Submission to Senate Economics Committee on the

New Research and Development Tax Credit Scheme

as proposed in the

Tax Laws Amendment (Research and Development) Bill 2010

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Recommendations

Based on matters raised and argued in the following submission, it is recommended that the Tax Laws Amendment (Research and Development) Bill 2010 and its Explanatory Memorandum be amended as follows:

1 Amend the definition of supporting activities (S355-30) as follows:

(1) ***Supporting R&D activities*** are activities directly related to *core R&D activities".
(2) However, an activity is not a ***supporting R&D activity*** if it would have occurred regardless of the core activities referred to (1) being undertaken

(The purposes of the amendment is to remove the dominant purpose test that will apply in most instances and to implement the draftsman intent as stated by Mr Paul McCullough, General Manager, Business Tax Division.)

2 The Bill's Explanatory Memorandum (EM) relating to the definition of core activities be changed to reduce the complexity for SMEs in applying the definition and not further narrowing what is eligible.

3 Subdivision 355-G (Clawback of R&D recoupments) be redrafted so that it takes into account that grants like the Green Car Innovation Fund grants are taxable**.**

4 Subdivision 335-H (Feedstock adjustment) be redrafted to make it much less complex and ensure that it implements the draftsman intent as stated by Mr Paul McCullough that there be no change from the feedstock rules of the R&D Tax Concession Scheme.

1 Background

The R&D Tax Credit Scheme to replace the current R&D Tax Concession Scheme was announced in the 2009/10 Budget, but its implementation to date has been a drawn out and arguably unsatisfactory process.

One significant event that occurred in the period of implementation was the release of the first exposure draft legislation and explanatory memorandum just before Christmas. This was subsequently acknowledgement by Mr Paul McCullough, that the draft legislation would have had unintended consequences and the needed to be more clear and less complex.

One consequence of the fist exposure draft would have been to reduce the benefit to industry compared to the existing R&D Tax Concession Scheme to between 10 and 30%.

This led to the release of a second exposure draft just before Easter that differs only minimally from the current Bill. Although the Government may state that they have been consulting with industry on the R&D Tax Credit proposal since it was announced in May 2009, the process as adopted resulted in the fundamentally flawed first exposure draft and this has reduced industry's opportunity to analyze and comment on what is in the current Bill to a short period starting April this year.

The Bill represents the Government's major industry support program and therefore it is important that it is practical and beneficial to its customers and embodies all the qualities of a well designed industry assistance program.

One of the purposes of this submission is to respectfully put the case that this has not been achieved, and, at the very least, the above four recommendations be adopted.

2 Summary of the R&D Tax Credit Scheme

The R&D Tax Credit Scheme adopts an entirely new approach to what is research and development that is based on the creation of new knowledge and the application of scientific method to create the new knowledge. This compares to the current scheme where core activities are likely to be eligible if they involve either innovation or technical risk. (These terms are defined in the current legislation.)

This new approach results in a much narrower definition of core activities and means that the new scheme will only support innovation if it coincides with the new definition. The new definition and the Bill's EM on this matter contains some terms foreign to most SMEs and the EM attempts to further narrow the scope of this definition.. This will result in complexity in complying and may mean that certain R&D projects are no longer eligible.

The second part of the new approach is that supporting activities, in most instances, will need to satisfy a dominant purpose test instead of the current directly related test. This is likely to result in many existing "supporting activities" becoming ineligible and add to complexity and compliance cost for SMEs.

The need to separately identify and link core and supporting activities and the new feedstock provisions also adds to complexity and compliance costs for SMEs.

The 6000+ SMEs who seek to benefit from the new program are likely to experience difficulty in determining with any certainty what qualifies and may find that much of the R&D that they are doing no longer qualifies.

The R&D Tax Credit Scheme as presented in the Bill is less generous, less predictable and more complex compared to the existing scheme and unintended consequences remain directly contradicting Ministers Swan's and Carr's following commitment made on 18 December 2009

"to follow through on the Government's commitment to deliver a more generous, more predictable, and less complex tax incentive by replacing the outdated and complicated R&D Tax Concession".

Revenue foregone may be 50% less compared to the existing scheme and therefore the commitments made by Ministers Carr and Swan that the new scheme will be revenue neutral may be dishonoured.

That the new scheme as proposed in the Bill may not implement industry policy for the following reasons:

- The second objective of the scheme is to support the creation of new knowledge, but this does not directly result in spillover, exports improved productivity or wealth creation .
- The new scheme directly supports innovation only when it falls within the narrow scope of the new definition of core activities. Thus many innovative based R&D projects may be excluded which directly conflicts with many statements by the current government on the importance of supporting innovation including the following –

"innovation is critical to the survival of manufacturing in Australia …that is why Labor says that, in the 21st century, innovation policy is industry policy."

and

"Australia has relatively few large firms so it is especially important that we lift the innovation performance of smaller firms".

The new scheme as defined in the current Bill may also provide only limited support to projects undertaken to develop and implement the many technologies needed to reduce greenhouse gas projects. In my previous submissions to Treasury on the R&D Tax Credit Scheme, I argued that limiting support for these projects may have net negative economic benefit.

I therefore respectfully request that the Senate Economics Committee seriously the above four recommendations since they will contribute to reducing complexity, and better meet industry policy objectives.

If the four recommendations were adopted, it most likely that the revenue foregone will still be less than that of the existing R&D Tax Concession Scheme, ie the Bill will remain revenue positive.

3 Core activities – the proposed narrow definition

The new definition is as follows:

1. are experimental activities, and

2. whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience,

3. but can only be determined by applying a systematic progression of work that is based on principles of established science; and proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions; and

4 are conducted for the purpose of generating new knowledge

This is much more narrow in scope compared to the current definition. in that the option of the "core" activities involving innovation defined as an appreciable element of novelty has been removed and the purpose is now limited to new knowledge. Thus experimental activities, that involve developing a product, process etc based on a novel concept or result in a novel outcome, may not satisfy the requirements of the new "core" activities definition if they do not satisfy paragraphs 2 to 4 of the new core activity definition.

Other potential difficulties faced by SMEs in applying this new core technology difficulties will be:

- Paras 2 and 3 are identified in EM 2.12 as describing the scientific method and this term will be widely used in documentation in administering the scheme. This and other terminology used in the definition is foreign to most SMEs who carry out practical R&D in a production environment.
- Para 4 requires that that the activities be conducted for the purpose of generation new knowledge. This is a concept foreign to virtually all SMEs. They generally undertake R&D for commercial purposes, eg to improve productivity and the competitiveness of their products and enter new areas of business. There is the potential for many core R&D activities to be excluded since the prime or main purpose or reason they are being undertaken is other than generating new knowledge.
- The Bill's accompanying Explanatory Memorandum interprets the definition very narrowly and, if applied in guidelines and rulings, will further limit what is eligible. This is detailed in the next part of this submission.

What is an eligible core activity according to this definition may be further narrowed by tests contained in the EM 2.13 to 2.17 which lists the following five types of activities as not passing the threshold test:

1 The knowledge of whether something is scientifically or technologically possible,

2 How to achieve it in practice, is deducible by a competent professional in the field on the basis of current knowledge, information or experience

3 The nature of the eligible experiment is such that there will be a clear risk that the outcome of the experiment will not be the desired one

4 Less rigorous knowledge discovery and problem solving techniques, such as 'trial and error' alone will not be sufficient to qualify as eligible experimentation

5 The knowledge being sought must go beyond validating a simple progression from what is already known and beyond merely implementing existing knowledge in a different context or location.

How these tests may further limit what is eligible is illustrated by applying them to the examples in the Bill's EM.

Test 1 would probably mean that not one of the examples 2.1 to 2.20 in the Bill's EM are eligible. The development of most products and processes would be considered possible at the commencement at the project unless what is proposed defies some law of science of technology or current knowledge provides sound evidence that achievement of the project objectives is unlikely. For example, in example 2.1 (Ecostartup), the knowledge existing at the start of the project is that C23 is possible if not fairly likely that it could be used to reduce emissions.

Test 2 - in EM example 2.11 (Matryoshkoala 3), the solution to the technical problem is likely to be deductible by a competent professional. It is noted that this test is a highly subjective and it is quite possible in contentious cases that one expert will be of the view that the outcome is deductible by a competent professional and the next will say that it is not. In making this judgment, it will be necessary to reconstruct what was the "current knowledge" at the time of the activity This test will create great uncertainty for SMEs.

Test 4 - An example of a project that may be considered to be mostly trial and error in nature is the Smartread example (EM example 2.3) which involves testing of various compounds. It is noted that the dictionary meaning of "trial and error" is defined as a method of discovery based on practical experiments rather than on theory EM example 2.11 (Matryoshkoala 3) may be be problem solving.

Test 5 – It may be argued that Examples 2.5 and 2.7 (Boulevard Mining 2 and 3) are simple progressions of the Boulevard Mining 1 project and therefore arguably ineligible..

The consequence is that the proposed legislation in combination with the above 5 tests in the EM may exclude many projects conducted by SMEs. Many SMEs adopt a conservative approach since they do not wish to be exposed to penalties or time consuming audits and this combined with the uncertainty involved in determining what is eligible may result in SMEs not claiming otherwise eligible projects.

Therefore it is strongly recommended that the Bill's EM relating to the definition of core activities be changed to reduce the complexity for SMEs in applying the definition and not further narrowing what is eligible.

4 Supporting activities – dominant purpose test to apply in most cases

It is most likely that the dominant purpose test will apply to most "supporting" activities undertaken by SMEs. Some of the reasons for this are:

- Almost all activities undertaken in projects where the objective is to develop a new or improved process or production plant, at the very least, directly relate to the production of goods and services. Thus the application of S355-35(1) (a) and (b) means that the dominant purpose test applies to most supporting activities undertaken in such projects.
- In most product development projects, best practice management technologies such "design for manufacture" and "concurrent engineering" are applied and this would probably mean that the dominant purpose test will apply to product design type "supporting activities' since they would be directly related to the production of goods.
- The dominant purpose test would apply to supporting activities such as the construction of prototypes even if they are not for sale since the "goods and services" referred to in S355-35 are not restricted to ones for sale.
- It is likely that dominant purpose test would apply to an activity involving the production of software code which is to be directly used to provide a service.
- The dominant purpose test applies to all excluded activities, some of which apply broadly. For example, the exclusion - "associated with complying statutory requirements and standards" would apply to most R&D activities undertaken by the manufacturing sector meaning that virtually all "supporting" activities undertaken by this sector would be subject to the dominant purpose test.
- Most SME manufacturers carry out R&D in a production environment. This may result in the dominant purpose test applying to most 'supporting activities" that they undertake.

The Bill's EM identifies the following two dominant purpose tests:

1. EM 2.24 - "*dominant purpose means the prevailing or most influential purpose*",
2. EM 2.22 - "*where supporting activities would have been undertaken anyway for normal operational reasons … the R&D tax incentive is not intended for them*".

EM 2.22 also identifies a sole purpose test in relation to production activities – "*production activities will only be eligible where the dominant (or sole) purpose for conducting them is to support core R&D.*" That a sole purpose may apply adds to the legal complexity and uncertainty for SMEs who conduct R&D in a production environment.

Mr Paul McCullough, General Manager, Business Tax Division, in providing evidence to the Senate Economics on 20 May 2010, indicated that the reason for the dominant purpose test was to exclude activities that would occur regardless (of whether the corresponding core activities were conducted). This corresponds to test 2 referred to above.

Test 1 in combination with the narrow legal interpretation of "the dominant purpose" and that a sole purpose test may apply will have the consequence of excluding many "supporting activities". This was the view the view of consultants such as Tracey Murray of BDO in evidence provided to the Senate Economics Committee.

This is further demonstrated in Examples 1 and 3 at Attachment 1 of this submission that are fairly representative of projects being undertaken by SMEs.. In these examples, the main or prevailing reason or purpose for undertaking the projects (and its activities) is commercial and hence the supporting activity dominant purpose test results in most supporting activities in the examples being ineligible

In addition, SMEs are likely to have difficulty in apply the dominant purpose test and this will add to uncertainty as to what is eligible.

Thus it is strongly recommended that the definition of supporting activities be changed to what is intended according to the draftsman (Mr Paul McCullough) as follows:

(1) ***Supporting R&D activities*** are activities directly related to *core R&D activities".
(2) However, an activity is not a ***supporting R&D activity*** if it would have occurred regardless of the core activities referred to (1) being undertaken.
(Please note that paragrah (2) may need to be reworded by a legislative draftsman)

5 Clawback of R&D recoupments

Subdivision 355-G specifies new clawback provisions that are more harsh than the clawback provisions in the current R&D Tax Concession legislation when the grant rate is less than 50%. Examples of a low grant rate are 25% for most Green Car Innovation Fund supported projects and 10% in EM example 3.12..

In attached example 2 which involves a company receiving a 25% Green Car Innovation Fund grant, the operation the new clawback formula in combination with tax payable on grant and application and compliance costs reduces the effective grant rate to a paltry 5%.

The draftsman appears to have overlooked the fact that grants are taxable. In example 3.12, the grantee would be $300,00 out of pocket since the grant is taxable.

Thus it is strongly recommended that Subdivision 355-G be redrafted so that it takes into account that grants like the Green Car Innovation Fund are taxable**.**

6 Feedstock adjustment – Subdivision 335 - H

Mr Paul McCullough in evidence provided to the Senate Economics Committee on 20 May 2010sysyed that the feedstock provisions are not changing (from the feedstock rules in the current R&D Tax Concession).

The current provisions as specified in the the Guidelines Part C of the R&D Tax Concession are relatively straight forward, but the new provisions in S335 – H are much more complex and are likely to apply more broadly. The complexity is illustrated in attached Example 2.

The complexity may be well beyond what SMEs and their suburban and country accountants currently deal with.

This it is strongly recommended that the feedstock adjustment provisions be revised to reduce complexity and ensure that what is implemented is in line with the intention as stated by Mr Paul McCullough

7 Will the R&D Tax Credit Scheme be revenue neutral?

Minister Carr in a speech made on 24 February 2010 at the AusBiotech CEO Summit, stated that the new R&D Tax Credit scheme "*will be revenue neutral"* (in comparison to the current R&D Tax Concession Scheme). This has been a continuing promise made by government ministers since the announcement of R&D Tax Credit Scheme.

Evidence has previously been supplied that merely abolishing the 175% premium may be sufficient to ensure revenue neutrality without otherwise tightening eligibility. Kris Gale of Michael Johnson & Assoc, using the limited public data available, demonstrated that solely abolishing the premium may be sufficient to balance the additional basic benefits for both small and large companies.

Therefore, it may be that the revenue foregone may be much less compared to the existing scheme for the reasons including

- Compared to the existing scheme, the proposed R&D Tax Credit Scheme will not necessarily support innovation. This branch of the core activities has been removed and therefore projects that involve innovation and experimental activities, but do not meet the new core activity definition will not qualify.
- As argued above, most "supporting" activities will be subject to the dominant purpose test and a significant proportion of activities will be excluded for this reason.
- The "not at risk" test has been tightened resulting in some projects being excluded.
- The feedstock rules are highly complex and may apply more generally
- Compliance including registration will be more complex, time consuming and expensive and this will deter some potential SME registrants from applying.
- Considerable uncertainty will be involved in applying parts of the legislation including the definition of core activities and the dominant purpose test. This may result in registrants, who claim conservatively since they do not want to be at risk of time consuming compliance actions or tax penalties, not claiming their full entitlement.
- The threat that registrants may be required to pay a fee.
- The new clawback provisions will reduce the net cost to revenue of programs like the green car innovation fund.

It is possible that when all these issues are factored in, introduction of the new scheme as implemented in the current Bill may reduce the revenue foregone by about 50%. However the amount is impossible to estimate and it is noted that Treasury has not done any effective evaluation of the impact of the changes on revenue.

In view of the issues covered above, it is most likely that the implementation of the four recommendations will still result in the cost to revenue not exceeding that of the current scheme.

Attachment 1 - Examples

Example 1 Mine Roofing Systems Pty Ltd (MRS)

As an alternative to the Boulevard Mining (BM) example, MRS develops the new cantilevered truss for tunnel support application in coal mines. MRS is a small manufacturing company and supplies a range of roofing systems to the mining industry. MRS is one of many Australian SMEs who collectively play an important role in improving productivity in the mining sector.

BM agrees to install the truss in its mine as in EM example 2.4. The main difference between the example 2.4 and this example is that MRS will develop the innovative truss and supply to other mining companies such as Mimic Mining.

The agreement with BM includes the following:

- BM agrees to purchase at least 20 more trusses if the technical objectives are achieved. A further issue is that an investor agrees to provide equity capital on the basis that if the project technically succeeds, then BM will place the above order. Without the prospects of further orders, the investor would not have provided the capital needed for the project to proceed. In addition, further sales to miners like Mimic Mining are likely if the project is technically successful.
- should technical failure occurs, BM and MRS agree to share the cost of removing the truss. This includes rectifying the effect of any events that occur including collapse of the roof resulting from the failure of the truss to support the mine roof. The purpose of the rectification would be to enable the tunnel to be mined.
- BM will pay MRS a fixed amount for the prototype truss and this is dependant on technical success. The amount is based on the cost of construction plus a small profit margin, but does not take into account the design cost. Should there be technical failure, any progress payments will need to be refunded.

The project activities comprise:

1 Design of the truss including finite element analysis for calculating the forces that the truss may required to withstand and optimizing the design as far as theoretically possible.
2 Construction of the truss.
3 Installation of the truss for the purpose of undertaking the unspecified experiments referred to in EM example 2.4
4 Conduct of the experiments.
5 Unfortunately the truss fails and the roof partially collapses and therefore the mine tunnel adjacent the truss needs to be dug out and the truss replaced with a conventional roof bolt system.

Core R&D Activities

In line with EM example 2.4, activity 4 is experimental and is considered to meet the requirements of the definition of core activities

An issue is whether activity 1 is a core activity. MRS decides that it does not satisfy the definition of core activities since the CAD design and FEA involves the application of existing knowledge, in this case, commercial software tools.

An alternative view is that MRS is conducting theoretical experiments for partially determining the truss performance and truss design required for differing tunnel widths and shapes as described in EM example 2.4. EM example 2.18, although addressing a related circumstance, provides no real assistance on this matter.

Supporting Activities

The first step is to ascertain whether to apply the "directly related" or the "dominant purpose" tests to activities 1 to 3 and 5.

Activity 1 - it is noted that it is good business practice to design for manufacture and for this reason, this activity is directly related to the manufacture of goods. Thus, due to adopting this good business practice, the dominant purpose test applies. That the truss would probably need to be designed to comply with an Australian standard is a second reason for the dominant purpose test applying.

Activity 2 – involves the manufacture of goods for sale – the dominant purpose test applies.

Activity 3 – installation involves in some production of coal – dominant purpose test applies.

Activity 5 – the main purpose is to enable the tunnel to be mined – the dominant purpose test applies.

MRS reads the EM and observes that, according to EM 2.24, "the dominant purpose means the prevailing or most influential purpose". MRS consults his dictionary and finds that "purpose" means reason. One this basis, MRS assesses that the most influential reason for undertaking the project and hence activities 1 to 3 is to win the BM order for the 20 trusses and possible subsequent orders. Thus MRS determines that activities 1 to 3 are not eligible.

MRS also assesses that activity 5 is in-eligible since the dominant purpose is to enable BM to mine the tunnel.

MRS observes that the activities 1 to 3 and 5 would have been eligible for the R&D Tax concession benefit.

Feedstock adjustments (May only be relevant if activities 1 to 3 eligible)

Since the truss is sold to BM, MRS is confronted with the need to determine the additional assessable income according to S355-465 and is confronted with the following new accounting terms:

"feedstock revenue for the feedstock output" that is equal to the following amount:

market value of the marketable product $\times$ $\frac{\textit{cost of producing the feedstock output}}{\textit{cost of producing the marketable product}}$

MRS also needs to calculate the additional assessable income according to S355-465(2)(b) to determine which is the lesser of the two amounts.

MRS and its accountant are not familiar with this and therefore the compliance cost relating to this is considerable.

Example 2 Last Australia Car Manufacturer (LACM) Pty Ltd

LACM is undertaking a project to develop a highly innovative hydraulic system for large passenger vehicles that are used for taxis and receives a Green Car Innovation Fund Scheme.

The grant is worth $1M and the grant rate is 25%. This means that LACM will need to spend $4M to receive the full $1M.

The hydraulic system has the potential to reduce fuel consumption by 45% when the taxis are used in cities and suburbs where there is mostly stop start use. (Please note that I am aware of innovative Australian technology that may achieve this.)

However, on receipt of the grant, LACM finds that not only is the grant taxable, but an additional 10% tax payable on the $4M project expenditure is payable.

There is considerable cost in applying for a grant and complying with the grant conditions and LACM estimates that this will total $100,000. With $300,000 tax payable since the grant is assessable income, clawback in the R&D Tax Credit Scheme (S355-G) requiring an additional tax of $400,000 being payable, the net grant is reduced to $200,000 and the net grant rate to only 5%.

Example 3 Aluminium Trailers

The following fictional example analyses how the proposed R&D Tax Credit Scheme may impact on what is eligible for support in respect to a project in the manufacturing sector that improves energy efficiency.

XY proposes to develop aluminium trailers for the Australian heavy trucking industry Several other Australian manufacturers have produced aluminium trailers but they have technically failed due to metal fatigue rpoblems. The technical objectives are that the trailers have a service life of 1,000,000 kms on all road conditions and are 3.5 tonnes lighter than equivalent steel trailers.

If the technical objectives are achieved and the trailers are broadly adopted by the Australian heavy trucking industry, major spillover benefits that may result include:

- greenhouse gas mitigation exceeding one million tonnes of CO_2 equivalents per year in Australia plus several times this amount overseas since it is planned to export the trailers to Asia, Africa and Europe and license the technology in the US.
- reduced operating costs for truck operators by up to 10%. Some of these savings may be passed onto consumers and businesses in remote locations in Australia.
- substantial export potential – the trailers can be shipped at low cost to Asia and Europe in car ferries that are used to import new cars into Australia and currently return empty.

- reduced maintenance of Australian roads which will save taxpayers many $M's per year.
- reduced heavy truck traffic since, in certain circumstance, 9 rigs with aluminium trailers will be able to transport the same load as 10 rigs with steel trailers
- successful commercialistion will result in the employment of several hundred staff in a location in Australia where unemployment rates are high.

XY has identified a design that XY believes will overcome the metal fatigue problems and achieve the weight saving objective. This design employs a combination of known engineering concepts. One prototype has been produced and tested and has partly proven the technical feasibility. This trailer has traveled only 100,000 kms. While service life on the many different road and load conditions encountered in Australia remains unknown , XY has identified a number of design improvement following the construction and testing of this trailer that will be applied in the project.

The project involves:

1) Detailed engineering design involving FEA.
2) Construction of 10 prototype trailers. This requires the production of tooling including expensive dies for extruding aluminum sections. This tooling is required to produce the 10 trailers and some or all may be used subsequently in production.
3) Trial of the trailers by a major trucking company ZZ in most operating conditions likely to be encountered in Australia. The trial involves fitting data logging equipment that will measure stress and loading and regular checking of the trailers by XY's technical staff. ZZ are indicating that they may purchase up to 500 trailers if the trial is successful and if the trailer meets Australian standards. The data measuring and logging system involves the development of the computer software for this purpose.
4) The trial is set to end when the trailers have traveled 1,000,000 kms. The trailers will be then stripped and components examined for metal fatigue and the data analysed. This feedback is likely to be used to further improve trailer design. The aluminium will be sold as scrap.

The cost of producing the prototype trailers is $100,000 per unit. An additional $200,000 is to be spent on tooling and $500,000 on the detailed engineering design. Manufacturing cost will need to be subsequently reduced to about $50,000 since the market price will need to be $80,000 or less for the trailer to be competitive in the market place. The scrap value of the trailers is $10,000 per unit.

It is proposed to achieve the reduction in manufacturing cost by volume production on a production line and undertaking a second R&D to develop improved manufacturing processes and plant that includes overcoming a technical problem being encountered in the manufacture of a major key component that is resulting in a high rejection rate. The 500 unit order should enable XY to raise at least some of the capital needed to establish the efficient manufacturing plant.

An additional fact is that aluminium trailers are being produced in Europe and the US, but are of a different design, are for carrying lighter loads (Australian regulations mean that heavier loads can be transported) and it has not been demonstrated that they will have the required service life in Australian operating conditions including rough outback roads.

Core activities

The activities that appear to be core activities are (3) and (4). Many questions need to be answered in determining whether they satisfy paragraphs 2 to 4 of the core technology definition and the test 1 to 5 identified in the Bill's EM and listed previously in this submission including:

Is new knowledge being generated since existing design techniques are being applied?

What will constitute the new knowledge – is it the trailer designs and knowhow?

Is generating the new knowledge the purpose of the activity or is it something else noting that prime reason for undertaking the project is to win orders for the trailer?

What is the hypothesis noting that this term is not part of the vocabulary of most SMEs?

Is how to achieve "it" deducible by a competent professional in the field on the basis of current knowledge, information or experience?

The knowledge of whether what is proposed is scientifically or technologically possible?

There are also other questions that need to be answered. At the very least, uncertainty exists whether "the core activities" are eligible.

Supporting activities

Activity 1 involves designing trailers for low cost manufacture on a production line and to comply with Australian standards and activity 2 involves the production of goods to Australian standards. Therefore the dominant purpose applies to activities 1 and 2.

As noted above, the prime reason for undertaking these activities is to win orders for the trailer. Therefore there it is unlikely that these activities are not supporting activities.

I have attempted below to apply a logical approach to applying the dominant purpose test.

The Bill's EM 2.24 refers to a the prevailing or most influential test and that it is necessary to undertake a "supporting activity" to enable a "core activity" to be undertaken is **insufficient** to establish that "supporting activity" passes this test. (EM 2.25). The likely relevant dictionary meanings of dominant is "primary" and purpose is the "reason why something is done".

The first logical step may be to list the purposes and then rank using criteria such as the influential test referred to in the EM. A list of the possible purposes for undertaking activity 2 may include (in no particular order):

(1) winning the contract to produce 500 trailers
(2) creating an improved trailer that achieves the technical objectives
(3) acquiring new knowledge that is about creating an improved trailer
(4) designing the trailer and obtaining data needed to meet Australian standards
(5) demonstrating the technical and commercial viability of the trailer
(5) to raise the additional funds for commercialistion
(6) winning other contracts
(7) generating profits and growing the company.

Probably the most influential reason in this case is that the project may lead to winning the contract and thus activities 1& 2 are ineligible.

Feedstock adjustments (likely to be applicable only if activities 1 and 2 eligible)

Where prototypes are scrapped, but the scrap has significant value is not issue covered in the Bill's EM and it is not clear from the legislation whether a feedstock adjustment is needed.

If a feedstock adjustment is required, its calculation is likely to be highly complex.

Attachment 2 – Who I am

This submission was prepared by Dr Terry Freund of Blue Sky Advisory Services. My background includes performing various R&D Tax Concession roles in administration and management including S39L determinations while working for AusIndustry in the period

1986 to 2002 and as a consultant providing R&D Tax Concession services since 2002. I currently have about 30 SME clients.