TR 2021/D3 - Income tax: research and development tax offsets - the at risk rule

This document has been finalised by TR 2021/5.

There is a Compendium for this document: **TR 2021/5EC** .

Status: **draft only – for comment**

Draft Taxation Ruling

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

Relying on this draft Ruling

This publication is a draft for public comment. It represents the Commissioner's preliminary view on how a relevant provision could apply.

If this draft Ruling applies to you and you rely on it reasonably and in good faith, you will not have to pay any interest or penalties in respect of the matters covered, if this draft Ruling turns out to be incorrect and you underpay your tax as a result. However, you may still have to pay the correct amount of tax.

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Status: **draft only – for comment**

What this draft Ruling is about

1. This draft Ruling[1] is about provisions in the research and development (R&D) regime that prevent an R&D entity[2] (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 *Income Tax Assessment Act 1997*[3] (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 goods or services.

3. This Ruling does not consider other exclusions or conditions relating to notional deductions for expenditure on R&D activity. 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.

Frequently used terms

4. 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.[4]

Ruling

The at risk rule

5. Expenditure can be claimed for the R&D tax offset only when you can notionally deduct it under Division 355.[5] The at risk rule compares consideration with R&D expenditure and can deny or reduce the expenditure you can claim for the R&D tax offset.

6. 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] All further references to 'this Ruling' refer to the Ruling as it will read when finalised. Note that this Ruling will not take effect until finalised.
[2] Section 355-35 of the *Income Tax Assessment Act 1997* (ITAA 1997).
[3] All legislative references in this draft Ruling are to the ITAA 1997 unless otherwise specified.
[4] 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 Tax Laws Amendment (Research and Development) Bill 2011.
[5] Sections 355-100, 355-205 and 355-480.
[6] Subsection 355-405(1).
[7] Subsection 355-405(2).

7. The consideration is worked out 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 receive[8]:

- 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).

8. 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 24 to 38 of this Ruling, with examples.

9. The at risk rule applies when you incur the expenditure that you seek to notionally deduct.[9] 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.

10. 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.[10]

11. The at risk rule does not apply where the R&D activities are covered by either paragraph 355-210(1)(b) or (c), which deal with R&D activities conducted for foreign residents that are connected or affiliated with you.[11]

Consideration

12. 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 depends upon the statutory context.[12] 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.[13]

Legal meanings of consideration

13. The term 'consideration' has various legal meanings, including meanings in contract law, conveyancing and revenue statutes.[14] For example, in *Chevron*, Robertson J held that the meaning of 'consideration' in the context of the transfer pricing provisions in

[8] Section 355-405.
[9] Subsections 355-405(1) and (2).
[10] Subsection 355-405(3).
[11] Subsection 355-405(4). The reference to foreign residents here includes references to certain R&D expenditures involving Australian permanent establishments. Sections 328-125 and 328-130 explain the meaning of connected entities and affiliates.
[12] *Brooks v Commissioner of Taxation* [2000] FCA 721 at [36].
[13] *Aubrey v The Queen* [2017] HCA 18 at [34].
[14] 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*).

Division 13 of Part III of the *Income Tax Assessment Act 1936* was not limited to the contract law meaning.[15]

14. While there exists a statutory definition of 'consideration' in the *Income Tax Assessment Act 1997*[16], 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.

15. 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.[17]

16. In *Scully*, it was held that the expression 'consideration … for or in respect of' indicated that the use of the word 'consideration' was not used in a technical sense.[18] 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

17. 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'.[19]

18. 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'.[20]

19. Furthermore, 'consideration' means more than merely non-monetary consideration 'involved with offer and acceptance'[21] for the purposes of the law of contract. The text of section 355-405 clearly evinces 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

20. 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 rules[22], the Commissioner's view is that 'consideration' incorporates a wider notion than consideration in a contractual sense

[15] *Chevron*.
[16] Subsection 995-1(1).
[17] *Bogiatto*.
[18] *Scully* (2000) 201 CLR 148, pages 164-165; cited in *Brooks v Commissioner of Taxation* [2000] FCA 721; 100 FCR 117, pages 128-129; cited in *Ludekens* 92 ATR 301 at [221]; cited in *Bogiatto* at [41].
[19] *Ludekens*.
[20] 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.
[21] *Archibald Howie Pty Ltd v Commissioner of Stamp Duties (NSW)* [1948] HCA 28; 77 CLR 143, page 152.
[22] In Subdivision 355-F.

(see Example 3 of this Ruling).[23] The Commissioner considers that a broad interpretation of 'consideration' in this context best achieves the object of the Subdivision, namely an integrity rule designed to deny or reduce an entity's notional deduction where their R&D expenditure is not at risk.

21. The use of the preposition 'of' instead of the conjunction 'for' also supports this.[24] 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.

22. Whether monetary or non-monetary benefits constitute 'consideration' depends on the circumstances.[25] Nonetheless, that which would constitute consideration for the purposes of the law of contract would generally, if not always, constitute 'consideration' for the purposes of section 355-405.[26]

23. If there is consideration, the amount of consideration for the purposes of 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. Further, both the tests will also need to be satisfied for the at risk rule to apply.

Nexus to expenditure test

24. 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, the at risk rule may apply.[27]

25. The natural construction of the term 'expenditure'[28] 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.[29]

26. 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.

[23] See *Ludekens* and *Bogiatto*.
[24] Subparagraphs 355-405(1)(a)(i) and (2)(a)(i).
[25] *Bogiatto;* citing *Ludekens*.
[26] See *Bogiatto* at [46] regarding the meaning of 'consideration' in the context of the promoter penalty provisions.
[27] In paragraphs 355-405(1)(a) and 355-405(2)(a).
[28] See subparagraphs 355-405(1)(a)(i) and 355-405(2)(a)(i).
[29] 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.

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Direct or indirect result

27. Consideration is received 'as a direct or indirect result'[30] of incurring R&D expenditure when it is a direct or indirect consequence, outcome or effect of incurring the expenditure.

28. 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.[31]

29. 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'.[32]

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

31. The fact 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

32. 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.

33. 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]

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[30] 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 18 May 2021.

[31] For example, see paragraphs 18 to 20 of Draft Taxation Determination TD 2020/D1 *Income tax: notional deductions for research and development activities subsidised by JobKeeper payments* regarding JobKeeper payments being received as a result of wage expenditure being incurred.

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

[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) or Subdivision 355-H (feedstock adjustments).

[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 18 May 2021.

34. 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.

35. 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).

36. 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?

37. 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 8 of this Ruling).

38. In contrast, consideration is not regardless of the results to the extent that your or your associate's 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, 7 and 9 of this Ruling).

Quantification of the consideration

39. 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.

40. Where non-monetary benefits are received, a value of that non-monetary consideration needs to be determined (see Examples 10 and 11 of this Ruling).[39]

41. 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.

42. 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

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

[37] The word 'results' is not defined in the legislation, and so 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, viewed 18 May 2021. 'Outcome' is consistent with the language used in what are 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.

[39] 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 that Ruling 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.

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 10 of this Ruling).

43. 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.[40]

44. 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.[41]

Examples

45. These examples do not, and are not intended to, consider the application of Division 355 more generally. 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

46. *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.*

47. *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.*

48. *Misschien retains a majority ownership interest in the research results as well.*

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

50. *The at risk rule applies because, when it incurred the R&D expenditure it seeks to claim, 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.*

51. *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

52. *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.*

53. *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.*

[40] For example, see paragraphs 34 to 40 of TD 2020/D1.
[41] Subsection 355-405(3).

54. *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.*

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

56. *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.*

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

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

59. *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.*

60. *Kannski incurs $100,000 of expenditure while conducting its research.*

61. *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.*

62. *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.*

63. *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.*

64. *In the event that Kannski had not received, or could not reasonably be expected to receive, the subsidy when it incurred the expenditure, then 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

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

66. *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.*

67. *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

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

69. *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.*

70. *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.*

71. *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 tangible good

72. *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 current technical specifications, at a price that depends on whether it does or does not have an improved range.*

73. *In return, Volatus agrees to pay Icterine:*

- *$100,000 to conduct the R&D activities, irrespective of whether the R&D activities are successful, and*
- *either*
  - *$200,000 for an existing glider without improved range, or*
  - *$500,000 for a glider with improved range.*

74. *Icterine ordinarily sells this 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 its expenditure on R&D activities, it can reasonably expect to receive $100,000 of consideration as a direct result of that expenditure being incurred. This is the amount specifically provided under the contract for Icterine to conduct its R&D activities.*

77. *Under the terms of the contact, 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 Icertine's R&D expenditure.

78. *The $100,000 consideration receivable for conducting the R&D activities satisfies the nexus to expenditure test. It is also receivable irrespective of whether or not Icterine's R&D activities to develop a glider with improved range are successful.*

79. *At the time Icterine incurs $400,000 on the R&D activities, it reasonably expects to receive an additional $200,000 regardless of the results of its R&D activities. If Icterine's R&D activities into developing a glider with improved range are unsuccessful, Volatus will buy the existing glider for $200,000.*

80. *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 amount regardless of the results of the R&D activities.*

81. *The at risk rule therefore operates to reduce Icterine's notional deduction of $400,000 (the R&D expenditure incurred) by $300,000. That is, Icterine could reasonably expect to receive both the $100,000 for conducting the R&D activities and $200,000 for 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.*

82. *In the alternative, 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 producing the improved glider (or incurring R&D expenditure). In this circumstance, there would be no nexus between the consideration for the sale of the existing glider and any R&D expenditure being incurred on the 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

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

84. *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.*

85. *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).*

86. *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.*

87. *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 to 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.*

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

Example 8 – repayable prepayments under a contract

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

90. *Yori will spend $400,000 on R&D activities to complete this contract. Due to a high degree of technical risk in conducting the R&D activities, Peradventure assists Yori by making a $100,000 pre-payment of consideration, on signing the contract. However, Yori is contractually obliged to repay the $100,000 pre-payment in the event it does not deliver the hearing protection device required under the contract.*

91. *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.*

92. *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.*

93. *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

94. *Urana Blue Pty Ltd (Urana) is an R&D entity that specialises in constructing unique watercraft (yachts and similar boats). Peradventure enters into a contract with Urana, who agrees 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.*

95. *Due to the high level of technical risk of the project, the contract will be paid in four instalments. The first three payments are payable at the commencement of each stage and the final payment is payable at the completion of all five stages.*

96. *In respect of stages 1 to 3, if Peradventure is unhappy with the work at the end of each stage up to and including stage 3, then Peradventure can take delivery of the outputs completed to the end of that stage (both tangible and intangible) and Peradventure will be under no further obligation to pay the future instalment. In addition, there is no obligation for Urana to repay the instalment amounts for stages 1 to 3 once the stage payment is received.*

97. *In respect of stages 4 and 5, Peradventure is only required to pay the remaining consideration for both stages at the end of stage 5 after final acceptance and function testing, plus final expert sign off that the yacht will meet all contractual specifications.*

98. *Peradventure will pay the contract price as follows:*

- *20% of the contact price ($100,000) is payable to Urana at the beginning of stage 1 (design and scoping)*
- *20% of the contact price ($100,000) is payable to Urana at the beginning of stage 2 (design tests and final design acceptance)*
- *20% of the contact price ($100,000) is payable to Urana at the beginning of stage 3 (core engineering and construction of the yacht)*
- *40% of the contact price ($200,000) is payable to Urana for stages 4 (multi-function fit-out of yacht) and 5 (final acceptance, function testing and final expert sign off) at the end of stage 5.*

99. *Over the course of the five stages of the contract, Urana will incur a total expenditure of $400,000 on R&D activities in five lots of $80,000, with each lot to be incurred immediately after the commencement of a stage.*

100. *Looking at the contract as a whole, the $500,000 of total consideration for Urana is received as a result of incurring the $400,000 of total R&D expenditure.*

101. *For the progress payments received with respect to stages 1 to 3, even if Peradventure determines that Urana has not delivered the desired outputs at the end of each of the stages 1 to 3, Urana is not required to repay each $100,000 payment received. The receipt of consideration for stages 1 to 3 depends only on completing the work required for that stage disregarding the outcome of the R&D activities which Urana incurred expenditure on immediately after the commencement of that stage.*

102. *At stages 4 and 5, taking into account the economic substance and legal form of the contract, it cannot be concluded that the final $200,000 instalment consideration is reasonably likely to be received regardless of the results of the stages 4 and 5 R&D activities which Urana incurred expenditure on immediately after the commencement of those stages. Urana can only reasonably expect to receive the final $200,000 instalment of consideration if the results of the stages 4 and 5 R&D activities culminates in final acceptance, function testing and final expert sign off.*

103. *Therefore, the amount of consideration under the at risk rule is the $300,000 (3 × $100,000) received for stages 1 to 3. Accordingly, the at risk rule will reduce Urana's notional deductions to $100,000 (worked out as $400,000 of R&D expenditure less $300,000 of consideration received).*

Example 10 – repayable loan

104. *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.*

105. *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.*

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

107. *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.*

108. *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.*

109. *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.*

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

Example 11 – related party non-recourse loan

111. *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. Little P and Peradventure both share common management.*

112. *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.*

113. *Peradventure was planning to undertake the R&D software production activity through one of its wholly-owned US entities, 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.*

114. *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.*

115. *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.*

116. *Shortly after receiving the $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.*

Status: **draft only – for comment**

117. *18 months after receiving the $10 million in loan funds, Little P has completed the R&D activities but because Little P's (and Peradventure's) management have a long standing 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.*

118. *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 Peradventure and the $10 million loan is forgiven. Peradventure then 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.*

119. *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. Little P receives the consideration to incur expenditure on R&D activities regardless of the results of Little P's R&D activities.*

120. *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.*

121. *Having regard to the long-standing 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.*

122. *Notwithstanding the loan facility at the time of its creation requiring Little P to repay Peradventure the $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.*

123. *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.*

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

Status: **draft only – for comment**

Date of effect

125. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the 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
25 June 2021

Appendix – Your comments

126. You are invited to comment on this draft Ruling including the proposed date of effect. Please forward your comments to the contact officer by the due date.

127. Please note that in preparing this draft Ruling we have already had regard to extensive feedback on the meaning of 'consideration' during public consultation on TD 2020/D1. Given the need to finalise TD 2020/D1 soon, if there are particular concerns regarding the analysis of 'consideration' in this draft Ruling, we would encourage you to contact us promptly so we can take these into account.

128. A compendium of comments is prepared when finalising this Ruling, and an edited version (names and identifying information removed) is published to the Legal database on ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: **23 July 2021**

Contact officer details have been removed following publication of the final ruling.

Status: **draft only – for comment**

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TD 2020/D1; TR 2006/10; GSTR 2001/6

Legislative references:

- ITAA 1936 Div 13 Pt III
- ITAA 1997 328-125
- ITAA 1997 328-130
- ITAA 1997 Div 355
- ITAA 1997 355-20
- ITAA 1997 355-25(1)
- ITAA 1997 355-100
- ITAA 1997 355-205
- ITAA 1997 355-205(1)(a)(i)
- ITAA 1997 355-210
- ITAA 1997 355-210(1)(b)
- ITAA 1997 355-210(1)(c)
- ITAA 1997 355-210(2)
- ITAA 1997 Subdiv 355-F
- ITAA 1997 355-405
- ITAA 1997 355-405(1)
- ITAA 1997 355-405(1)(a)
- ITAA 1997 355-405(1)(a)(i)
- ITAA 1997 355-405(1)(a)(ii)
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- ITAA 1997 355-405(2)(a)
- ITAA 1997 355-405(2)(a)(i)
- ITAA 1997 355-405(2)(a)(ii)
- ITAA 1997 355-405(3)
- ITAA 1997 355-405(4)
- ITAA 1997 355-410
- ITAA 1997 Subdiv 355-G
- ITAA 1997 Subdiv 355-H
- ITAA 1997 355-480
- ITAA 1997 995-1(1)
- GSTA 1999 9-75(1)

Cases relied on:

- Archibald Howie Pty Ltd v Commissioner of Stamp Duties (NSW) [1948] HCA 28; 77 CLR 143; [1948] 2 ALR 489; 49 SR (NSW) 112; 66 WN (NSW) 51; 22 ALJ 331
- Aubrey v The Queen [2017] HCA 18; 260 CLR 305; 343 ALR 538; 91 ALJR 601; [2017] ALMD 2088
- Berry v Commissioner of Taxation [1953] HCA 70; 89 CLR 653; 10 ATD 262; 27 ALJ 660
- Brooks v Commissioner of Taxation [2000] FCA 721; 100 FCR 117; 2000 ATC 4362; 44 ATR 352; 173 ALR 235
- Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) [2015] FCA 1092; 2015 ATC 20-535; 102 ATR 13; [2016] ALMD 107; [2016] ALMD 717
- Chief Commissioner of State Revenue v Dick Smith Electronics Holdings Pty Ltd [2005] HCA 3; 221 CLR 496; 79 ALJR 550; 213 ALR 230
- Commissioner of Taxation v Bogiatto [2020] FCA 1139; 2020 ATC 20-757
- Commissioner of Taxation v Scully [2000] HCA 6; 201 CLR 148; 2000 ATC 4111; 43 ATR 718; 74 ALJR 504; 169 ALR 459
- Commissioner of Taxation of the Commonwealth of Australia v Ludekens [2013] FCA 142; 2013 ATC 20-375; 92 ATR 301; 2013] ALMD 4185; [2013] ALMD 4186
- 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 Tax Laws Amendment (Research and Development) Bill 2011
- Macmillan Publishers Australia, *The Macquarie Dictionary online*, www.macquariedictionary.com.au

ATO references

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