6 OTHER ISSUES

3.6.1 Consolidated groups

The consultation paper stated that consolidated groups with aggregated annual turnover of less than \$20 million will be able to access quarterly credits with modifications to address particular risks, for example, the risks associated with entry and exit of subsidiaries. The draft legislation does not address this and further consideration will be given to the relevant issues when finalising the

legislation. Issues for quarterly credits include: (i) application of the history test when an R&D performing entity leaves or joins a consolidated group and (ii) the appropriate calculation of a standard amount in such circumstances.

3.6.2 Other legislative amendments

The draft legislation includes a technical amendment to ensure that the R&D tax incentive operates as intended. This amendment clarifies that companies who are controlled by an exempt entity at any time during the income year are only entitled to the 40 per cent non-refundable tax offset. The amendment will provide clarity for administrators and for companies on the application of the rules for access to R&D tax offsets by companies that are part owned by tax exempt entities (such as universities).

Further technical amendments have also been made to ensure the efficient operation of the R&D quarterly credits scheme, including for example the order in which refundable tax offsets are to be applied and additions to the Dictionary to the ITAA 1997.

Exposure draft legislation	Items 32-37
Explanatory memorandum	1.161 — 1.164 Consequential Amendments