TR 2021/5EC - Compendium

Australian Government
Australian Taxation Office

Public advice and guidance compendium – TR 2021/5

Relying on this Compendium

This Compendium of comments provides responses to comments received on draft Taxation Ruling TR 2021/D3 *Income tax: research and development tax offsets – the at risk rule*. It is not a publication that has been approved to allow you to rely on it for any purpose and is not intended to provide you with advice or guidance, nor does it set out the ATO's general administrative practice. Therefore, this Compendium does not provide protection from primary tax, penalties or interest for any taxpayer that purports to rely on any views expressed in it.

Summary of issues raised and responses

Issue number	Issue raised	ATO response
Consideration		
1	The term 'consideration' is defined in section 995-1 of the *Income Tax Assessment Act 1997*[1] and has the same meaning as 'consideration' defined in section 9.15 of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act). The term 'consideration' in the context of section 355-405 should therefore take on the meaning outlined in section 995-1 (thus section 9.15 of the GST Act). The use of the term 'supply of goods and services' in paragraph 2, and reference to the GST Act in footnote 39, of the draft Ruling, supports this assertion.	We disagree. Paragraph 13 of the final Ruling explains why we consider 'consideration' does not take its meaning in subsection 995-1(1). That is, the definition of 'consideration' in section 995-1 is in the context of consideration for a taxable supply and has the same meaning as for goods and services tax (GST) purposes. This definition is not determinative of the meaning of 'consideration' for all income tax purposes. The reference to 'supply of goods and services' in paragraph 2 of the final Ruling has been changed to 'products or services' for clarity. That paragraph addresses the purpose of the Ruling, being to provide certainty to taxpayers on the application of the 'at risk' rule in a broad range of situations. It provides the example of where research and development (R&D) activities are carried out in the context of commercial contracts for the supply of products or services, as this is a common scenario where the 'at risk' rule applies and mistakes in its application may occur. It does not define or limit the view in this Ruling on the meaning of 'consideration'. The reference in the final Ruling to footnote 40 of the Goods and Services Tax Ruling GSTR 2001/6 *Goods and services tax: non-monetary consideration* is included to refer readers to guidance on the

[1] All legislative references in this Compendium are to the *Income Tax Assessment Act 1997*, unless otherwise indicated.

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		Commissioner's view on the *valuation* of non-monetary consideration. The principles are relevant in other contexts, such as the 'at risk' rule, where non-monetary benefits are received. The reference does not suggest conformance with the GST Act definition of 'consideration'.
2	The draft Ruling relies on Thawley J's comments in *Commissioner of Taxation v Bogiatto* [2020] FCA 1139 (*Bogiatto*) to broaden the meaning of the term 'consideration' to include non-monetary benefits. This contradicts the Decision Impact Statement on *Bogiatto* which limited the use of the case to circumstances involving promoter penalty laws. It is inconsistent to limit the application of Thawley J's comments on record keeping to the promoter penalty provisions yet use other aspects of the case to widen the meaning of consideration in section 355-405.	The Decision Impact Statement on *Bogiatto* refers to the Federal Court's views about the relevance of record keeping to the standard of evidence for the Commissioner to discharge the onus of proving a promoted scheme benefit was not reasonably open at law. It states that the ATO accepts the Court's views, and considers the views are specifically directed to the discharge of the onus of proof in applications made by the Commissioner under the promoter penalty laws, and have no relevance to establishing an assessment, is excessive under Part IVC of the *Taxation Administration Act 1953*. *Bogiatto* is referenced in the draft Ruling in the context of illustrating how courts have approached the interpretation of the term 'consideration' to include non-monetary benefits. We have not broadened the meaning of 'consideration' in the final Ruling, rather interpreted it as having regard to recent case law.
3	The widest definition of the term 'consideration' has been asserted in cases related to the application of the promoter penalty provisions (*Commissioner of Taxation v Ludekens* [2013] FCA 142 (*Ludekens*)) and *Bogiatto*. Neither case asserted that a loan should be viewed as non-monetary consideration despite both cases confirming that the term consideration should be given its broadest meaning. The Commissioner's interpretation is not supported either legislatively or judicially.	As noted in our response to Issue 2 of this Compendium, case law has held that the meaning of 'consideration' can capture non-monetary benefits, which includes a loan. In particular, *Ludekens* does, in fact, consider whether non-monetary consideration would include a loan. At [40] in *Ludekens*, Middleton J noted that '… the Commissioner submitted that 'consideration' as it appears in s 290-60(1)(b) may encompass the receipt of non-monetary benefits (***such as a promise to perform or pay an amount***)' (emphasis added). Middleton J also stated in *Ludekens* at [46]: > I accept the submissions of the Commissioner that had the legislature intended to strictly confine the application of s 290-60 to monetary benefits, it could have employed a more definite term to achieve such an end (such as 'payment' or 'amount').

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4	The interpretation taken by the Commissioner in the draft Ruling (see, for example, Example 6 of the draft Ruling) is at odds with the intended operation of section 355-405 as evidenced in paragraph 3.166 of the Explanatory Memorandum to the Tax Laws Amendment (Research and Development) Bill 2010 (the EM). The 'at risk' provisions will not apply where the expectation of receiving consideration is for the development and sale of a product. Where this product development involves R&D activities, it cannot be said that the expectation of receiving consideration exist irrespective of the results of the R&D activities.	The EM does not suggest that the 'at risk' rule can never apply to contracts for the development and sale of a product. It will depend on the particular facts of the arrangement. Paragraph 3.166 of the EM focuses on the application of the results test. In that example, the expectation of receiving consideration for the development and sale was based on: • the terms of the contract, and • the entity's experience and technical capability concerning the degree of confidence about successfully performing that contract. Where product development involved R&D activities, and delivery of the product required those R&D activities to be, in effect, successful, it cannot be said that the consideration could reasonably be expected to be received regardless of the results of those activities. Example 6 of the final Ruling does not state the 'at risk' rule will not apply to all contracts involving the sale and development of a product. Rather, it likewise illustrates the 'at risk' rule will not apply where such sale and development of a product is dependent on the outcome of the R&D activities. That is, Example 6 of the final Ruling is consistent with paragraph 3.166 of the EM.
Reasonably expected to receive consideration		
5	Paragraph 2.53 of the EM provides an example where the claimant has 100% expectation that all outputs associated with the conduct of the R&D activities will be sold. Therefore, at the time when the claimant incurred the expenditure on their R&D activities, they had a reasonable expectation of receiving consideration as a direct or indirect result of incurring the R&D expenditure, regardless of the results of the activities. This example is a direct contradiction to the position taken by the Commissioner in the draft Ruling.	We disagree. The consideration described in paragraph 2.53 of the EM is akin to that in Example 5 of the final Ruling. While the expenditure may have been incurred as a result of the anticipated receipt of consideration, the consideration is not received or reasonably expected to be received as a result of the expenditure. Therefore, the 'at risk' rule will not apply to prevent a notional deduction.

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Expenditure		
6	The use of the definite article 'the' in paragraph 355-405(1)(a) means that 'the expenditure' is a direct and specific reference to 'expenditure' in sections 355-205 or 355-480. It is only expenditure that meets the definition of a 'notional deduction' that is able to be deducted for the purpose of making a claim under Division 355. The phraseology in paragraph 20 of the draft Ruling of the term 'their' instead of 'the' could lead the reader to assume that consideration for any expenditure could be used to deny a notional deduction.	We consider that no changes are necessary to the final Ruling. We think it is clear from paragraph 4 of the final Ruling that it is only expenditure that can be notionally deducted under Division 355 that can be claimed for the R&D tax offset. The term 'their' used in paragraph 19 of the final Ruling is in reference to that entity's R&D expenditure, not any expenditure.
7	The following statement in paragraph 21 of the draft Ruling is incorrect: 'The consideration also need not be received for, or as a result of, any activities being conducted.' Consideration, in the context of section 355-405, must be received or reasonably expected to be received as a result of expenditure incurred. That expenditure must be incurred on the conduct of activities which the R&D entity registers under section 27A of the *Industry Research and Development Act 1986.* If the consideration is not receivable as a result of incurring the expenditure on registered R&D activities, the first part of the 'expenditure not at risk integrity measure' fails.	It is necessary to determine whether an activity is an eligible R&D activity to ascertain whether the expenditure incurred will give rise to a notional deduction under sections 355-205 or 355-480. Therefore, the eligibility of an R&D activity is a preliminary issue that needs to be determined before section 355-405 has any application. As explained in paragraph 19 of the final Ruling, section 355-405 is an integrity provision which reduces or denies eligible notional deductions if the expenditure is not at risk. Subparagraph 355-405(1)(a)(i) makes reference to the consideration being as a direct or indirect result of the expenditure being incurred, not activities.
Equity, convertible instruments, arm's length loans and venture funding		
8	The Commissioner should clarify the 'at risk' rule will not apply to loans provided from non-related entities and subsequently converted to equity when the 'at risk' rule will apply to venture funding, such as where start-up R&D entities receive loans or venture capital fund raising, or where equity or convertible notes are issued for undertaking R&D activities.	The Ruling sets out principles capable of applying to situations more broadly. It is not possible for the Ruling to cover every scenario which may attract the application of the 'at risk' rule. Whether the 'at risk' rule would apply to loans that are subsequently converted to equity will depend upon having regard to the factors in subsection 355-405(3), in addition to satisfying the nexus to expenditure test and regardless of results test.

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		Whether the 'at risk' rule would apply to venture funding depends upon the particular facts and circumstances that give rise to the funding, including any terms and conditions related to convertible notes or debt instruments. This will depend upon having regard to the factors in subsection 355-405(3), in addition to satisfaction of both the nexus to expenditure test and regardless of results test. Taxpayers seeking further certainty are encouraged to engage with the ATO for advice or guidance.
Mischief and unintended consequences		
9	The ability to subvert the intended application of section 355-405 by redrafting contracts (see Example 6 of the draft Ruling) demonstrates that the interpretation of the provisions is not consistent with the intentions outlined in the EM.	Whether or not the 'at risk' rule applies requires characterisation of the arrangement, with the terms of any contract between parties being a relevant consideration.
10	Paragraph 37 of the draft Ruling states that consideration is receivable where it depends only on 'supplying an effective ownership interest in the outcome of the R&D activities'. Section 355-410 will apply in this instance rather than section 355-405 as the consideration is tied to the outcome or results of the R&D activities.	We disagree. Section 355-410 applies to an R&D entity in situations including where the R&D entity can deduct expenditure incurred on R&D activities under sections 355-205 or 355-480. However, an R&D entity cannot deduct expenditure under sections 355-205 or 355-480 if the conditions of section 355-405 are met. Therefore, section 355-410 cannot apply where the 'at risk' rule applies.
Other comments		
11	The term 'effective ownership interest' as referenced in paragraph 4 of the draft Ruling does not appear within Division 355 nor does it appear in the EM referenced. There is no connection in interpreting the operation of sections 355-210 and 355-405. As there is no legislative or EM basis to support the use of the term, it should be removed from the final Ruling.	We have noted the concerns raised and moved the explanation to footnote 32 of the final Ruling, which clarifies the meaning of 'effective ownership interest' when referred to in this Ruling, and takes into account paragraph 3.54 of the EM and section 355-210. Paragraph 3.54 of the EM uses the term 'effectively owns' in explaining one of the factors considered in determining whether R&D activities are 'conducted for' the R&D entity under section 355-210. Section 355-405 can limit the deduction of expenditure allowable under section 355-205. The types of activities an R&D entity can deduct under section 355-205 must meet the criteria set out in section 355-210.

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12	The introductory paragraphs in the draft Ruling should include more discussion about the purpose of the 'at risk' rule (that is, the mischief it intends to prevent, how the law works to prevent it, and the important concepts required for the section to be enlivened). The last sentence in paragraph 5 of the draft Ruling suggests that any consideration received will mean that expenditure is denied.	Noted, however no changes have been made to the final Ruling. Paragraph 4 of the final Ruling states that 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. This does not mean *any* consideration *will* result in the R&D tax offset being denied.
13	Paragraph 6 of the draft Ruling refers to the denial of notional deductions based on the amount of consideration received without any reference to the key requirements for enlivenment of the provisions that the consideration be received or likely to be received regardless of the outcome of the R&D activities. It may be better to discuss the requirement that consideration is 'received' or 'reasonably expected to be received' regardless of outcomes before talking about denial of notional deductions.	We agree. Paragraph 6 of the final Ruling has been changed accordingly.
14	Where the term 'expenditure' is used, it should be changed to 'expenditure incurred' to reflect the context in section 355-405(1)(a) and the comments in paragraph 7 of the draft Ruling.	Paragraph 355-405(1)(a) specifies that the time for determining whether the 'nexus to expenditure' and 'regardless of results' tests are satisfied is when the R&D entity incurs the expenditure. However, we disagree that the term 'expenditure' should be changed to 'expenditure incurred' throughout the Ruling, because the term 'expenditure' also arises in other contexts in the section; for example, the consideration being a 'result of the expenditure being incurred' (subparagraphs 355-405(1)(a)(i) and (2)(a)(i)) and the 'activities on which the expenditure is incurred' (subparagraphs 355-405(1)(a)(ii) and (2)(a)(ii)).
15	The opening line in paragraph 7 of the draft Ruling should be changed to 'The amount of consideration relevant to any reduction in notional deductions is worked out …'.	We agree. Paragraph 5 of the final Ruling has been changed accordingly.
16	The Ruling's introduction should make clear that the 'at risk' rule is a different and separate integrity measure to the strand of the 'on own behalf' test that deals with financial	Explanation of the 'on own behalf' test (section 355-210) is beyond the scope of this Ruling. Footnote 3 of the final Ruling has been included.

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	risk. These tests are often confused and conflated in practice.	
17	The wording of paragraph 21 of the draft Ruling should be amended to 'The use of the preposition 'of' instead of the conjunction 'for' in the term 'as a direct or indirect result of the expenditure being incurred' also supports this.'	We agree. Paragraph 20 of the final Ruling has been changed accordingly.
18	The wording of paragraph 24 of the draft Ruling should be amended to '… as a result of that expenditure being incurred.'	We agree. Paragraph 23 of the final Ruling has been changed accordingly.
19	Further clarification of paragraph 28 of the draft Ruling should be provided with the addition of the following sentence to the end of the paragraph: 'However, where it can be shown that the consideration would be received without the expenditure being incurred, no denial of notional deductions for the expenditure will result.'	Where consideration is received, or reasonably expected, and that receipt or expectation is not a consequence, outcome or effect of you incurring any R&D expenditure, then it cannot be concluded that the consideration is received, or reasonably expected, as a direct or indirect result of the expenditure. Paragraphs 26 to 30 of the final Ruling explain that you need some connection to the incurring of the expenditure.
20	Paragraph 36 of the draft Ruling should be changed to the following summary: 'Can it be objectively concluded when the money was spent that you or your associate will receive or could reasonably be expected to receive consideration whatever the outcomes of the R&D activities are?'	No change has been made to the final Ruling. We consider the wording in paragraph 35 of the final Ruling sufficiently explains the objective nature of the test.
Examples in the draft Ruling – R&D eligibility conditions		
21	Many of the examples are written without consideration as to whether the requirements in paragraph 355-210(1)(a) would be satisfied or whether some activities are eligible R&D activities. It may be appropriate to make a statement at the beginning of the examples that the Ruling does not consider whether notional deductions could be denied under those provisions.	Paragraph 44 of the final Ruling reinforces the point at paragraph 3 of the Ruling and expressly states that the examples in the Ruling illustrate principles outlined in the Ruling and do not consider other exclusions or conditions relating to notional deductions for expenditure on R&D activity.
Example 2 of the draft Ruling		

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22	The facts in this example should be clearer regarding: • the technical R&D outcomes not being relevant as to whether Fortasse receives the consideration, and • the 'timeliness and quality standards' are part of expected processes required to conduct the research in an appropriately rigorous nature, not part of the technical matter/hypothesis being investigated through conduct of R&D activities.	Noted. Paragraph 51 of the final Ruling reflects the fact that the consideration is receivable regardless of the results of the research. Also, the words 'irrespective of the result' have been added to paragraph 57 of the final Ruling.
23	An example should be added (or Example 2 in the draft Ruling extended) where the timeliness and quality standards are not met, so no consideration is actually received, but note that section 355-405 will still apply to prevent a claim of notional deductions.	We agree. The 'at risk' rule can apply where consideration can 'reasonably be expected'. Example 9 of the final Ruling has been updated to demonstrate a situation where consideration reasonably expected, but not yet received, is taken into account to reduce or deny a notional deduction. Taxpayers seeking further certainty are encouraged to engage with the ATO for advice or guidance.
Example 3 of the draft Ruling		
24	The facts do not state whether the rebates were known to the company before or after it incurred its R&D expenditure. This is critical in determining whether section 355-405 or Subdivision 355-G applies. It is rare that government subsidies will apply to expenditure that has already been incurred.	We agree. Paragraph 59 of the final Ruling reflects additional facts.
25	It would be useful if the example, and the final Ruling more generally, could clarify whether government grants and subsidies would be 'consideration' for the purposes of the 'at risk' rule. Previous examples on the ATO website have implied, but not stated, that the future receipt of government grants would not trigger the 'at risk' provisions.	If a grant is received in respect of expenditure previously incurred, and there was no reasonable expectation of receiving the grant at the time the expenditure was incurred, then the 'at risk' rule has no application. This aspect of the 'at risk' rule is illustrated in Example 4 of the final Ruling. The clawback adjustment guide recognises that, in some cases, a government grant might cause the application of the 'at risk' rule depending on the particular circumstances.
26	Example 3 of the draft Ruling is contrary to the examples provided in the EM and on the ATO's website. It is acknowledged that these examples do not state whether the rebates were known to the company before or after it	We disagree that the interpretation or application of the 'at risk' rule is limited or constrained by Subdivision 355-G, noting that section 355-440 is contained in Subdivision 355-G.

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	incurred its R&D expenditure. As this appears to be a critical factor in determining whether section 355-405 or Subdivision 355-G applies, it is a significant omission from the previous publicly-available examples. It fails to take into account that former Subdivision 355-G (up to 30 June 2021) and current section 355-440 (from 1 July 2021) recognise that the expenditure is eligible and is not affected by the 'expenditure not at risk' provisions. Normally the arrangements with such a grant or subsidy require the R&D entity to report on the progress and results of the funded R&D. This meets the requirement that the consideration must only be receivable with regard to the results of the R&D activities because the R&D entity's periodic and final reports require the results to be measured, documents and reported.	We note that the clawback recoupment provisions contained in Subdivision 355-G have no application where a notional deduction has been denied in full, including where this result occurs by virtue of the 'at risk' rule applying. This view is consistent with that expressed by the Commissioner at paragraph 7 in Taxation Determination TD 2021/9 *Income tax: JobKeeper payments received or expected as a result of research and development expenditure* as to the application of the 'at risk' rule to JobKeeper amounts received by an employer R&D entity. Whether an R&D entity needs to report on the progress and results of its R&D activities to receive a grant or subsidy is not determinative to whether the 'at risk' rule applies. A requirement to report on progress and results does not mean the consideration cannot be received, or reasonably expected, regardless of the results of those activities. As stated at paragraph 34 of the final Ruling, '[t]he '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'.
27	The draft Ruling does not consider provisions specifically enacted to apply to government recoupment or grants and the appropriate interaction between section 355-405 and Subdivision 355-G. The interpretation adopted in the draft Ruling would result in the 'at risk' rule applying to all government recoupments, both reimbursements (for example, subsidy or rebates) and grants. This would make Subdivision 355-G redundant which cannot be the correct application of these provisions.	We consider that Subdivision 355-G has no application where a notional deduction has been denied in full, including where this occurs by virtue of the 'at risk' rule applying. However, we do not agree that the interpretation of section 355-405 in the Ruling renders the clawback recoupment provisions in Subdivision 355-G redundant, with no work for the provision to do. The clawback recoupment provisions could still apply where the elements of section 355-405 are not satisfied, such as where an R&D entity: • incurs R&D expenditure for which no consideration is received or could reasonably be expected to be received at the time they incur the expenditure, or • receives a grant that was conditional on the successful outcome of the R&D activities.
28	The final Ruling should clarify whether all government grants and subsidies would represent 'consideration' for the purposes of the 'at risk' rule.	We do not consider all government grants and subsidies will automatically be subject to the 'at risk' rule. Whether a government grant or subsidy attracts the operation of the 'at risk' rule depends upon its terms and conditions.

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		Even where a government grant or subsidy constitutes 'consideration' for the purposes of the 'at risk' rule, the 'nexus to expenditure test' and 'regardless of results test' must both be satisfied for the 'at risk' rule to apply. For example, Cash flow boost tax time essentials states that an R&D entity does not trigger the 'at risk' rule if they receive a cash flow boost payment.
29	For JobKeeper, the consideration is not receivable as a direct or indirect result of incurring R&D expenditure, therefore section 355-405 does not apply. The recoupment rules do not apply. This is because the consideration is not on or in relation to R&D activities and there is no requirement for any business to incur any expenditure on R&D activities to be eligible for JobKeeper.	We disagree. The Commissioner's view of the application of the 'at risk' rule to JobKeeper payments is contained in TD 2021/9.
Example 4 of the draft Ruling		
30	The final Ruling should consider under what circumstances there would be a reasonable expectation of resulting knowledge being commercially valuable regardless of the results of the R&D experiments. For example, where the R&D experiments are more research discoveries that create new and saleable knowledge, regardless of what the knowledge shows.	The degree of confidence in activities being successful is more relevant to the prerequisite question of whether they are in fact 'R&D activities' as defined in sections 355-20 or 355-25. Whether the R&D expenditure (and R&D activities) are likely to result in commercially valuable knowledge is not determinative of whether the 'at risk' rule will apply. It is necessary to identify consideration received or reasonably expected as a direct or indirect result of the R&D expenditure incurred, not merely the possibility of commercial valuable knowledge being created. For instance, as noted in paragraph 29 of the final Ruling, the 'at risk' rule does not apply to consideration from a contract an R&D entity had not reasonably expected to enter when they incurred the expenditure.
Example 6 of the draft Ruling		
31	The conclusion that $200,000 of the R&D expenditure is not at risk disregards the fact that the $200,000 is arm's length consideration for the acquisition of the product.	The arm's length price of the glider has not been disregarded. It is specifically mentioned in Example 6 (at paragraph 74 of the final Ruling) to illustrate that the 'at risk' rule can apply in situations where a tangible good is sold for an arm's length price.

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	The acquisition of the glider is more directly linked to the manufacturing costs that the taxpayer incurred in building the glider. The remaining R&D expenditure (besides the $100,000 reimbursed) remains at risk because the taxpayer will not have any financial benefit from the contract if it does not result in an improved product.	Whether the acquisition of the glider is 'more directly linked' to another variable, such as the manufacturing costs, does not determine whether the 'at risk' rule applies. It is not necessary to identify the prevailing or dominant reason for which consideration is received or reasonably expected. The 'at risk' rule is concerned with expenditure that can be notionally deducted under sections 355-205 or 355-480, rather than whether the taxpayer receives a net financial benefit from a contract.
32	It is not sufficiently clear regarding Icterine's performance of R&D activities, and whether there is also an obligation under the contract for Volatus to purchase the existing glider without improved range.	Example 6 has been amended in the final Ruling to provide further clarity regarding Volatus' obligations under the contract. The explanation in paragraph 72 of the final Ruling is clear regarding Volatus' obligation to pay Icterine either $200,000 for an existing glider without improved range or $500,000 for a glider with improved range. Paragraph 73 of the final Ruling also makes clear that either acquisition is conditional on R&D activities being conducted first.
33	In a fact scenario where Volatus would acquire the existing glider irrespective of the R&D work being performed, there is no link between performance of the R&D activity and the acquisition of the glider. The $200,000 purchase price is not received as a direct or indirect result of the expenditure being incurred. This matter is only discussed in paragraph 82 of the draft Ruling, without a detailed explanation or conclusion on the matter being presented.	Paragraph 79 of the final Ruling sufficiently explains the alternative scenario where the acquisition of the existing glider is not conditional on conducting any R&D activities. It recognises the nexus to expenditure test would not be met. The purpose of Example 6 (including the variation in paragraph 79 of the final Ruling) is to highlight the importance of characterising the arrangement as a whole, with the terms of any contract being a relevant consideration. We do not think further elaboration is required.
34	Paragraph 77 of the draft Ruling adds or alters the contractual position set out in paragraphs 72 and 73 of the draft Ruling. It would be better to have all of the facts related to the contractual arrangements stated together.	We agree. Paragraph 77 of the final Ruling has been updated accordingly.
35	In Example 6 of the draft Ruling, the client agrees to buy either the unimproved product for its arm's length price or an improved product for a higher price if the R&D entity agrees to conduct R&D to create the improved product. This artificial circumstance is used to create the impression that the choice to purchase the unimproved version only if the R&D entity conducts R&D activities renders some of the	Example 6 of the final Ruling is intended to illustrate that consideration received for an arm's length sale of a good may, on the facts, attract the operation of the 'at risk' rule where the receipt of that consideration is contingent on the entity conducting R&D activities.

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	R&D expenditure not at risk. This is a poor example of receiving consideration as an indirect result. It needs to be rewritten to prevent this from causing incorrect assessments by taxpayers or in ATO reviews.	
Example 7 of the draft Ruling		
36	We agree the expenditure deemed to be not at risk to Vahest would be the correct outcome. However, while such a commercial arrangement may exist, this is not common. Usually, the contractual arrangement between the parties is such that a contractor (Vahest) would not have a reasonable expectation to receive consideration for expenditure incurred on R&D activities where the R&D is not successful. Providing a counterfactual scenario could be as follows: However, if the contractual arrangement between the parties is such that Vahest would not be entitled to receive consideration for the $100,000 incurred on R&D activities where the R&D activities are unsuccessful then it may be the case that the expenditure incurred by Vahest is at its risk.	We agree. Paragraph 86 of the final Ruling has been updated accordingly.
37	On the facts, it is questionable whether the activities described would satisfy the eligible R&D activity requirements. The mere construction of the plant would not likely constitute either a core R&D activity (no new knowledge) or supporting activity (plant construction costs not incurred for the dominant purpose of testing work). It is likely that the claim will be limited to the cost of activities related to testing the performance of the equipment in the specific circumstances required by Peradventure. The risk provisions should therefore be limited to an adjustment based on the amount of consideration received for the conducting of the testing activities involving R&D.	As stated in paragraph 3 of the final Ruling, it does not consider other exclusions or conditions relating to notional deduction on R&D activity. Paragraph 44 of the final Ruling also sets out the assumptions underlying the examples in the final Ruling, including that other requirements are met. Example 7 of the final Ruling illustrates that the consideration must be received, or reasonably expected, as a direct or indirect result of the R&D expenditure being incurred. As stated in paragraph 20 of the final Ruling, there is no requirement that consideration is received 'for' incurring the expenditure, or as a result of conducting the R&D activities.

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	For this reason, it is not correct that the entire $500,000 has the requisite nexus to the R&D expenditure incurred. It seems unlikely that where $500,000 is paid for acquisition of the device, and $100,000 relates to R&D activities, that no part of the remaining consideration is received for activities or physical supplies that are not related to expenditure incurred on R&D.	
38	If the R&D entity needs to conduct R&D activities that have uncertain outcomes to improve the product to meet the new requirements and make the sale, then it should be treated in the same manner as in Example 5 of the draft Ruling because the $500,000 is not reasonably able to be considered receivable until the R&D results meet the client's needs.	As stated in paragraph 84 of the final Ruling, the facts in the example are such that consideration is receivable regardless of whether or not the R&D activities are successful. This can be distinguished from Example 5 of the final Ruling, where the 'at risk' rule did not apply because 'the consideration is not received or reasonably expected to be received as a result of the expenditure'.
Example 8 of the draft Ruling		
39	The language 'high level of technical risk' may be considered as a return to the former R&D tax concession definition which is no longer relevant. Consider that the language reflecting experimental and new knowledge related requirements in section 355-25 should be adopted.	We agree. The use of the term 'high level of technical risk' may cause confusion. The term has been substituted in Examples 8 and 9 of the final Ruling to reduce any confusion.
Example 9 of the draft Ruling		
40	The taxpayer is guaranteed to receive $300,000 for the first three stages. The taxpayer incurs $240,000 of R&D expenditure that is not at risk ($80,000 × 3). The $300,000 paid for the first three stages does not in any way represent consideration for the R&D activity carried out in stages 4 and 5. This is because the taxpayer receives the $300,000 regardless of whether the customer agrees for stages 4 and 5 to proceed. During stage 4 and 5, the taxpayer incurs R&D expenditure of $160,000. At the time it incurs the expenditure, it cannot be concluded that consideration will be received for the R&D	Example 9 has been amended in the final Ruling to provide further clarity regarding how the 'at risk' rule applies to contracts with instalment payments. However, we do not agree with the comments that suggest the 'at risk' rule matches consideration received, or reasonably expected, precisely against R&D expenditure that the consideration is received 'for'. This is an incorrect interpretation of the test, as the nexus between the consideration and expenditure is merely 'a direct or indirect result'.

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	activities regardless of the outcome. Therefore, the expenditure at risk is $160,000. The expenditure denied under the 'at risk' rule should be limited to $240,000. The example indicates that consideration that is not directly or indirectly related to expenditure incurred on R&D is still taken into account in the reduction of notional deductions. This is not consistent with paragraph 41 of the draft Ruling which implies the need to apportion consideration 'where only part of the consideration satisfies the nexus test.'	
41	The calculation in the draft Ruling seeks to apply a whole project methodology. The legislation however only recognises R&D expenditure on R&D activities, not projects. It is clear in the contract that the activities are sequential, and each successive activity is dependent on the results of the previous activity.	Example 9 has been amended in the final Ruling to provide further clarity regarding how the 'at risk' rule applies to contracts with instalment payments. We do not agree that Example 9 applies a whole of project methodology. Each amount of consideration, and whether it satisfies both the 'nexus to expenditure test' and 'regardless of results test', is examined separately.
Example 10 of the draft Ruling		
42	Example 10 of the draft Ruling appears to be derived from GST concepts regarding consideration provided and received where a financial supply is made. Complexity of this concept and its presentation in the example may confuse some readers.	We acknowledge the comment but Example 10 of the final Ruling is considered useful in illustrating when the 'at risk' rule will not apply to non-monetary consideration in the form of an interest in a credit arrangement. We consider the example particularly useful when compared with Example 11 of the final Ruling.
Example 11 of the draft Ruling		
43	Example 11 of the draft Ruling should be supplemented by a clear statement there is no inference of a potentially wide application of the 'at risk' rule to a range of start-up R&D entity scenarios with loans from non-related entities, or venture capital fund raising via equity or convertible notes for undertaking R&D.	See our response to Issue 8 of this Compendium for more discussion on equity, convertible instruments, arm's length loans and venture funding.
44	Make Example 11 analogous to some more common commercial situations. Non-recourse loan transactions are	The final Ruling does not seek to address every possible scenario or variation. The examples provided in the final Ruling are considered to adequately illustrate the principles in the final Ruling.

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	not widely used and could be the subject of separate ATO guidance.	Taxpayers seeking further certainty are encouraged to engage with the ATO for advice specific to their circumstances.
45	The unrepaid R&D expenditure funded by the loan is the amount of expenditure that was not at risk. This is the $10 million less the $500,000 expenditure that was not on R&D activities less the value of the intangible assets 'paid' to the lender by being transferred to them without payment, not the full $10 million as stated in the draft Ruling.	This analysis confuses the value of the consideration received, or reasonably expected, with how that consideration was used. The subject of the 'at risk' rule is whether consideration is a direct or indirect result of R&D expenditure, not whether R&D expenditure is a direct or indirect result of the consideration (that is, it does not matter that the entity chose to spend $500,000 of the expenditure on non-R&D activities).
46	The application in Example 11 of the draft Ruling only disadvantages certain separate R&D entities within a group of entities. If the R&D entity funds its R&D by its own operations, the internal funding arrangements would not render any R&D expenditure not at risk.	The outcome applies in situations where a non-recourse loan exists, not because an R&D entity is within a group. If the loan were structured differently a different outcome may occur, regardless of whether the loan is from a related party or within a group.
47	Forfeiture of the assets (being the commercial value of the outcomes of the R&D activities) is non-monetary consideration repaid by the R&D entity against the loan, so the total value of the consideration should be reduced by this amount.	The value of the non-monetary consideration, being the commercial value of the outcomes of the R&D activities, is taken into account. Paragraph 127 of the final Ruling states: > … 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. The application of the 'at risk' rule needs to be determined when the R&D entity incurs the R&D expenditure. Based on the facts in Example 11 of the final Ruling, taking into account what was likely to happen or exist after the R&D expenditure was incurred, no value could be applied to the outcomes of the R&D activities and related information. Therefore, the value of the consideration Little P could reasonably be expected to receive was $10 million.
48	The practical application of this is more likely to be that the Commissioner may consider that the loan is unlikely to be repaid if the R&D is not successfully commercialised long before any actual R&D or commercialisation failure or any debt forgiveness. This may be highly subjective and will need to be assessed in case-by-case circumstances.	Whether the Commissioner considers that loan consideration can reasonably be expected will depend upon anything that happened or existed before or at the time the R&D expenditure is incurred and anything likely to happen or exist after that time. A comprehensive list of all things that will be taken into account is not possible, as this depends upon the facts and circumstances of each case. If

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	The final Ruling should provide examples of when the Commissioner is likely to form this opinion and what an R&D entity can do to ensure that internal funding arrangements will not render the entirety of the R&D expenditure not at risk.	further certainty is required taxpayers may engage with the ATO for advice or guidance.
49	Example 11 should be amended in the final Ruling to a more common commercial situation, such as it being reasonable to assume the taxpayer could obtain alternative or additional funding.	We are of the view that all examples in the final Ruling sufficiently illustrate the principles in the Ruling. Whether or not a taxpayer is able to obtain alternative or additional funding is highly fact-specific and raises issues relevant to other R&D conditions.
50	The line of reasoning in the draft Ruling could be read as suggesting the loan agreement is the consideration rather than the potential forgiveness of it being consideration.	Non-monetary benefits can include a promise to perform or pay an amount. Examples 10 and 11 have been amended in the final Ruling to reflect that the non-monetary consideration is the interest in the credit arrangement.
51	Subsection 355-405(3) states that one is to have regard to anything that happened or existed before or at the time the expenditure is incurred and anything that is likely to happen or exist after that time. The Commissioner should provide a list of factors which the ATO would take into account when looking at subsection 355-405(3).	The factors the Commissioner could consider under subsection 355-405(3) are broad, as evidenced by the reference to 'anything' in the provision. We are unable to cover every variation in facts in the final Ruling. Taxpayers seeking further certainty are encouraged to engage with the ATO for advice or guidance.
52	The very nature of R&D activities is that the outcome is unknown. The R&D tax offset may be claimed whilst the R&D could ultimately be deemed a technical failure with the loan never repaid. Typically, the loans will be repaid where the R&D is a success, either in cash or equity, but not if the R&D activity results in failure. Hence, whether the claimant is at risk for the expenditure outlaid from the loan funds is not 'regardless of the R&D results' – both success and failure are R&D results. The Commissioner may consider it likely that a loan will not be repaid long before any commercialisation failure or debt forgiveness occurs. What can an R&D entity do to ensure that internal funding arrangement will not attract the 'at risk' rule?	We acknowledge that the outcomes of core R&D activities are unknown, as required under section 355-25. However, the eligibility of an activity is a prerequisite issue that needs to be determined before section 355-405 has any application. Section 355-405 is an integrity provision whereby eligible notional deductions may be reduced or denied where the expenditure is not at risk. If a loan contract specifies that the borrower will not be liable to repay the loan amount if R&D activities are a failure, then it is likely the 'at risk' rule would apply for the reasons given in Example 11 of the final Ruling. If the borrower is merely practically unable to repay the loan (but legally obligated to do so), then it is less likely the 'at risk' rule would apply. In both scenarios, anything that is likely to happen or exist after the time the R&D expenditure was incurred needs to be taken into account to determine the value of the consideration received, albeit the value of the consideration received at the time the expenditure was incurred.

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		If further certainty is required taxpayers may engage with the ATO for advice or guidance.
53	Non-recourse loan transactions are not widely used and could be the subject of separate ATO guidance. It would be preferable to include an example with a longer more commercial period, where royalty income is intended to repay the loan, but the income derived is not sufficient to enable repayment and the loan is forgiven years later outside of standard management policies or practice.	Noted. Refer to our response to Issue 47 of this Compendium regarding the need to take into account anything that is likely to happen or exist after the time the R&D expenditure was incurred to determine the value of the consideration received.
Other examples for inclusion in final Ruling		
54	A simple example should be included in the final Ruling involving an R&D entity undertaking both R&D and non-R&D activities when supplying services to a customer. The R&D entity retains all IP and knowledge and makes key project decisions. The contract specifies that the customer will not need to incur any consideration if the R&D entity was unable to fulfill the terms of the contract. In this scenario, the 'at risk' rule would not apply to deny or reduce expenditure on the R&D activities and expenditure on the non-R&D activities would be excluded from notional deductions.	We consider that Examples 6, 8 and 9 in the final Ruling already sufficiently illustrate the 'regardless of results test'. To the degree the proposed example involves non-R&D activities being excluded from notional deduction, we note that this is not a matter involving interpretation or application of the 'at risk' rule. Taxpayers seeking further certainty are encouraged to engage with the ATO for advice specific to their circumstances.
55	An example should be included in the final Ruling where a supplier agrees to supply a product for its customer, but the supplier and customer agree in the contract that they will collaborate in R&D. In this example both the supplier of the product and the supplier's customer will incur eligible R&D expenditure.	The final Ruling does not seek to address every possible scenario or variation. The examples provided in the ruling are considered to adequately illustrate the principles in the Ruling. Taxpayers seeking further certainty are encouraged to engage with the ATO for advice specific to their circumstances.
56	The final Ruling should provide some examples involving receipts from insurance claims in a variety of scenarios, including as a result of failed R&D activities. These could	The final Ruling sets out principles capable of applying to situations more broadly. It is not possible for the final Ruling to cover every scenario which may attract the application of the 'at risk' rule.

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	compare insurance policies and what was evident at the time expenditures.	Taxpayers seeking further certainty are encouraged to engage with the ATO for advice or guidance.
57	The final Ruling should include an example that reflects a situation where an associate of an R&D entity receives the consideration in question. This type of scenario can be common with inbound biotechnology companies.	We think it is clear from the wording in paragraph 355-405(1)(a), and paragraph 5 of the final Ruling, that the consideration does not need to be received by the same entity that incurred the R&D expenditure in order for the 'at risk' rule to apply – it could be received by an associate of the R&D entity (as defined in section 318 of the *Income Tax Assessment Act 1936*). This aspect of the application of the 'at risk' rule is uncontentious and we think it does not require a specific example.