General Manager
Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

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Dear Sir

The new research and development tax incentive ("the Proposal")

Thank you for the opportunity to comment on the Treasury Proposal.

The Property Council is the peak body representing the interests of owners and investors in Australia's $400bn property investment sector.

The Property Council has 2000+ members from developers, buildings and fund managers through to investment banks and superannuation funds. The Property Council serves the interests of companies across all four quadrants of property investment - debt, equity, public and private.

Our members support the Government initiative to better target research and development (R&D) tax incentives, however we are concerned that the Proposal is too narrowly focussed. The current Proposal unnecessarily excludes incentives for legitimate R&D activities which help drive innovation in the Property sector.

There is considerable concern that the Proposal will stall future R&D in the property & construction industry. The Proposal will make it significantly harder for Government to achieve its policy aims for affordable and climate change.

We have real concerns that denying claims of eligible expenditure for prototypes that are contracted for sale will significantly inhibit future development of new technologies that provide Australia with environmental benefits, new know how and important competitive advantages.

The R&D incentives in past years have been used to develop fundamental innovations that:

1) deliver more effective building techniques which reduce building costs and construction time for developments;

2) provide critical technical processes that enable the green retro fit of buildings, tri-generation, chilled beam air conditioning and advances in green building efficiency.

Without new construction innovations many projects will be "dumbed down" to

only use standard existing technologies and processes.

The existence of R&D incentives for buildings provides further funding for viable business cases to design major innovations that enhance building performance or reduce construction costs.

For example, a member company recently had a contract to design and construct a commercial building. The company could have used only existing technologies and processes to meet the basic contract requirement. However, by including the estimated R&D Tax Concession benefit from the prototyping expenditure in the building, supported by an Advanced Registration process, the company made a business case to reinvest these funds in the building.

This project sought to develop technologies and processes to achieve 6 Green Star building performance at a construction cost similar to a traditional building. The major advances achieved in this project have lead to sustainable development proposals, without a price premium, gaining more market acceptance. This is an important advance to the benefit of the industry and as a large step toward minimising the carbon footprint of commercial buildings. This project would not have proceeded in this manner without the R&D Tax Concession benefit.

The Problem

The current proposal will effectively exclude the majority of property related R&D projects because the incentive:

1) is only available to companies which excludes other structures from using the incentive, such as staples where the R&D may be conducted within the trust structure of the staple;

2) does not clearly identify how the concession should be applied to R&D activities with multiple parties such as joint ventures or subcontracting;

3) requires core and support R&D to be split out and costed, which is often impractical on large developments and a compliance nightmare;

4) targets only R&D that “would not have occurred without the incentive” which is subjective and impractical because it is impossible to split out any “additional” R&D in property projects which are largely unique;

5) requires eligible R&D *activities* to be both innovative and technically risky which will deny incentives to legitimate R&D projects because a project can be innovative and technically risky where the individual activities may be one or the other but not necessarily both;

6) proposes artificial limits on supporting activities eligible for R&D incentives which do not account for the crucial importance of these activities within R&D for developments.

The Property Council considers that each of these issues can be simply addressed while maintaining the integrity of the R&D provisions. The detail of

each recommendation is outlined in the attached submission:

1) Allow the R&D incentive to be used by entities other than companies including unit trusts;

2) Provide further detail on the meaning of “on own behalf” and remove obsolete provisions that unintentionally prevent the unwarranted separation of financial risk and ownership;

3) Do not distinguish between core and supporting R&D;

4) Do not require R&D incentives to be targeted at an impractical and unclear concept of “additional R&D”;

5) Move towards defining R&D projects rather than R&D activities and drop the dual test for innovation and technical risk;

6) Drop proposed limits on supporting activities in favour of limits on indirectly related supporting activities;

7) Maintain the current R&D exclusions to the definition of core activities.

We would appreciate the opportunity to discuss this submission with you further at your convenience.

In the meantime, please do not hesitate to contact me directly on 0406 45 45 49.

Yours sincerely

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Property Council of Australia

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Submission: Treasury Review of R&D Incentives

Property Council of Australia
October, 2009

1 R&D Incentive Recommendations

Issue 1 – Access to the new incentive

Para 19. *Only companies will be eligible for the new R&D tax incentive. Generally, an entity that is treated as a company in the tax law will be treated as a company for the new R&D tax incentive. Extending eligibility to other entities would create significant integrity and administrative issues, especially in the area of trusts.*

Discussion

Businesses operate through a variety of structures, with valid commercial reasons for doing so. This is particularly the case in the property and construction industry, where the use of unit trusts features strongly.

By limiting the new incentive to companies, this creates a bias against businesses operating via other legitimate structures. This, in turn, can create a bias against certain industries where the use of alternative structures is common.

We see no insurmountable reasons as to why the new program could not be extended beyond companies. We note that the tax credit introduced in New Zealand was open to a range of entities including trusts, partnerships and even individuals. We are not aware of any additional administrative difficulties arising from this.

Recommendation

We recommended that the new R&D tax incentive should be open to entities other than companies. Limiting claimants to companies fails to recognise the various entities (particularly unit trusts in the property and construction industry) that legitimately conduct R&D of the type the Government wishes to encourage and support.

For unit trusts, the R&D incentive could be structured as either:

(a) a cash payment to the unit trust; or

(b) a deduction for the unit trust which would form part of a non-assessable distribution by the unit trust for which no CGT event E4 cost base reduction is required to be made.

Issue 2 – The 'on own behalf' rules

Para 31. The new R&D tax incentive will retain the rule that a company can only claim eligible R&D activities conducted by the company or on its behalf. This rule enables the appropriate claimant to be identified, and prevents the duplication of claims where R&D is contracted out.

Discussion

We recognise the merits of ensuring that R&D claims are not made by multiple entities in respect of the same R&D activities. However, we would like to highlight a significant problem which we believe exists due to the interaction of two provisions in the current legislation, namely, s73B(9) and s73CA.

S73B(9) is the provision in the legislation which prevents a company from claiming R&D that it carries out on behalf of any other person. The test applied by the ATO in interpreting this provision involves the weighing up of three key criteria, namely who:

- bears the financial risk associated with an R&D project;
- has control over the R&D project; and
- effectively owns the project results.

S73CA is a provision which was introduced in order to address R&D syndicates, and operates to limit deductions for R&D expenditure when that expenditure is deemed to be 'not at risk'.

Both of these provisions deal with the financial risk associated with R&D expenditure. However, depending on the interpretation adopted, different outcomes can be arrived at under the two provisions. In particular, it is possible that both parties to a contract involving R&D are denied access to an R&D tax credit, one by s73B(9) and the other by s73CA. Indeed the ATO has previously signalled its intention to interpret the provisions in this way, in its guidance on page 23 to 25 of Part C of the Guide to the R&D tax concession, and thereby deny both parties a tax deduction. This is clearly unsatisfactory as meritorious R&D should be claimable by one party.

While the above interpretation has been relaxed somewhat via the issuing of ATOID 2009/107, the potential still exists for the misapplication of s73CA in circumstances where it was not intended to apply.

Recommendation

Since the demise of R&D syndicates, s73CA is now effectively obsolete. To solve the problem identified above, we recommend that an equivalent to s73CA should not be included in the new legislation.

In addition, we recommend that further detail regarding 'on own behalf' be legislated in order to provide greater certainty to claimants.

Issue 3 – Administration

Para 47. The new R&D tax incentive will require companies to distinguish between core and supporting R&D. However, companies also will be able to draw on more extensive guidance material (from both the new legislation and guidance issued by the administrators) than is currently available.

Discussion

We believe that a requirement to distinguish between core and supporting R&D will add an unnecessary layer of compliance and complexity to the R&D tax incentive. We also believe that such a requirement is contrary to Principle 4 of the Paper which is intended to provide efficient and effective administration of the new tax credit.

The terms *core and supporting R&D* are unique to R&D tax incentive programs. These terms are not used elsewhere in the construction industry and we doubt they are commonly used in any industry – except in relation to R&D tax incentives.

We do not believe that any companies would have accounting systems that are capable of easily differentiating between core and supporting R&D expenditure. Typically, expenditure records are project based, with indirect costs being apportioned from company overheads.

Similarly, technical documentation is not separated into core and supporting R&D. Rather, the documentation in relation to a specific project will include technical investigations, architectural and engineering drawings, other design documentation, expert reports, modelling analyses, work protocols, test reports, etc. The activities in relation to these will be a combination of core and supporting activities, and will vary depending on the nature of the project.

We believe that it would require an unacceptable allocation of time and resources to develop systems to distinguish activities and expenditure between core and supporting R&D. The cost of compliance would be excessive and it would detract from the ease of application of the new R&D tax incentive. This may also be a deterrent to companies that do not have the record keeping systems, nor the available resources to comply with such a requirement.

The PCA is in favour of additional guidance materials to assist with an understanding of the breadth and operation of the new R&D Tax Incentive. It is the view of many of our members that scope of the current R&D Tax Concession is not well understood within the construction industry.

Recommendation

We recommended that there be no requirement for companies to distinguish between core and supporting R&D.

We also recommend that further guidelines be provided with an industry focus to allow for greater clarity and certainty in relation to eligibility criteria, and that these guidelines be provided in a timely manner so as to allow adequate time for understanding and planning.

Issue 4 – Eligible R&D Activity

Principle 5

The new R&D tax incentive should target R&D that:

(a) is in addition to what otherwise would have occurred; and

(b) provides spillovers - benefits that are shared by other firms and the community - that are large relative to the associated subsidy.

Para 48. A public subsidy for R&D should generate additional R&D activity with benefits that spillover to other firms and the community. This 'additionality and spillovers' test applies to the new R&D tax incentive as a whole, rather than individual R&D activities.

Para 49. In a broad-based entitlement scheme that allows claimants to self-assess, administrators cannot practically assess whether individual activities provide spillovers and whether the R&D would have occurred in the absence of a subsidy. However, the principle of additionality and spillovers will underpin the design of the rules for what activities will be eligible for the new R&D tax incentive.

Para 50. The Government appreciates that previous attempts at tightening the definition of eligible R&D activity under the current scheme were contentious and that some stakeholders are satisfied with the current definition. However, a new definition of eligible R&D activity is an essential component of the new R&D tax incentive package. Without it, the Government cannot afford to proceed with the incentive at the current rates and turnover threshold and would continue to leave the Budget exposed to lower value-add claims.

Discussion

Principle 5 of the Paper makes the assumption that there is a base level of R&D that will be undertaken irrespective of the availability of Government support for R&D in the form of the R&D tax incentive. However determining what "would otherwise have occurred" and what is in addition to this, is a subjective test, which is prone to inconsistent interpretation, both at the taxpayer and regulator level.

A subjective approach to public policy introduces irregularities and inconsistencies, and may impede the effectiveness of the intended policy. We believe that it is imperative that this does not form a part of the 'objectives' to the new tax credit, nor a part of the resulting legislation.

The Australian construction industry is extremely competitive and there is a constant need to develop new and improved products and processes and to acquire new knowledge. The construction industry generates significant spill-over benefits for the Australian community through its R&D, in the form of additional jobs, housing and the advancement of technology. It is impossible to predict which R&D is "additional" to what would have been undertaken without the existence of a tax incentive.

Recommendation

We recommend that the emphasis on "additionality" be removed, and that the focus be on providing greater clarity in relation to the eligibility of R&D activities and expenditure.

Continued support of the construction industry via the new R&D tax incentive would assist with promoting a culture of innovation, which is necessary if Australia is to remain a world leader in this industry.

Issue 5 – Core R&D

Principle 6

> *Eligible R&D activity will be defined as systematic, investigative and experimental activity that:*

(a) involves both innovation and high levels of technical risk; and

(b) is for the purpose of producing new knowledge or improvements.

Para 52. *The definition of core R&D will not alter the SIE or purpose requirements. However, the Government's current intention is that the definition of core R&D will require SIE activities to be both innovative and technically risky. These conditions go more to the heart of why a subsidy for R&D is warranted. The absence of either of these factors reduces the likelihood the activity will produce spillover benefits and be in addition to what would otherwise occur.*

Para 53. *Innovation is one of the ways in which companies seek to differentiate themselves from their competitors and improve profitability. There is a level of innovation that will occur in the absence of a subsidy. Similarly, companies routinely make commercial judgements about undertaking activities that involve technical risk based on the probability of success, the benefits of success and the costs involved.*

Para 54. *Subsidising an activity that is innovative but not risky may, at the margins, lead to additional R&D with benefits extending beyond an individual company. However, it is more likely to do no more than subsidise a company for doing what is already commercially sensible. Similarly, a subsidy for activities that involve high levels of technical risk but are not inherently innovative may lead to additional activity but is unlikely to deliver benefits beyond an individual company.*

Para 55. *A definition which requires that core R&D activities involve both innovation and high levels of technical risk means that the new scheme will better align with the Frascati Manual and international practice. Currently Australia has one of the broadest definitions of R&D (when compared to the Frascati Manual). Many countries, including the United Kingdom and the United States, take a narrower approach.*

Discussion

To begin, we submit that the concept of requiring both innovation and high levels of technical risk in order to satisfy the definition of eligible activities is flawed as this test would need to be applied at the activity level, rather than at the project level. Applying a dual test to each activity would result in a dramatic reduction in eligibility, notwithstanding that the collection of activities (ie, the overall project) may involve both innovation and high levels of technical risk.

Furthermore, the current R&D Tax Concession has been effective in supporting, and creating additional R&D. This Concession has been successful, albeit it provides an alternate test for innovation or high levels of technical risk.

The contention that a new program will only meet its aims of *being more effective in delivering support for business R&D*, and *deliver additional spillover to other firms and the community*, by tightening the definition of R&D as detailed above is unfounded.

It seems unnecessary to tighten the definition of R&D in order to achieve this outcome. R&D activities can arise in those circumstances which involve either innovation or high levels of technical risk, with spillover benefits to the Australian community.

For example, consider the situation where a company seeks to undertake a development on a site which has profile that would ordinarily make it unsuitable for the desired development. In particular, it may be badly contaminated or have poor geotechnical characteristics. The company would be faced with significant technical uncertainty, but it may not necessarily create an innovative solution. Notwithstanding this, it will still need to undertake extensive R&D in order to achieve its objective, and there would be considerable spillover benefits to the broader community. These benefits would include additional employment, utilisation of otherwise unusable land, and significant knowledge as to how to undertake similar projects in the future.

This example illustrates the effectiveness of the current definition of R&D activities. The R&D tax concession would support the company in overcoming great technical uncertainty, and there would be spillover benefits for the broader community. This highlights that the premise of Paragraph 54 of the Paper is without basis.

With respect to the paragraph 55 of the Paper, we do not agree with the statements made. A review of the Frascati Manual and the definition of R&D activities used in a number of foreign jurisdictions shows that there is no requirement for both innovation "and" high levels of technical risk to be present in order to align the definition with the Frascati manual and international practice.

Recommendation

We recommend that the requirement that core R&D involves both innovation and high levels of technical risk should not be adopted.

We further recommend that consideration be given to moving away from a definition of R&D activities in favour of a definition of R&D projects.

A suitable definition of R&D project might be:

"Eligible R&D project means a group of activities which, collectively:

(a) are undertaken for the purpose of:

  (i) acquiring new knowledge; or

  (ii) creating new or improved materials, products, devices, processes or services;

(b) are undertaken in a systematic, investigative and experimental manner; and

(c) involve either innovation or a high level of technical risk;

and includes all activities necessary to achieve the desired purpose."

Issue 6 – Supporting R&D

Principle 7

Supporting R&D will continue to be recognised under the new R&D tax incentive, but claims will be subject to new limitations.

Question 4

Should supporting activities:

(a) be capped as a proportion of expenditure on core R&D?

(i) If so, what would be the appropriate proportion (for example, 1:1)?

(b) only be eligible where they are for the sole purpose of supporting core R&D activity?

(c) exclude production activities or dual role activities?

(d) only be eligible on a net expenditure basis?

(e) attract a lower rate of assistance than core R&D?

(i) If so, what would be the appropriate rate?

Discussion

We do not support any of the proposed limitations to supporting activities. Each of the proposed options would require a differentiation between core and supporting R&D which, as we have already indicated, we do not support. Specific concerns in relation to each of the proposed limitations are outlined below.

(a) Imposing a cap on supporting activities discounts the value of such activities in the completion of an R&D project. Construction companies undertake a range of supporting activities which are unique to the industry, and imposing a cap on these activities will result in a significant bias against the industry.

While the cost of supporting activities may often exceed the cost of the core activities, we submit that this is irrelevant. The undertaking of these activities is a necessary requirement to fulfilling the technical objective, which typically focuses on the development of new or improved processes, or the acquisition of new knowledge. Capping supporting activities as a proportion of the expenditure on core R&D will impede the continuation of many R&D projects, and may limit the achievement of technical advancements within the industry.

(b) R&D within the construction industry typically involves undertaking activities (particularly supporting activities) in-situ, - ie, as part of the commercial activity of the company. This is a necessary part of attempting to develop new and improved processes and acquire new knowledge.

It is unreasonable to prescribe that supporting activities should only be eligible where they are for the sole (or even dominant) purpose of supporting core R&D. Denying the eligibility of supporting activities which, due to the scale required within the construction industry, are undertaken as part of a larger project with a commercial purpose, fails to appreciate the manner in which R&D activities are undertaken within the industry.

In order to determine the technical outcome of many construction related R&D projects, it is essential that the R&D activities are extended into a commercial environment. Excluding supporting activities unless they are solely or predominately undertaken for the purpose of supporting core activities, will significantly reduce the amount of funding for R&D in the construction industry that will be provided by the new R&D Tax Incentive.

(c) For the reasons outlined above, we believe that supporting activities should not exclude production or dual role activities.

It is with interest that we note that the Paper refers to the fact that the United Kingdom and Canada have adopted an approach where activities with a purpose other than R&D are excluded from their respective R&D incentive programs. Both of these countries rank below Australia with the current program of the R&D Tax Concession, in relation to the ratio of BERD as a percentage of GDP[1]. The Paper has highlighted that the new R&D Tax Incentive will be tightening the eligibility criteria, as well as creating a revenue neutral program over the first four years of operation.[2] Yet it also states that it will be more effective in delivering support for R&D[3]. If the program aims to mirror the definitions of the United Kingdom and Canada, it is possible that the objectives will not be met, and the BERD as a percentage of GDP will reduce within Australia, rather than move above the average of 1.59%[4].

(d) Limiting eligibility of supporting activities to a net expenditure basis effectively equates to a providing greater level of support for unsuccessful R&D than would be provided for successful R&D. In other words, the tax incentive would reward failure rather than remaining neutral and rewarding all R&D equally.

In addition, the application of such a system would be particularly problematic for the construction industry, where a project may run for several years. It is often not until well after the project has been completed that the final financial position is known, particularly where liquidated damages and warranty costs are involved. As a result, the outcome of the project may not be known at the time of preparing the R&D claim. This would add a further layer of compliance and complexity, with a need to amend claims in future years.

(e) We believe that a two tiered program would also add unnecessary complexity and compliance issues to the program. Furthermore, such a system would discount the value of supporting activities.

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[1] Australian Bureau of Statistics, Research and Experimental Development, Businesses, Australia, 2007-08

[2] Paragraph 14, The Paper

[3] Paragraph 8, The Paper

[4] Ibid 21

Supporting activities within the construction industry are an essential element of eligible R&D projects and, in our view, are as important as the core R&D activities. Should supporting activities attract a lower rate of assistance, the construction industry would be inequitably disadvantaged through the receipt of a lower base of Government support for R&D. Without undertaking supporting activities, R&D projects within the industry would be dramatically reduced, and the level of advancement and progression within the industry would be negatively impacted upon.

Recommendation

We believe that, in order for the new tax incentive to be *"more effective in delivering support for business R&D and in targeting that support to where it is most likely to produce net-benefits for the Australian community",* it needs to be broad based and of application to all industries including the construction industry.

While we recognise the challenges in providing a program that is revenue neutral over its first four years, we are unsure as to the extent of modelling that has been undertaken to reflect all relevant factors associated with the difference between the old and new programs. If, (after considering the impact of the removal of the 175% R&D tax concession) there is a need to introduce limitations to expenditure, we recommend that Treasury consider restricting the claiming of *indirectly related* supporting expenditure, rather than directly related supporting activities such as those discussed above. Indirectly related supporting expenses in the form of overheads, for example, could be capped – perhaps even on an industry basis.

We recommend that further economic investigations and modelling be undertaken to analyse and understand the impact of the proposed changes at an industry level. Following such analysis, Treasury would be better placed to determine the actual impact of the proposed changes across particular industries and then develop a program that does not create any industry bias.

Issue 7 – Excluded Activities

Question 5

Should the current list of activities excluded from being considered core R&D be:

(a) amended in any way?

(b) extended to exclude certain activities from being considered supporting activities?

Discussion

We believe that the current list of activities excluded from being considered as core R&D is both reasonable and adequate.

There does not appear to be any practical basis to extend the list to exclude any of the activities from being supporting activities. Many of these activities are necessarily undertaken as part of the R&D project, and their exclusion would hinder the progression of the project.

Recommendation

The exclusions to the definition of core activities should be maintained and remain unchanged. The exclusion should not be extended to supporting activities.