



TR 2021/5 - Income tax: research and development tax offsets - the 'at risk' rule

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Taxation Ruling

Income tax: research and development tax offsets – the ‘at risk’ rule

❶ Relying on this Ruling

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

If this Ruling applies to you, and you correctly rely on it, we will apply the law to you in the way set out in this Ruling. That is, you will not pay any more tax or penalties or interest in respect of the matters covered by this Ruling.

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What this Ruling is about

1. This Ruling is about provisions in the research and development (R&D) regime that prevent an R&D entity¹ (you) from notionally deducting expenditure that is not 'at risk'.
2. In particular, this Ruling considers the tests for determining whether your expenditure is 'at risk' under section 355-405 of the ITAA 1997² (the 'at risk' rule). It will provide certainty to taxpayers about whether the 'at risk' rule is satisfied; for instance, where R&D activities are carried out in the context of commercial contracts for the supply of products or services.
3. This Ruling does not consider other exclusions or conditions relating to notional deductions for expenditure on R&D activity.³ Therefore, a statement in this Ruling that the 'at risk' rule applies or does not apply does not imply that the expenditure would otherwise be notionally deductible under Division 355.

Ruling

The 'at risk' rule

4. Expenditure can be claimed for the R&D tax offset only when you can notionally deduct it under Division 355.⁴ The 'at risk' rule compares consideration with R&D expenditure and may deny or reduce the expenditure you can claim for the R&D tax offset. Expenditure that is not notionally deductible under Division 355 may otherwise be deductible or depreciable outside of Division 355.
5. The amount of consideration relevant to any denial or reduction in notional deduction is worked out as at the time you incurred the expenditure. It is the consideration that you, or an associate of yours, received or could reasonably be expected to receive⁵:
 - as a direct or indirect result of expenditure being incurred (the nexus to expenditure test), and
 - regardless of the results of the activities on which you incur the expenditure (the regardless of results test).
6. The 'at risk' rule applies to that 'part' of the consideration that meets the nexus to expenditure test and the regardless of results test. The 'at risk' rule does not require the total consideration to satisfy the nexus to expenditure test and the regardless of results test. We consider each test in further detail in paragraphs 23 to 37 of this Ruling, with examples.
7. The notional deduction is denied in full where the amount of consideration is equal to or greater than the expenditure.⁶ Where the amount of consideration is less than the expenditure, the notional deduction is reduced by that amount.⁷

¹ Section 355-35 of the *Income Tax Assessment Act 1997* (ITAA 1997).

² All legislative references in this Ruling are to the ITAA 1997, unless otherwise specified.

³ Including but not limited to whether or not the activity is an eligible R&D activity within the meaning of section 355-20, or whether the conditions for the R&D activities in section 355-210 are met.

⁴ Sections 355-100, 355-205 and 355-480.

⁵ Section 355-405.

⁶ Subsection 355-405(1).

⁷ Subsection 355-405(2).

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8. The 'at risk' rule applies when you incur the expenditure that you seek to notionally deduct.⁸ If you incur expenditure at different points in time for the same R&D activity, you must apply the 'at risk' rule at each of those points in time.

9. When considering the application of the 'at risk' rule at the time you incur the expenditure, regard is to be had to anything that happened or existed before or at that time, and anything that is likely to happen or exist after that time.⁹

10. The 'at risk' rule does not apply to expenditure incurred on R&D activities covered by either paragraphs 355-210(1)(b) or (c), which deal with R&D activities conducted by a permanent establishment for other parts of a body corporate, and R&D activities conducted for foreign residents that are connected or affiliated with you.¹⁰

Consideration

11. The term 'consideration' in the context of Division 355 is not legislatively defined. It is a technical term in the law of contract, but whether the term is used in a technical or non-technical sense in Division 355 depends upon the statutory context.¹¹ Where words in an Act have acquired a legal meaning prior to enactment, it is presumed the legislature intends them to have that meaning, unless a contrary intention appears from the context.¹²

Legal meanings of consideration

12. The term 'consideration' has various legal meanings, including meanings in contract law, conveyancing and revenue statutes.¹³ For example, in *Chevron*, Robertson J held that the meaning of 'consideration' in the context of the transfer pricing provisions in Division 13 of Part III of the *Income Tax Assessment Act 1936* was not limited to the contract law meaning.¹⁴

13. While there exists a statutory definition of 'consideration' in the ITAA 1997¹⁵, that definition is in the specific context of consideration 'for a taxable supply' and has the same meaning as that in the *A New Tax System (Goods and Services Tax) Act 1999*. That definition is not determinative of the meaning of 'consideration' for all income tax purposes.

14. In *Bogiatto*, Thawley J interpreted the meaning of 'consideration' within paragraph 290-60(1)(b) of Schedule 1 to the *Taxation Administration Act 1953*. As noted by Thawley J, non-monetary benefits that are not 'consideration' for the purposes of the law of contract may also fall within the meaning of 'consideration' for the purposes of other tax provisions.¹⁶

15. In *Scully*, it was held that the expression 'consideration ... for or in respect of', in the context of the taxation of eligible termination payments, indicated that the use of the

⁸ Subsections 355-405(1) and (2).

⁹ Subsection 355-405(3).

¹⁰ Subsection 355-405(4). See also sections 355-215 and 355-220. Subsection 995-1(1) contains the definition of 'foreign resident'. Sections 328-125 and 328-130 explain the meaning of connected entities and affiliates.

¹¹ *Brooks v Commission of Taxation* [2000] FCA 721 at [36].

¹² *Aubrey v The Queen* [2017] HCA 18 at [34].

¹³ See *Archibald Howie Pty Ltd v Commissioner of Stamp Duties (NSW)* [1948] HCA 28; *Berry v Commissioner of Taxation* [1953] HCA 70; *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* [2015] FCA 1092 (*Chevron*); *Chief Commissioner of State Revenue v Dick Smith Electronic Holdings Pty Ltd* [2005] HCA 3; *Commissioner of Taxation v Bogiatto* [2020] FCA 1139 (*Bogiatto*); *Commissioner of Taxation v Scully* [2000] HCA 6 (*Scully*); *Commissioner of Taxation of the Commonwealth of Australia v Ludekens* [2013] FCA 142 (*Ludekens*).

¹⁴ *Chevron* at [86–87].

¹⁵ Subsection 995-1(1).

¹⁶ *Bogiatto* at [48], per Thawley J.

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word ‘consideration’ was not used in a technical sense.¹⁷ Likewise, the Commissioner considers the phrase ‘direct or indirect result’ to indicate that the word ‘consideration’ is not used in a technical sense.

Consideration includes non-monetary benefits

16. The Commissioner’s view is that the term ‘consideration’ includes non-monetary benefits. There is nothing in the text of section 355-405, or its legislative history, to indicate that the term ‘consideration’ should be given an unduly strict interpretation, such as excluding non-monetary benefits. As noted by Middleton J in *Ludekens*, if the legislature had intended to strictly confine a provision to monetary benefits, it could have employed a more definite term such as ‘payment’ or ‘amount’.¹⁸

17. If ‘consideration’ was narrowly interpreted as confined to monetary benefits, situations where no payments had been made would be excluded from the application of the ‘at risk’ rule. This outcome would be contrary to the express language of the provision and deny application of the provisions where the consideration ‘could reasonably be expected’.¹⁹

18. Furthermore, ‘consideration’ means more than merely non-monetary consideration ‘involved with offer and acceptance’²⁰ for the purposes of the law of contract. The text of section 355-405 clearly demonstrates an intention for the ‘at risk’ rule to apply where a *reasonable* expectation of receiving consideration exists, rather than only where a promise to pay is received in formation of a binding contract.

Meaning of ‘consideration’ in section 355-405

19. Commencing with the text of section 355-405, read in context and having regard to the purpose of the R&D scheme and the R&D integrity rules²¹, the Commissioner’s view is that ‘consideration’ incorporates a wider notion than consideration in a contractual sense (see Example 3 of this Ruling).²² The Commissioner considers that a broad interpretation of ‘consideration’ in this context best achieves the object of Subdivision 355-F, namely as an integrity rule designed to deny or reduce an entity’s notional deduction where their R&D expenditure is not ‘at risk’.

20. The use of the preposition ‘of’ instead of the conjunction ‘for’ in the phrase ‘as a direct or indirect result of the expenditure being incurred’ also supports this.²³ There is no requirement that the consideration be received for you to incur the expenditure. The consideration also need not be received for, or as a result of, any activities being conducted. The respective subject matter of the nexus enquiry for application of the ‘at risk’ rule is expenditure.

21. Whether monetary or non-monetary benefits constitute ‘consideration’ depends on the circumstances.²⁴ Nonetheless, that which would constitute ‘consideration’ for the

¹⁷ *Scully*, as cited in *Brooks* at [36], *Ludekens* at [42] and *Bogiatto* at [41].

¹⁸ *Ludekens* at [46], per Middleton J.

¹⁹ For example, see *Bogiatto* at [43-44] for reasons why a broad construction of ‘consideration’ was adopted by the Federal Court in the context of the promoter penalty regime.

²⁰ *Archibald Howie Pty Ltd v Commissioner of Stamp Duties (NSW)* [1948] HCA 28; 77 CLR 143, page 152.

²¹ In Subdivision 355-F.

²² See *Ludekens* and *Bogiatto*.

²³ Subparagraphs 355-405(1)(a)(i) and (2)(a)(i).

²⁴ *Bogiatto*, citing *Ludekens*.

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purposes of the law of contract would generally, if not always, constitute 'consideration' for the purposes of section 355-405.²⁵

22. If there is consideration, the amount of consideration for the purposes of applying the 'at risk' rule is the total of both the monetary benefits and the value of any non-monetary benefits to which both the 'nexus to expenditure' test and 'regardless of results' test are satisfied.

Nexus to expenditure test

23. If, at the time you incur expenditure on R&D activities, you or your associate have received or could reasonably be expected to receive consideration as a result of that expenditure being incurred, the 'at risk' rule may apply.²⁶

24. The natural construction of the term 'expenditure'²⁷ in section 355-405, having regard to the broader statutory context within which the 'at risk' rule operates, is that it refers to expenditure incurred by an entity on R&D activities for which it seeks to claim a notional deduction under section 355-205 or 355-480 (R&D expenditure). Therefore, the consideration captured by the nexus to expenditure test is that amount of consideration which can objectively be concluded as being received or receivable as a direct or indirect result of having incurred that R&D expenditure.²⁸

25. The nexus to expenditure test is concerned with the actual expenditure that an R&D entity has in fact incurred, rather than other expenditures or courses of action which the R&D entity could have chosen.

Direct or indirect result

26. Consideration is received 'as a direct or indirect result'²⁹ of incurring R&D expenditure when it is a direct or indirect consequence, outcome or effect of incurring the expenditure.

27. The fact that consideration may also be received as a result of something other than the expenditure being incurred does not alter the conclusion that the consideration is received as *a result* of that expenditure being incurred.³⁰

28. Use of the indefinite article 'a' supports this view. Particularly in its application to indirect situations, the degree of connection required is less demanding than would be required by the phrase 'caused by'.³¹

29. For the nexus to expenditure test to apply, you or your associate must have received, or have a reasonable expectation to receive, consideration at the time you incur the expenditure. For example, the 'at risk' rule does not apply to include consideration from

²⁵ *Bogiatto* at [46].

²⁶ In paragraphs 355-405(1)(a) and (2)(a).

²⁷ See subparagraphs 355-405(1)(a)(i) and (2)(a)(i).

²⁸ If an R&D entity incurs expenditure unrelated to R&D activities, within the meaning of section 355-20, that expenditure does not attract the operation of section 355-405. It is noted the expenditure would also fail the requirements to be notionally deductible under either sections 355-205 or 355-480.

²⁹ The word 'result' is not defined in the legislation and therefore takes its ordinary contextual meaning. *The Macquarie Dictionary* defines 'result' as 'that which results; the outcome, consequence, or effect' – Macmillan Publishers Australia, *The Macquarie Dictionary* online, www.macquariedictionary.com.au, accessed 6 December 2021.

³⁰ For example, see paragraphs 19 to 21 of Taxation Determination TD 2021/9 *Income tax: JobKeeper payments received or expected as a result of research and development expenditure* regarding JobKeeper payments being received as a result of wage expenditure being incurred.

³¹ *Nguyen v Motor Accidents Authority of New South Wales & Anor* [2011] NSWSC 351 at [117].

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a contract you had not reasonably expected to enter into at the time you incurred the expenditure, such as supplying an effective ownership interest³² in the results of past R&D activities for consideration (see Example 4 of this Ruling).³³

30. The fact that expenditure is incurred on R&D activities conducted in the course of providing something for which the consideration is received or expected does not, of itself, cause the nexus to expenditure test to be satisfied. The nexus to expenditure test is an objective enquiry as to whether the consideration is a result of the R&D expenditure. It is not an enquiry as to whether the R&D expenditure is incurred as a result of the consideration. The fact that the consideration might fund the expenditure does not of itself determine whether the consideration is as a result of that expenditure (see Example 5 of this Ruling).

Regardless of results test

31. The 'at risk' rule applies only where you or your associate have received, or can reasonably be expected to receive, consideration regardless of the results of the activities on which you incurred the expenditure.³⁴ This is referred to as the 'regardless of results' test.

32. The words 'regardless of' mean without regard to, without paying attention to, or irrespective of the results of the activities on which you incurred the expenditure.³⁵

33. Given the context of section 355-405 in Division 355, the reference to 'activities'³⁶ is considered to be a reference to the R&D activities. It is not a reference to the commercial or contractual activities of the entity in any broader sense.

34. The 'results' are the outcomes of your R&D activities on which you incurred R&D expenditure, rather than the process that led to those outcomes.³⁷ You or your associate can receive consideration regardless of the results, even if you are required to conduct the R&D activities in a particular way (see Examples 1 to 3 of this Ruling).

35. The regardless of results test is an objective one.³⁸ It is a question of fact whether you or your associate have received, or could reasonably be expected to receive, consideration regardless of the results of the R&D activities on which you incurred R&D expenditure. From a practical perspective, it may be useful to ask:

Disregarding the outcomes of the R&D activities (whatever those outcomes may or may not be), can it be objectively concluded that you or your associate have received or could reasonably be expected to receive consideration?

³² In this Ruling, an 'effective ownership interest' is a legal, equitable or economic interest in know-how, intellectual property or other results arising from an R&D entity's expenditure on R&D activities. This is one of the factors considered in determining whether R&D activities are 'conducted for' an R&D entity for the purposes of section 355-210. Refer to paragraph 3.54 of the Explanatory Memorandum to the Tax Laws Amendment (Research and Development) Bill 2010 (the EM).

³³ The supply of an effective ownership interest in the results of past R&D activities could cause adjustments under section 355-410 (disposal of R&D results).

³⁴ In subparagraphs 355-405(1)(a)(ii) and (2)(a)(ii).

³⁵ The phrase 'regardless of' is not defined in the legislation, and so takes its ordinary contextual meaning. *The Macquarie Dictionary* defines 'regardless of' as 'paying no attention to ... without consideration of ...' – Macmillan Publishers Australia, *The Macquarie Dictionary* online, www.macquariedictionary.com.au, accessed 6 December 2021.

³⁶ See subparagraphs 355-405(1)(a)(ii) and (2)(a)(ii).

³⁷ 'Outcome' is consistent with the language used in the definition of 'core R&D activities' in subsection 355-25(1).

³⁸ The Court in *Manolas v The Queen* [2018] NTCCA 12 found that 'regardless of' refers to an objective regard that a reasonable objective observer would have, not to the subjective regard of a given individual.

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36. Examples of where consideration is received or could reasonably be expected to be received, regardless of the results, are where the consideration depends only on:

- incurring the expenditure (see Examples 1 and 3 of this Ruling)
- conducting the activities on which the expenditure is incurred (see Example 2 of this Ruling), or
- supplying an effective ownership interest in the outcomes of the R&D activities whatever those outcomes may be (see Example 7 of this Ruling).

37. In contrast, consideration is not regardless of the results to the extent that you or your associates' receipt of that consideration can be affected, directly or indirectly, by the results of the R&D activities you incurred expenditure on (see Examples 6, 8 and 9 of this Ruling).³⁹

Quantification of the consideration

38. To apply the 'at risk' rule, you must quantify the amount of consideration you or your associates receive or could reasonably be expected to receive.

39. Where non-monetary benefits are received, a value of that non-monetary consideration needs to be determined as at the time the expenditure is incurred (see Examples 10 and 11 of this Ruling).⁴⁰

40. Where only part of the total consideration satisfies the nexus to expenditure test and the regardless of results test, the 'at risk' rule applies only to that part.

41. A contract may require multiple deliverables, but for which a single or undissected lump sum will be received. In these circumstances, the part of the consideration that satisfies the tests is to be determined on a fair and reasonable basis, having regard to the economic substance and not just legal form (see Example 9 of this Ruling).

42. An entity might also receive consideration as a result of incurring both R&D expenditure and non-R&D expenditure. The 'at risk' rule only applies to deny or reduce a notional deduction for R&D expenditure in relation to that portion of the consideration received as a result of incurring the R&D expenditure. A fair and reasonable basis for determining that portion of consideration is required.⁴¹

43. In working out the amount, portion or value of consideration you or your associate received or can reasonably be expected to receive, consider the circumstances as a whole, having regard to what has happened and what is likely to happen.⁴²

Examples

44. These examples do not, and are not intended to, consider the application of Division 355 more generally, including whether or not the underlying activities would be

³⁹ See also paragraph 3.166 of the EM, which explains how the 'at risk' rule operates in the context of the development and sale of a product where consideration is conditional on the successful performance of a contract.

⁴⁰ For guidance as to the Commissioner's view on the valuation of non-cash consideration, refer to Goods and Services Tax Ruling GSTR 2001/6 *Goods and services tax: non-monetary consideration*. Although GSTR 2001/6 considers non-monetary consideration for the purposes of subsection 9-75(1) of the *A New Tax System (Goods and Services Tax) Act 1999*, the principles discussed within it are presently relevant.

⁴¹ For example, see paragraphs 36 to 42 of TD 2021/9.

⁴² Subsection 355-405(3).

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R&D activities⁴³ or the subject expenditure otherwise notionally deductible. They cannot be used to draw any further conclusions about notional deductions beyond the application of the 'at risk' rule.

Example 1 – contract to conduct research for variable consideration

45. *Misschien Pty Ltd (Misschien), an R&D entity, enters a contract with Perchance Ltd (Perchance) that requires Misschien to conduct botanical research to specified quality standards.*

46. *Under the contract, Perchance obtains an ownership interest in the results of the research. In return, it pays Misschien \$1.20 for every \$1 Misschien incurs on the research.*

47. *Misschien retains a majority ownership interest in the research results.*

48. *Two months after entering the contract, Misschien spends \$100,000 on the research.*

49. *The 'at risk' rule applies because when it incurred the R&D expenditure which it intends to claim as a deduction, Misschien could reasonably expect to receive \$120,000 consideration:*

- *as a direct or indirect result of incurring the expenditure on the research*
- *irrespective of the results of the research.*

50. *As the consideration is greater than the R&D expenditure incurred, the 'at risk' rule denies Misschien's notional deduction in full.*

Example 2 – contract to conduct research for fixed consideration

51. *Perchance Ltd (Perchance) has a contract with Fortasse Pty Ltd (Fortasse), an R&D entity which conducts hydrological research. Perchance agrees to pay Fortasse \$120,000 for research that meets quality and timeliness standards in exchange for a minority interest in the results. The contract provides for the payment to be made regardless of the results of the research.*

52. *Fortasse spends \$100,000 on the research three weeks after entering the contract, which it intends to claim as a deduction under section 355-205.*

53. *To ascertain whether the 'at risk' rule applies, Fortasse needs to consider not only the terms of the contract but also anything that happened or existed before or at the time the expenditure was incurred.*

54. *Fortasse reasonably expects to receive \$120,000 of consideration as an indirect result of incurring the expenditure on the research.*

55. *Fortasse's receipt of the consideration does not depend on anything other than it performing hydrological research to the required standards. The consideration is received irrespective of the research results.*

56. *Fortasse is not required by the contract to spend anything, but to conduct the research it will practically need to do so.*

57. *The consideration is reasonably expected to be received as a direct or indirect result of incurring the expenditure on the research, irrespective of the results. The 'at risk'*

⁴³ Within the meaning of section 355-20.

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rule therefore applies. As the consideration is greater than the R&D expenditure incurred, the 'at risk' rule denies Fortasse's notional deduction in full.

Example 3 – subsidy as a result of incurring expenditure

58. Under a state government incentive scheme, Kannski Pty Ltd (Kannski), a fluid mechanics research company, is entitled to receive a subsidy of 30 cents for every \$1 of expenditure it incurs on research that meets specified quality standards.

59. Kannski incurs \$100,000 of expenditure while conducting its research. It is aware of the state government incentive scheme at the time it incurs the expenditure.

60. Kannski reasonably expects to receive \$30,000. It does not matter that there is no contractual requirement for Kannski to incur the expenditure. The subsidy is consideration Kannski reasonably expects to receive, as a direct or indirect result of the expenditure incurred on research. The consideration has the necessary nexus to the expenditure.

61. The consideration does not depend on anything other than Kannski performing research to the required standards. The consideration is received regardless of the research results.

62. As the consideration Kannski expects to receive is less than the R&D expenditure it incurred, the 'at risk' rule reduces Kannski's notional deduction to \$70,000.

63. In the event that Kannski had not received, or could not reasonably be expected to receive, the subsidy when it incurred the expenditure, the 'at risk' rule would not apply. For example, this may occur if the subsidy was announced and applied retrospectively to expenditure that had previously been incurred. In this situation, the R&D recoupment rules in Subdivision 355-G may apply.

Example 4 – consideration not reasonably expected

64. Eble Pty Ltd (Eble), an R&D entity specialising in acoustic engineering, incurs \$100,000 of expenditure on research.

65. This research generates new knowledge which is commercially valuable. A year after concluding the research, Eble is sought out by Peradventure Ltd (Peradventure) and the two parties enter into a contract under which Eble agrees to supply an effective ownership interest in the research results to Peradventure for \$200,000.

66. The 'at risk' rule does not apply to deny or reduce the \$100,000 of R&D expenditure that Eble seeks to notionally deduct. When Eble spent the money on research, it did not reasonably expect to receive this consideration.

Example 5 – R&D activities not necessary to perform contract

67. Magari Pty Ltd (Magari), an R&D entity specialising in medical prosthetics, enters into a contract with Peradventure Ltd (Peradventure) and agrees to supply a medical device that meets several precise technical specifications for a fixed contract price of \$500,000.

68. Magari has previously manufactured a device that meets the specifications and is able to fulfil the contract and supply the device irrespective of any choices it makes concerning the manufacturing process. However, it decides to spend \$100,000 on eligible R&D activities to determine whether it can substitute materials to produce a device with the same standards at lower cost.

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69. Although Magari was not obliged to undertake R&D activities on the device, having regard to all that happened or existed (or that was likely to happen or exist), its decision to incur the expenditure on its eligible R&D activities at the time it incurred that expenditure was heavily influenced by its contract with Peradventure. While the expenditure may have been incurred as a result of the anticipated receipt of the consideration, the consideration is not received or reasonably expected to be received as a result of the expenditure.

70. The nexus to expenditure test is not satisfied, so the 'at risk' rule does not apply to reduce or deny Magari's notional deduction for the R&D expenditure it seeks to claim.

Example 6 – contract to conduct R&D activities and supply a tangible good

71. Icterine Pty Ltd (Icterine), an R&D entity specialising in aeronautics, has a contract with Volatus Pty Ltd (Volatus) for Icterine to both:

- conduct R&D activities to determine whether the range of Icterine's existing solar-powered glider can be improved beyond present capabilities, and
- deliver to Volatus a solar-powered glider that meets technical specifications, at a price that depends on whether it does or does not have an improved range.

72. In return, Volatus is required to pay Icterine either:

- \$200,000 for an existing glider without improved range, or
- \$500,000 for a glider with improved range.

73. Under the terms of the contract, Volatus will only acquire a glider (existing or improved) if Icterine first conducts the R&D activities and thereby incurs expenditure on those activities. That is, the consideration attributable to the sale of the glider – existing or improved – is received or reasonably expected to be received as a direct or indirect result of its R&D expenditure being incurred. The fact that consideration might ultimately only be for the sale of an existing glider does not alter the conclusion that the consideration is a result of Icterine's R&D expenditure.

74. Icterine ordinarily sells its existing model of glider to other arm's length parties for \$200,000.

75. A month after the contract is signed, Icterine incurs \$400,000 on its R&D activities. The glider is not a tangible depreciating asset for Icterine.

76. At the time Icterine incurs \$400,000 on the R&D activities, it reasonably expects to receive \$200,000 regardless of the results of the R&D activities. If Icterine's R&D activities to develop a glider with improved range are unsuccessful, Volatus will buy the existing glider for \$200,000.

77. The potential \$500,000 consideration attributable to a glider with improved range is wholly dependent on the success of the R&D activities. Therefore, Icterine does not have a reasonable expectation to receive the \$500,000 regardless of the results of the R&D activities.

78. The 'at risk' rule therefore operates to reduce Icterine's notional deduction of \$400,000 (the R&D expenditure incurred) by \$200,000. That is, Icterine could reasonably expect to receive \$200,000 for the sale of an existing glider at the time it incurred the R&D expenditure as a result of the R&D expenditure being incurred and regardless of the results of the activities on which the expenditure is incurred.

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79. The conclusion might be different if Volatus had agreed to separately acquire the existing glider and any improved glider, and the acquisition of the existing glider was not conditional on Icterine conducting R&D activities. In this circumstance, there would be no nexus between the consideration for the sale of the existing glider and any R&D expenditure incurred to develop an improved glider. Therefore, whether the 'at risk' rule applies depends on characterising the arrangement as a whole, with the terms of any contract between the parties being a relevant consideration.

Example 7 – R&D activities necessary to perform contract

80. Vahest Pty Ltd (Vahest), an R&D entity specialising in production engineering, enters into a contract with Peradventure Ltd (Peradventure) and agrees to supply a water-treatment device to specification for a fixed contract price of \$500,000.

81. Vahest has previously manufactured a water-treatment device that meets the specifications, but Peradventure requires Vahest to supply all things necessary to maintain, operate and modify the device under a number of unique conditions in Peradventure's production facility.

82. To receive the \$500,000, Vahest must:

- provide a water-treatment device that meets the specifications
- test the device under a range of listed operating conditions in Peradventure's production facility where the tests will scientifically determine
 - how each operating condition will affect the device's
 - power and consumables consumption
 - likely rates of wear and tear of components over extended periods of operation, and
 - operational life and/or maintenance requirements
 - what future opportunities may exist to improve operation, and
- supply all the outputs of its R&D activities (including intellectual property, licences, manuals and test data for operating, maintaining, repairing and modifying the device in the future) royalty-free to Peradventure (although Vahest retains ownership of any primary patents generated as a result of doing the work).

83. A month after entering into the contract, Vahest spends \$100,000 on R&D activities and reasonably expects to receive \$500,000 for the combined supply of the device and R&D activity outputs as a direct result of the expenditure. The \$500,000 consideration has the requisite nexus to the R&D expenditure incurred.

84. Vahest will undertake eligible R&D activities and, regardless of whether or not these R&D activities are successful, is required to supply Peradventure with all the outputs of those activities, including the relevant rights, test data and intellectual property material for the device's use. The activities only inform Peradventure of how the water-treatment device operates under a range of test conditions and Vahest receives the consideration regardless of the results of the activities. Therefore, Vahest reasonably expects to receive \$500,000 regardless of the results of the R&D activities.

85. The 'at risk' rule therefore denies Vahest's notional deduction for the expenditure incurred.

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86. *In the alternative, if the contractual arrangement between the parties is such that Vahest would not be entitled to receive any consideration if the R&D activities are unsuccessful, the 'at risk' rule would not apply to the expenditure incurred by Vahest.*

Example 8 – repayable prepayments under a contract

87. *Yori Pty Ltd (Yori), an R&D entity specialising in acoustic safety equipment, is contracted by Peradventure Ltd (Peradventure) to construct a new type of hearing protection for consideration of \$500,000.*

88. *Yori will spend \$400,000 on R&D activities to complete this contract. Peradventure assists Yori by making a \$100,000 prepayment of consideration on signing the contract. However, Yori is contractually obliged to repay the \$100,000 prepayment in the event it does not deliver the hearing protection device required under the contract.*

89. *This \$100,000 is consideration received as a result of Yori incurring the \$400,000 of R&D expenditure needed to complete the contract. Therefore, the consideration Yori receives has the requisite nexus to the R&D expenditure it incurs.*

90. *However, in determining the amount and value of consideration brought to account under the 'at risk' rule, regard must be had to everything that has occurred and is likely to occur at the time the R&D expenditure was incurred.*

91. *Viewed objectively, at the time Yori incurred \$400,000 of expenditure it could not reasonably expect to retain the \$100,000 prepayment or receive the \$500,000 of total consideration regardless of the outcomes of its R&D activities. As such, the 'at risk' rule does not reduce or deny Yori's notional deduction for its R&D expenditure.*

Example 9 – contract with instalment payments

92. *Urana Blue Pty Ltd (Urana) is an R&D entity that specialises in constructing unique watercraft (yachts and similar boats). Peradventure Ltd (Peradventure) enters into a contract with Urana to supply a yacht that can be configured for a large number of different functions from racing to luxury cruising for a fixed contract price of \$500,000.*

93. *This yacht will be constructed over five stages. Due to the complexity in performing the contract, it will be paid in four instalments at various times throughout the yacht's construction.*

94. *Under the terms of the contract:*

- *Peradventure will pay to Urana*
 - *an upfront amount of 10% of the contract price (\$50,000)*
 - *20% of the contract price (\$100,000) on the completion of stage 1 (design and scoping)*
 - *30% of the contract price (\$150,000) on the completion of stage 2 (design tests and final design acceptance), and*
 - *a final 40% of the contract price (\$200,000) on final completion of*
 - *stage 3 (core engineering and construction of the yacht)*
 - *stage 4 (multi-function fit-out of yacht), and*
 - *stage 5 (final acceptance, function testing, expert sign off and delivery of the yacht)*

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- *there is no obligation for Urana to repay the first three instalment amounts once received.*

95. *The contract is completed over two income years, with Urana successfully delivering a yacht that meets Peradventure's specifications:*

- *stage 1 is completed in the first year*
- *stage 2 commenced in the first year and completed in the second year, and*
- *stages 3, 4 and 5 each commencing and completed in the second year.*

96. *In delivering the yacht, Urana incurred total expenditure of \$400,000 on its R&D activities. The expenditure was comprised of:*

- *during stage 1 – \$50,000 (incurred in the first income year)*
- *during stage 2 – \$150,000 (incurred in the first income year)*
- *during stage 3 – \$150,000 (incurred in the second income year)*
- *during stage 4 – \$50,000 (incurred in the second income year), and*
- *during stage 5 – \$0.*

97. *Other than Urana being able to progress from stage 3 to 4, Urana's ability to achieve each milestone at the end of each earlier stage does not depend upon the results of its R&D activities. Furthermore, the timing of each instalment payment is on the completion of each stage and not for the specific work or services performed during each stage.*

98. *Urana has incurred R&D expenditure in each of the two income years in which its contract with Peradventure is completed. It therefore needs to consider the application of the 'at risk' rule in each year to determine if the notional deduction for its R&D expenditure in those years is reduced or denied.*

First income year

99. *When Urana incurred \$50,000 of R&D expenditure during stage 1, it had already received \$50,000 in consideration. Similarly, when Urana incurred \$150,000 of R&D expenditure during stage 2, it had received total consideration of \$150,000 made up of \$50,000 received upfront and \$100,000 received at the end of stage 1.*

100. *In addition to the consideration received, Urana also needs to consider how much of the remaining consideration of \$350,000 potentially payable under the contract it could reasonably expect to receive at the time it incurred the R&D expenditure during stages 1 and 2. In doing so, Urana must also have regard to anything that is likely to happen or exist after that time.*

101. *Urana is entitled to receive total consideration of \$500,000 only if it completes its contract and supplies to Peradventure the constructed, fully-fitted and function-tested yacht. Urana cannot complete the contract without conducting its R&D activities. The total \$500,000 consideration therefore has the relevant nexus with R&D expenditure incurred by Urana under the project.*

102. *However, when Urana incurred its R&D expenditure for stages 1 and 2, it could not reasonably expect to receive the final \$200,000 instalment payable on completion of stages 3, 4 and 5. This is because the receipt of that final instalment is dependent on Urana being able to supply the completed yacht, which itself is dependent on the*

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outcomes of Urana's R&D activities. The final instalment is not received regardless of the results of those R&D activities.

103. *Consequently, having regard to the terms of the contract, Urana could reasonably expect to receive consideration of \$300,000 as a result of the expenditure incurred on its R&D activities during stages 1 and 2, regardless of the outcomes of those activities.*

104. *The amount of consideration captured under the 'at risk' rule is consequently \$300,000 and, in the first income year, Urana's notional deduction of \$200,000 is reduced to \$0. The \$200,000 consideration that reduces Urana's notional deduction in the first income year will not be applied to reduce or deny any notional deduction in a subsequent income year.*

Second income year

105. *The contract was completed in the second income year.*

106. *On the assumption that the outcomes of Urana's R&D activities continued to be unknown when it incurred its R&D expenditure for stages 3 and 4, the final instalment of \$200,000 for completion of stages 4 and 5 is not captured by the 'at risk' rule. This is because the final instalment remained dependent on Urana supplying the completed yacht.*

107. *At the time Urana incurred R&D expenditure for stages 3 and 4, it had received and could only reasonably expect to receive consideration of \$300,000 as a result of its R&D activities, regardless of the outcomes of those activities (that is, the total consideration for stages 1 to 2). Of that \$300,000, \$200,000 has already attracted the operation of the 'at risk' rule to reduce Urana's notional deduction in the first income year. This \$200,000 amount will not be applied to reduce or deny Urana's notional deduction in the second income year.*

108. *Consequently, the amount of consideration that will reduce Urana's notional deduction in the second income year is \$100,000. Urana's notional deduction is \$100,000, worked out as the R&D expenditure incurred for stages 3 and 4 (\$200,000) less the \$100,000 consideration.*

109. *The conclusion might be different if, on review of both the contract and substance of the agreement, the contract is capable of apportionment and division between multiple deliverables. This may be the case, for example, where the consideration in respect of one deliverable is objectively independent of the R&D expenditure incurred in performance of a different deliverable. In such a case, it may be that there is no nexus between the consideration received (or receivable) for one deliverable and the R&D expenditure incurred in respect of another deliverable. Therefore, whether the 'at risk' rule applies depends on characterising the arrangement as a whole, with the terms of any contract between the parties being a relevant consideration.*

Example 10 – repayable loan

110. *Hartlock Pty Ltd (Hartlock) is a small pharmaceuticals R&D entity that takes out a full recourse loan of \$100,000 from ABC Bank Ltd (ABC) to fund its research into producing its latest heart medication. The parties are dealing with each other at arm's length.*

111. *Interest is payable on the loan and the loan is repayable after a five-year term to ABC. This money is loaned on the condition that Hartlock must use the loan funds to incur expenditure on R&D activities which meet certain quality standards.*

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112. *Shortly after signing the loan agreement, Hartlock draws down and receives the \$100,000 loan proceeds from ABC.*

113. *The agreement by ABC to grant the loan facility in favour of Hartlock is non-monetary consideration (being an interest in a credit arrangement) which Hartlock receives to incur expenditure on R&D activities regardless of the results of Hartlock's R&D activities.*

114. *However, in working out the value of that consideration for determining the amount subject to the 'at risk' rule, it is necessary to consider what has happened and what is likely to happen.*

115. *In this case, at the time Hartlock is granted the loan, Hartlock is required to repay and expects to have the capacity to repay ABC the \$100,000 of borrowed monies, together with interest under the terms of the loan. As the financial benefits Hartlock has received will be equalled or exceeded by its financial obligations under the terms of the loan, the value (and amount) of consideration to Hartlock under the 'at risk' rule is nil.*

116. *The 'at risk' rule will not prevent Hartlock from notionally deducting all of its R&D expenditure.*

Example 11 – related-party non-recourse loan

117. *Little Perad Pty Ltd (Little P) is a newly-incorporated resident software production R&D entity that is a wholly-owned subsidiary of a large non-resident multinational, Peradventure Ltd (Peradventure). Little P and Peradventure both share common management.*

118. *Little P undertakes to produce a new type of client relationship software that tracks retail customer purchases and uses predictive algorithms to predict future purchases based on the customer's social media behaviour.*

119. *Peradventure was planning to undertake the R&D software production activity through one of its wholly-owned entities in the United States (US) of America, but because of the availability of the R&D tax offset and relevant programming expertise in Australia, it set up Little P to do so.*

120. *Peradventure agrees to lend Little P up to \$10 million to meet its total project budget to finance expenditure on the required software production R&D activities, on the condition they spend 95% of the funds on those activities.*

121. *The loan agreement states that the loan is repayable over a five-year term to Peradventure at an arm's length interest rate, with the first repayment of \$1 million due 18 months from the execution of the loan agreement. Little P is not required to conduct the R&D activities in accordance with any other agreements between Little P and Peradventure.*

122. *Shortly after receiving \$10 million in funds, Little P expends \$9.5 million of the funds on R&D expenditure and \$500,000 on other company running costs.*

123. *Eighteen months after receiving \$10 million in loan funds, Little P has completed the R&D activities but because Little P's (and Peradventure's) management have a longstanding policy that no further debt or equity funding would be made available by Peradventure for the project and none was likely to be sought outside the corporate group, Little P cannot make the first loan payment.*

124. *As a result, all assets and information produced by Little P (the software program and associated results of R&D activities) are forfeited to its lender and ultimate owner*

Status: **legally binding**

Peradventure and the \$10 million loan is forgiven. Peradventure proceeds to transfer the software program, intellectual property and associated results of Little P's R&D activities to a US subsidiary in order to complete commercialisation of the software program.

125. *Assuming the activity conducted by Little P is not to a significant extent for Peradventure and is an R&D activity for which a notional deduction is available under subparagraph 355-205(1)(a)(i) and subsection 355-210(2), the agreement by Peradventure to grant the loan facility in favour of Little P for which Little P is entitled to draw down the entirety of its \$10 million project budget is non-monetary consideration (being an interest in a credit arrangement). Little P receives the consideration to incur expenditure on R&D activities regardless of the results of Little P's R&D activities.*

126. *In working out the value of that consideration for determining the amount subject to the 'at risk' rule, it is necessary to consider what has happened and what is likely to happen.*

127. *Having regard to the longstanding policy that Little P and Peradventure's common managers had about the likelihood of obtaining additional funding for Little P to meet its loan obligations, it can be readily inferred that at the time Little P expended \$9.5 million:*

- *Peradventure would exercise its rights under the loan agreement to demand payment in default 18 months after the date of the loan contract*
- *Little P would not have, could not seek or be otherwise provided with additional funding to make the required \$1 million loan payment*
- *Little P's assets, which are mainly the outcomes of the R&D activities and related information which has commercial value to Peradventure, would therefore be forfeited to Peradventure as security holder, and*
- *effectively, Little P's loan would be forgiven to the extent to which the outstanding liability to Peradventure is greater than the value (if any) of the outcomes of the R&D activities and related information to Peradventure.*

128. *Notwithstanding the loan facility at the time of its creation requiring Little P to repay Peradventure \$10 million of borrowed monies together with interest, taking into account what has happened and inferences as to what is likely to happen, at the time Little P incurred its expenditure on R&D activities:*

- *the \$10 million loan it received was not expected to be repaid, and*
- *the software product and supporting information (R&D results, whatever they were) would pass to Peradventure under the terms of the loan.*

129. *Therefore, the value and amount of consideration under the 'at risk' rule is \$10 million. Accordingly, the 'at risk' rule will reduce Little P's notional deduction for its R&D expenditure to nil.*

130. *The exclusion in subsection 355-405(4) does not apply as the expenditure is not covered by paragraph 355-210(1)(c).*

Status: **legally binding**

Date of effect

131. This Ruling applies both before and after its date of issue. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation

22 December 2021

Status: **not legally binding**

References

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TR 2021/D3

Related Rulings/Determinations:

GSTR 2001/6; TR 2006/10; TD 2021/9

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- Aubrey v The Queen [2017] HCA 18; 260 CLR 305; 343 ALR 538; 91 ALJR 601; [2017] ALMD 2088
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- Chief Commissioner of State Revenue v Dick Smith Electronics Holdings Pty Ltd [2005] HCA 3; 221 CLR 496; 79 ALJR 550; 213 ALR 230
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- Manolas v The Queen [2018] NTCCA 12; 335 FLR 213; 273 A Crim R 457
- Nguyen v Motor Accidents Authority of New South Wales & Anor [2011] NSWSC 351; 58 MVR 296

Other references:

- Explanatory Memorandum to the Tax Laws Amendment (Research and Development) Bill 2010
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ATO references

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