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Dear Mr Hawkins

The new research and development tax incentive draft legislation("the draft R&D legislation")

Thank you for the opportunity to appear before the Senate Economics Committee on Friday 21st May, 2010 to comment on the proposed R&D legislation.

The Property Council has encouraged Government to reform the R&D tax incentive regime.

Our members are still concerned that the proposed draft legislation will stall future R&D in the property & construction industry.

It will unnecessarily exclude incentives for legitimate R&D projects that help drive innovation in the property sector. This, in turn, will make it significantly harder for Government to achieve its policy aims on affordable housing and climate change. R&D incentives are considered crucial to being able to "green" existing buildings and design new more efficient communities in the future.

This document seeks to clarify and reiterate the key points we made, and to address several questions raised at the hearing.

We acknowledge and appreciate that some changes have been made to the draft R&D legislation however, they do not address the problems with sufficient clarity.

Following on from our previous submissions, there are four key concerns which we believe will have a significant detrimental impact on the level of R&D in the property and construction industry:

1) **New definition of Core R&D** – the focus is skewed towards "research" and away from "development" potentially excluding property R&D undertaken within a building. This would be an unusual outcome.

The definition should ensure the actual creation of new or improved materials, products and devices processes and services are Core R&D. This can be simply achieved by:

1) removing two words in the definition *"about"* and *"the"* at 355-25; or
2) including a number of examples in the EM which show what building related R&D could legitimately use the incentive.

2) **New definition of Supporting R&D** – requiring activities be undertaken for the *"dominant purpose"* of supporting core R&D is impractical for on-site R&D that eventually gets used in the building. It is difficult to argue "dominant purpose" when there is another use even though the R&D is legitimate and appropriate.

Again the solution is simple:

1) change dominant purpose to *"substantial purpose";* and
2) include EM examples that show property related examples that can legitimately use the incentive and satisfy the purpose test

3) **Feedstock provisions –** are not appropriate for R&D industries that do not build prototypes and mass manufacture products. For the property industry it will effectively deny legitimate R&D costs for on-site tests used in the building as it will treat the building as a prototype.

The provisions do not give the same result for all industries and will effectively mean the majority of any incentive to the property industry will be inappropriately repaid.

The proposed feedstock rules should reflect their original purpose and apply to mass manufacture.

4) **Section 355.225**, relates to specifically excluded expenditure. It indicates that building costs are excluded from the R&D incentive but does not clarify in what circumstances.

In the current legislation, the exclusion was applied to the construction of R&D facilities. The current exclusion should confirm that this is still the case.

It makes no sense for the exclusion to apply to anything but construction of R&D facilities.

We believe that each of these issues can be simply addressed while maintaining the integrity of the R&D provisions.

Please do not hesitate to contact me directly on 0406 45 45 49 if there are any further queries.

Yours sincerely

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Submission: Senate Inquiry R&D Incentives

Property Council of Australia
May, 2010

1 R&D Incentive Recommendations

Issue 1 – 355-25, Definition of Core R&D Activities

"(1) Core R&D activities are experimental activities:

(a) whose outcome cannot be known or determined in advance on the basis of current knowledge, information or experience, but can only be determined by applying a systematic progression of work that:

(i) is based on principles of established science; and

(ii) proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions' and

(b) that are conducted for the purpose of generating new knowledge (including about the creation of new or improved materials, products, devices, processes or services)."

Discussion

The new definition omits the requirement that both 'considerable novelty' and 'high levels of technical risk' be present in order for activities to be considered core R&D.

The new definition retains the meaning behind these two terms and carries their meaning with the 'and' test into the new program. Thus, the substance of the definition is not significantly different to that proposed in the first exposure draft although we do acknowledge the changes made.

Of particular concern though, is that the focus of the new definition is on generating new knowledge, rather than extending to the application of that knowledge. It effectively emphasises "research" and ignores " development".

We understand that this focus stems from a belief that greater benefits flow to the broader community from generating knowledge rather than from the application of that knowledge.

In practical terms, this definition raises a question of whether a building development that involves onsite R&D can even be considered as an R&D cost under the incentive.

For instance, in order to test a green retrofit for insulation or structural supports for an unusual building, it is necessary to conduct the R&D within the building to take account of all variables, however the costs associated with that test may not fit the definition of core R&D.

This would be a very unusual outcome but it depends on how you interpret "new knowledge" regarding: improving materials, products, processes or services – does it include extending the application of that knowledge.

We believe that there is significant public benefit where the focus of R&D is in its practical application. Indeed, this is where tangible commercial outcomes are achieved

and value created. It is also where companies take on significant risks and where technical failures often occur.

We believe that the definition is disproportionately skewed away from application R&D.

Proposed Solution

We propose modifying section 355-25(b) to better encompass the 'development' activities of R&D projects.

The definition should ensure the actual creation of new or improved materials, products and devices processes and services are Core R&D. This can be simply achieved by:

1) removing two words in the definition *"about"* and *"the"* at 355-25; or
2) including a number of examples in the EM which show what building related R&D could legitimately use the incentive.

This modification presents a practical reflection of the scope of activities that are required when undertaking R&D across many industries, including the property and construction industry.

Issue 2 –355-30 "Supporting" R&D Activities

Discussion

The proposed R&D Bill indicates that, where supporting activities produce goods or services or are directly related to producing goods or services, they will only be eligible where they are for the *"dominant purpose"* of supporting core R&D. This will effectively exclude many activities that are undertaken in support of the R&D but do not meet the dominant purpose test.

R&D within the property and construction industry typically involves undertaking activities (particularly supporting activities) as part of the commercial activity of the company. This is a necessary part of attempting to generate new knowledge and develop new and improved processes.

It is unreasonable to prescribe that supporting activities should only be eligible where they are for the dominant purpose of supporting core R&D. In order to determine the technical outcome of many construction related R&D projects, it is essential that the R&D activities are undertaken on a commercial scale and in a commercial environment (eg on-site).

New construction techniques that are investigated under an R&D project have to be tested, in many cases, by the partial build of the project to conclude the R&D. This activity is clearly supporting R&D because without it, the success of the research and design cannot be verified and new knowledge cannot be generated. However, the dominant purpose of the activity is not to support the core R&D, but to construct the actual building.

Only in situations where prototypes are purpose built would the dominant purpose test be satisfied. The Property and Construction industry works on a scale that would make individual prototypes impractical, expensive and ineffective.

Excluding supporting activities unless they are undertaken for the dominant purpose of supporting core activities will significantly reduce the amount of funding for R&D in the property and construction industry under the new R&D Tax Incentive.

The approach is impractical for on-site R&D that eventually gets used in the project. It is difficult to argue "dominant purpose" when there is another use even though the R&D is legitimate and appropriate.

Proposed Solution

We recommend that the "dominant purpose" requirement for supporting activities be removed. We recommend introducing a "substantial purpose" test rather than the proposed "dominant purpose" test:

1) change *"dominant purpose"* to *"substantial purpose"* in the bill*;* and
2) include EM examples that show property related examples that can legitimately use the incentive and satisfy the purpose test

Issue 3 – 355H Feedstock Expenditure

Discussion

The first exposure draft of the R&D Bill contained a very restrictive augmented feedstock rule. This rule reduced the R&D credit to the extent that there was any output of value from the R&D activities. In effect, it reduced the R&D credit to a subsidy for failure.

The second exposure draft had no feedstock rule, but it was noted that the final feedstock provisions would be contained in the Bill and that these would be similar to the current feedstock provisions in section 73B of the ITAA 1936.

This was seen as a very positive move.

The Bill contains a new set of feedstock provisions but they apply more broadly. than the existing feedstock provisions.

In many respects they operate in a similar way to the originally proposed augmented feedstock rule. This is due to an expansion of the expenditures included in the definition of feedstock input, the broadening of the concept of feedstock output (the marketable output) and the requirement to add an amount to assessable income.

We are specifically concerned with the broader application of the feedstock provisions as stated in the EM.

In particular, the ATO currently treats the feedstock provisions as being applicable to mining and mass manufacturing type activities rather than one-off construction activities. However, the EM notes that the new provision will not be confined to mass production activities and is therefore likely to extend to one-off construction projects.

The new provisions seem complex and unnecessarily restrictive – again being more akin to a subsidy for failed R&D rather than incentive to generate new knowledge.

They are not appropriate for R&D industries that do not use prototypes and mass manufacture products.

For the property industry it will effectively deny legitimate R&D costs for on-site tests used in the building as it will treat the building as a prototype.

The provisions do not give the same result for all industries and will effectively mean the majority of any incentive to the property industry will be inappropriately repaid.

Proposed Solution

The proposed feedstock rules should reflect their original purpose and apply to mass manufacture.

Issue 4 –355-225, Expenditure that cannot be notionally deducted

"Expenditure on buildings, certain assets and interest

(1) Sections 355-205 (deductions for R&D expenditure) and 355-480 (deductions for earlier year associate R&D expenditure) do not apply to the following expenditure:

(a) expenditure incurred to acquire or construct:

(i) a building or a part of a building; or

(ii) an extension, alteration or improvement to a building;

*(b) expenditure included in the *cost of a tangible *depreciating asset for the purposes of Division 40 (as that Division applies as described in section 355-310 or otherwise);*

(c) expenditure incurred for interest (within the meaning of Division 11A of Part III of the Income Tax Assessment Act 1936) payable to an entity."

Discussion

If the provisions are read strictly, any expense incurred by a construction company for R&D purposes will not be allowed to be notionally deducted under R&D legislation, if any of the activities involve building construction.

The wording of the exclusion is not substantially different to what is in the current legislation. However, it has long been understood that the correct interpretation of the current provision is that a company cannot claim the acquisition or construction costs relating to a building that will be used for R&D purposes. However, it can claim construction costs where the construction is itself eligible R&D.

Although the explanatory memorandum provides a construction example (Whist), we are not comfortable that the current interpretation can be relied upon with regard to the proposed legislation.

Should the current interpretation not be adopted, this would effectively end any R&D claims in the construction industry. As a result the construction industry would be substantially penalised compared to other industries, and this is at odds with the R&D tax credit being a broad based incentive.

Proposed Solution

The Bill should imbed the current understanding and interpretation into Section 355-225, by stating that the expenditure relates to the construction costs of a building that will be used for R&D activities (ie essentially a form of laboratory), and that costs associated with construction activities that are themselves R&D activities would be allowed for notional deduction.

2 Senate Hearing Questions

The questions below are provided based on the notes taken during the Hearing and will be confirmed once the transcript is available.

1) Is a company able to claim the cost of an entire building under the R&D Tax Concession? More specifically, is it possible to claim a whole $100m building in relation to a new air conditioning system worth $15m in R&D.

On the basis of only the limited facts available, we cannot see how $15m in R&D can lead to a legitimate claim for an entire building under the current legislation. We note however, that the circumstances of this individual case may be substantially more involved.

In some circumstances it may be possible that a portion of the construction of a building could be claimed, where it is absolutely necessary for that construction to be undertaken in order to properly conduct the R&D.

This would be, for example, where modelling is insufficient or incapable of verifying a design and it is necessary to construct a pre-determined portion of the building and then perform in-situ testing. If successful, the design is verified and modelling may be sufficient in future situations as the knowledge base has been expanded. If unsuccessful, remedial action would be necessary, which may include substantial re-design and structural strengthening. Again, this adds to the knowledge base and may allow more accurate modelling to occur in the future.

In most cases, the R&D build (where necessary) would amount to a proportion of the building structure needed to confirm the experiment. In the large majority of cases this would not be anywhere near the entire value of the building.

If the Senate is concerned with "whole of building" claims, it can simply be dealt with through an appropriate EM example, without risking the integrity of the rules to guard against this extreme possibility.

2) Would moving from a 'dominant' purpose test to a 'substantial' purpose test safeguard against misuse of public money? How?

We are concerned that the "dominant purpose" test will exclude activities that contain significant technical uncertainty, carry a substantial financial burden and must be carried out in order to verify whether the R&D being undertaken is successful or not.

As we have previously noted, it would be very rare that any supporting R&D activities in the property and construction industry are undertaken for the "dominant purpose" of R&D. This is because all successful R&D is (where possible), incorporated into the project - It then becomes an arguable point whether the "dominant purpose" is the R&D or the building's commercial completion itself.

It does not alter the fact that the R&D was legitimately undertaken to resolve a significant risk through experimentation.

The "dominant purpose" test is simply too difficult to satisfy because it excludes the possibility of another material purpose.

A "substantial purpose" test instead still requires R&D to be conducted as part of the activity as a prerequisite for satisfying the test, but allows for the possibility that there are other material purposes for conducting the activities.

The integrity of the test is therefore not disturbed as it does not "lower the bar" for R&D but does recognise other purposes can exist.

A claim for supporting R&D is only legitimate where the activity is absolutely essential to the R&D itself - such as where some construction has to be undertaken in order to properly conduct the R&D.

3) Is there a repository used by the construction industry that allows knowledge created by R&D projects to be shared?

There is no formal repository for sharing R&D outcomes in the construction industry. This is mainly because such a repository would largely negate any competitive advantages gained from undertaking the R&D. This situation, however, is not unique to the construction industry. We are not aware of any industry that would share knowledge in this manner. Some industries have established cooperative research centres, however these bodies represent only a small portion of R&D being undertaken in each industry and are the R&D is strictly controlled.

There are, however, several avenues through which new knowledge in the construction industry is disseminated. On a formal basis, these include industry conferences and articles published in industry journals. Obviously, there is some intellectual property that is retained by the company that has developed it, but general principles are made available to the broader industry.

The outcomes of R&D projects in the construction industry are also disseminated through informal channels. For example, the first 6-Star Green Rated building of a particular type will have raised the standard for the whole industry, and future clients and/or tenants will demand the same level of efficiency and technology from their buildings. While the specific knowledge obtained from undertaking the R&D projects is not shared, the achievements of the R&D are. This spurs other industry players to innovate in order to maintain industry competitiveness. A certain level of knowledge is also retained by employees and contractors, and this is often disseminated throughout the industry as these employees and contractors move between employers.

4) **When discussing the 75 storey building complex, can you provide an example of a situation where a project has fallen over?**

The possibility of a building collapsing during or after construction is highly unlikely. This is not so much related to the lack of risk associated with trialling new technologies, but rather the measures and processes the industry has put in place to prevent such an event occurring.

It is important to understand that R&D may be undertaken on one element of the building, which requires other aspects of the building to be completed in order to determine the success of the R&D. Examples of this include load

testing, frequency testing, wind testing and a host of other measures. If at any stage during the design and construction, of the building it is determined that a structural element may be at risk of failure, immediate action is taken to prevent this.

Remedial action may take the form of large scale redesign, changed material selection or several other alternatives. Sometimes the construction has to be abandoned. Most of these alternatives are accompanied by significant costs, however the chance of catastrophic failure is remote as remedial action will be taken when evidence of component failure first becomes apparent.

Thankfully, we are unable to provide an example of an Australian building that has collapsed due to unsuccessful R&D initiatives.

In practical terms, the most prevalent risk (outside of a catastrophic failure), is the potential for ongoing R&D costs to continue while a satisfactory solution is found that will enable to project to continue. These costs ultimately eat into the commercial viability of the project and the incentive mitigates this risk and encourage the industry to innovate.