Duke, Jennifer

From: Thompson, Rachel (RG)
Sent: Wednesday, 28 April 2010 9:51 AM
To: Duke, Jennifer
Subject: FW: ICAA: Feedback on new R&D ED [SEC=UNCLASSIFIED]
Importance: High
Security Classification: UNCLASSIFIED

For info - suggest that we just print and scan the ICAA's emails and the attachment to their last email.

Thanks, Rachel

From: Donna Bagnall [mailto:donna.bagnall@charteredaccountants.com.au]
Sent: Wednesday, 28 April 2010 9:08 AM
To: Thompson, Rachel (RG); Yasser El-Ansary
Subject: RE: ICAA: Feedback on new R&D ED [SEC=UNCLASSIFIED]
Importance: High

Hi Rachel

We are comfortable with the emails below and the attachment being published. They are not confidential.

Thanks and regards
Donna
Donna Bagnall
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Chartered Accountants
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Please consider the environment before printing this email.

From: Thompson, Rachel (RG) [mailto:Rachel.Thompson@TREASURY.GOV.AU]
Sent: Tuesday, 27 April 2010 7:44 PM
To: Yasser El-Ansary; Donna Bagnall
Subject: FW: ICAA: Feedback on new R&D ED [SEC=UNCLASSIFIED]

Yasser and Donna

As you know, it's our practice to publish any public submissions that we receive in response to draft legislation etc. On that basis, I was wondering if you would be comfortable with us publishing the email chain below?

If you would prefer, we could treat your comments as a confidential submission from the ICAA (in which case they would not be published). Alternatively, we would be happy for you to submit a document that incorporates the points made in your emails.

Please give me a call if you would like to discuss.

Kind regards,
Rachel

Rachel Thompson
Industry Tax Policy Unit
Business Tax Division
The Treasury

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Email: rachel.thompson@treasury.gov.au

From: Yasser El-Ansary [mailto:tax.counsel@charteredaccountants.com.au]
Sent: Monday, 19 April 2010 8:44 AM
To: Antioch, Gerry; McCullough, Paul
Cc: Donna Bagnall
Subject: RE: ICAA: Feedback on new R&D ED [SEC=UNCLASSIFIED]

Gerry / Paul

Further comments are attached, this time about certain paragraphs in the explanatory memorandum.

Unless something further comes through today, this is the final set of comments on the second exposure draft to this point.

Regards,
Yasser.

Yasser El-Ansary

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From: Yasser El-Ansary [mailto:tax.counsel@charteredaccountants.com.au]
Sent: Wednesday, 14 April 2010 4:32 PM
To: McCullough, Paul
Cc: Antioch, Gerry; Donna Bagnall
Subject: ICAA: Feedback on new R&D ED
Importance: High

Hi Paul

As requested at our meeting on 1 April, please find below our feedback on the drafting of the second ED and EM. The focus of this feedback is on the "dominant purpose" test for supporting R&D activities. We intend to send through some further comments later this week or on Monday at the latest.

"Dominant purpose" test for Supporting R&D

The "dominant purpose" test is one of the main concerns with the ED and EM. The dominant purpose test applies only to supporting activities that are production activities (or directly related to production), or an excluded activity. Based on the EM examples, dominant purpose will be largely dependent upon evidence/documentation to establish that the activities were undertaken for the dominant purpose of supporting the core R&D activities, and not for the ultimate commercial objective of production. This change introduces a completely new concept to the R&D incentive which increases the likelihood of significant new and unanticipated points of contention for claimants in a fundamental area of the incentive, i.e. eligibility of supporting activities.

'Production of goods or services'

The EM appears to interpret the new "dominant purpose" test, in conjunction with the new 'core R&D' definition, in a manner that could remove much of the existing support for development-end activities conducted in the factory environment that are vital for productive commercialisation.
'Core R&D activities' have a substantially reworded definition (carrying with it the associated uncertainties that come with such significant changes in terminology). In addition, it has been redefined in a way which could be interpreted more restrictively than the current definition, as it requires the purpose to be 'generating new knowledge' (including knowledge 'about the creation of' new or improved products, processes, services, materials or devices). According to the Object clause (s355-5) however, R&D is clearly intended to extend to "generating new knowledge... in either general or applied form".
In our view, the EM contains numerous industrial/commercial production examples where the activities are likely to involve core R&D, being applied knowledge, but all surrounding activities are automatically assumed to be supporting activities and then subjected to the dominant purpose test.

EM examples

- Boulevard Mining I (Eg 2.4, p24) – the example accepts that application of the scientific method is required to address the gap in knowledge, and the project is about how the truss will function as a tunnel support for varying tunnel widths. As such, the tunnel shaping and truss design/erection activity in the novel tunnel environment is an integral part of the experimental process and arguably a core activity, not a supporting activity, therefore would not be subject to the dominant purpose test for that particular tunnel or experimental series of tunnels. Contrast the supporting activities in Eg 2.8 (road and access tunnel) which would be subject to the dominant purpose test.

- Boulevard Mining II (Eg 2.5, p25) – this example is unclear as to whether any of the activities are claimable as part of the implementation and it needs to be clarified. Were the experiments with 10 combinations of truss designs and tunnel shapes undertaken in the Boulevard Mining I project? If so, the example should confirm whether they were each eligible as core R&D activities under Eg 2.4, and indicate what 'applied' knowledge / experimental activities were eligible as core R&D.

- The distinction that seems to be drawn in the EM between 'acquiring knowledge' (eligible) and 'applying knowledge' (ineligible) is confusing as both of these activities can constitute eligible core R&D – refer Eg 2.5 (para 5), Eg 2.7 (para 2) and 2.9 (para 4). The use of these expressions should therefore be reviewed and a clearer expression used to distinguish between eligible and ineligible R&D. That is, in the latter case the question is more so whether the application of the knowledge meets the definition of core R&D, i.e. needs a scientific method to resolve uncertain outcomes that cannot be predicted and has a purpose of new knowledge generation, as opposed to routine/non-scientific activities. The EM does appropriately reflect this test in a number of places in the examples, but the dichotomy between 'applied' and 'acquired' knowledge should be avoided as it is apt to mislead and cause confusion by suggesting that applied knowledge does not generate new knowledge.

To this extent, there is a disconnect between the definition of "core R&D" and the Object clause, and the EM examples illustrate the confusion that this causes. We recommend that the definition of 'Core R&D" be amended to clarify the "applied" knowledge aspect in line with the Object clause.

We also recommend that the EM be amended to clarify and better illustrate the operation and scope of the new 'core R&D' test in the factory and field environment so that claimants can understand what is an eligible R&D production trial.

- Matryoshkoala examples – again, there is an assumption that all factory production line activities are supporting activities, not involving core R&D. Refer Eg 2.10, p31 (para 10 – Supporting R&D activities). This is not completely accurate and is confusing for claimants. If production line activities are the scientific experimental activities themselves, albeit 'applied knowledge', then they are core R&D and are not subject to the dominant purpose test. They qualify in their own right, not as supporting activities. While "pre-production" tooling up and trials are excluded from being core R&D, all factory trials up to and other than those ordinary production run activities are eligible core R&D if they meet the new test. See Eg 2.11, p32 (para 9 – Exclusions) which acknowledges that this type of experimental production line activities would not be caught by the pre-production exclusion (but yet confusingly it concludes that they would be supporting activities).

  The explanation of the relationship between full scale production runs and the 'pre-production' exclusion (in Eg 2.11 p31) is unclear and confuses concepts of core and supporting activities. This is because the activities described are core R&D, not supporting R&D, so the dominant purpose test has no application.

- In Example 2.12 Matryoshkoala III, it is stated that "The lengthy test with the production line running is a part of the experiment as it is part of the logical progression of work that leads to the experimental results. However, although running the production line as a whole might be necessary for the experiment, only running the 10 metre section encompassing the tight turn would form part of the experiment".
  This attempt in the EM to narrowly define what the scope of 'an experiment' is considered a major problem. The new definition is centred upon experimental activities, though its scope is not elaborated upon, other than also requiring the experiment to generate new knowledge (either general or applied). With the attempt in the EM to introduce a narrow scope of what is an experiment, we believe it will be inconsistent with the ordinary meaning of the term and create uncertainty in industry about the extent of activity that will be eligible core R&D activity.

  As a general observation, the restrictive approach to core R&D activities taken in the EM examples creates the need for artificial fragmenting of the activities (such as Eg 2.12, p33), and seems like a return to the old approach. This makes the law very complex, difficult to apply and uncertain as to how to work out where R&D starts and finishes, then starts again then finishes in a series of activities. R&D case law has rejected this approach in the past.

'Directly related to production of goods or services'

The concept of 'directly related to the production of goods' seems to be interpreted as: activities having a "direct, close and relatively immediate relationship with" the production activities.
It is not clear what activities this would bring in to the dominant purpose test, eg packaging end of the production line, or perhaps a much broader range of related activities that could be said to relate directly to production. Production is not defined. It is certainly unclear in a non-factory, field environment context, but even considering a standard product development factory environment, assessors may look to interpret this expansively with the result that it could be as broad in effect or broader than the augmented feedstock rule.

The examples contain no guidance on this as they do not appear to give any examples of what is regarded as

'production' and 'directly related to production' activities.

EM examples

- Boulevard Mining I – tunnelling – it is not clear whether this is regarded as "production" itself or "directly related to production".
- Matryoshkoala II – packaging process – it not clear whether this is regarded as "production" itself or "directly related to production".

If these activities are "production", what breadth of activities beyond this would be considered to be "directly related to production"? This issue creates a large amount of uncertainty in determining which activities could be brought into the dominant purpose test.

Excluded activities subject to dominant purpose test

If the dominant purpose test is retained, it should not be applied to the list of "excluded activities" - there is no rationale for this and to our minds it is difficult to understand how the test would apply or why it should operate in that way. We have had the opportunity to review the comments provided to you by Ernst & Young in an email on Friday evening ("Dominant test should not apply to the old exclusions list"), and our views are broadly in line with those expressed in the email. As such, we believe that para (a) should be removed from ss355-35(2), or restricted to particular activities that are to be targeted, eg excluded software [Section 355-30(o)].

If you have any questions at all about the above comments, please call me on (02) 9290 5623.

Regards,
Yasser.

Yasser El-Ansary

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Specific comments on paragraphs 2.13, 2.14, 2.15 & 2.16 of the Explanatory Memorandum

1. At 2.13, the concept of the "competent professional working in the field" is retained from what was para 2.25 in the previous EM dealing with technical risk; now referred to as "the knowledge gap and degree of uncertainty that an eligible experiment will be seeking to address". Paragraph 2.14 also brings back to the concept of "significant" technical risk once again. There also concerns with the distinction between R&D and "trial and error" at para 2.15.

2. "The competent professional" test. It is reasonable to assume companies will use suitably qualified and knowledgeable employees or contractors to carry out R&D activities. Further, if companies were able to readily deduce how to achieve a required practical outcome, then carrying out a program of experimental activities to try to achieve it would not be necessary.

3. "Significant" risk. The significant technical risk reference will inevitably result in Innovation Australia having to exercise its discretion as to what the acceptable level of technical uncertainty will be. It will be regarded as a retrograde step from where "high levels of technical risk" were defined in the old legislation.

4. "Trial and error". Much experimental activity which takes place in manufacturing industry would be characterised, by those carrying out the activities, as a "trial and error" process. This is not to say that there isn't a scientific method being applied. However, to cast aspersions as to the eligibility of activities characterised as "trial and error" would be to mislead companies as to the eligibility of their activities. It is also considered incorrect to attempt to exclude "trial and error" activities from the definition of R&D, instead categorising such activity as "knowledge discovery and problem solving techniques". The fact that companies may make 'errors' in the course of development activities is confirmation of the risks being undertaken in conducting trials.

5. New knowledge – The 'objective approach'. At para 2.16 a distinction is made between activities for the purpose of acquiring new knowledge and "experimental activities that merely confirm what is already known ... even though that know-how might not exist within the firm conducting the activities". This approach to the interpretation of 'new knowledge' is fundamentally flawed and should not be left in the EM. It should be replaced with guidance that makes it clear thaty creating know-how that may already exist but is not available to the claimant company is an eligible purpose. This element of subjectivity in determining 'new knowledge' is important to many Australian companies who attempt to compete with larger or overseas companies but who are unable to either access the technology on acceptable commercial terms.

   We believe that Treasury needs to further consider the impact of the 'objective test' for the following reasons:

   a. A company may make all reasonable efforts to identify technology in the public domain but still not be aware of activities being carried out somewhere else in the world and thus embark on an experimental programme which may confirm what someone else already knew, but about which the claimant company was unaware.

   b. Two companies may simultaneously be carrying on development activities with the same objective. Applying the objective test only one of them could satisfy the eligibility criteria, which would be an impractical outcome. Most (non-related) companies operate in a

competitive environment where a free flow of information does not readily exist in respect of particular knowledge or technology at any given time.

c. The existence of technology with certain capability or to address a particular requirement may be known, but there may be a myriad of aspects to the technology which are not in the public domain and about which an experimental programme may (or may not) reveal new knowledge.

d. There may be numerous reasons why companies would carry out an experimental programme of activities to develop a capability 'in-house' which in some way could be considered to replicate or confirm existing knowledge or technology. This is particularly relevant to many small to medium businesses who compete in Australia against imports or who compete on a worldwide basis against often larger corporations. It is a notable characteristic of innovative small to medium sized Australian businesses that they have the flexibility to create their own technology that can compete against more established technology from larger businesses. They should be encouraged to conduct experimental programmes, even if it relates to technology which is known to someone else.

   To use an example to illustrate this point, say an Australian company decided to embark upon a programme of experimental development with the ultimate objective of being able to take people to the moon. If the objective test of new knowledge was applied, none of the experimental programme would qualify as eligible R&D on the basis that they were merely confirming knowledge created by NASA in 1969. It had been previously accepted in published material that that new knowledge could be obtained in creating technology which, whilst it may have existed, was not available to a company on acceptable commercial terms. The same approach should now be adopted in dealing with the new definition of R&D.