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The Treasury
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PARKES ACT 2600

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Dear James

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

Thank you for the opportunity to provide comment on the second draft R&D legislation.

Our members welcome the changes made to the second draft R&D legislation as a result of feedback received on the first exposure draft. However, these changes do not adequately address all the concerns identified in our previous submissions.

The proposed second draft R&D legislation will substantially limit access to R&D incentives for the property and construction industry and hold back future R&D in the sector.

The Property Council considers that the remaining 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.

In summary, the Property Council recommends that Treasury should:

- 1) allow access to the R&D incentive by other entities including unit trusts
- 2) rethink the definition of 'core R&D activities'
- 3)remove the dominant purpose test
- 4)provide a more thorough construction industry example in the explanatory memorandum
- 5)clarify exclusions in section 355-220.

The **Voice** of Leadership

This submission should be read in conjunction with our previous submissions dated 26 October 2009 and 10 February 2010.

We look forward to discussing this submission with you.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R Fitzgerald', with a long horizontal flourish extending to the right.

Roberto Fitzgerald
Executive Director International & Capital Markets
Property Council of Australia

Submission:
Treasury Review of
R&D Incentives:
Second exposure draft

Property Council of Australia
April 2010

Issue 1 – Access to the Proposed R&D Tax Credit

The new exposure draft still limits access to the proposed incentive to companies. As noted in our previous submissions, 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.

We again recommend that entitlement to the concession be extended beyond companies. We note that if the object of the credit is to encourage industry to conduct R&D, then the type of entity that conducts the R&D should be irrelevant.

We would be most interested to understand the reasoning behind limiting access only to companies.

Issue 2 – Core R&D

Section 355-25 provides the proposed definition of 'core R&D activities'. This definition is completely new, both in the way it is structured and in the terminology used.

While the words 'innovation' (or 'considerable novelty') and 'high levels of technical risk' are not explicitly used, the proposed definition still requires both of these elements to be present. Thus, in this regard, the definition is not dissimilar to the one contained in the first exposure draft and the issues raised in our previous submissions remain relevant now. In particular, the proposed definition is unnecessarily more restrictive than the definition under the current legislation.

A further concern is that the proposed definition seems to focus on the 'research' aspect of R&D rather than being broadly focussed on research 'and' development. In particular, the proposed definition requires that the activities be conducted "for the purpose of generating new knowledge (including knowledge **about the** creation of new or improved materials, products, devices, processes or services)" [emphasis added]. This can be contrasted to the current definition which extends beyond generating knowledge "about the creation" to the actual creation itself. We feel that this change in focus discriminates against the 'development' aspect of R&D, and should be addressed.

Finally, we are concerned that the Explanatory Memorandum states that the purpose of experimental activities means the sole or dominant purpose for which the activities are undertaken. In a commercial environment, particularly in the property and construction industry, very few activities would ever be undertaken for the sole or dominant purpose of generating new knowledge. This is an unreasonable raising of the bar with respect to purpose and is inconsistent with the application of the current legislation, which also uses the words "the purpose". We strongly oppose this interpretation and recommend that Treasury review its thinking on this point.

Issue 3 – Supporting R&D

The proposed definition of 'supporting R&D activities' is positive in that it defines such activities as those that are directly related to core R&D activities. This is consistent with the definition under the current legislation. However we are concerned with requirement that activities that are:-

- (a) excluded activities (as per section 355-30); or
- (b) the production of goods or services; or
- (c) directly related to the production of goods or services

must be undertaken for the dominant purpose of supporting core R&D activities in order to qualify as supporting R&D.

Presumably construction activities would be considered "the production of goods or services" or "directly related to the production of goods or services".

The vast majority of R&D in the property and construction industry is undertaken in a commercial environment and on a commercial scale. However, it is very rare that any construction is undertaken for the dominant purpose of generating new knowledge or supporting core R&D. However, this does not mean that the R&D is any less genuine or worthy of support.

Where construction activity is an integral part of the R&D, there appears no valid or logical reason to deny support merely because there is an over-arching commercial purpose associated with the construction. We recommend that the dominant purpose test be removed.

In addition, it is the view of the PCA and its members that construction activities would ordinarily be considered core R&D rather than supporting R&D, because they would form part of the eligible experiment. However, it appears from the Explanatory Memorandum that this view is not shared by Treasury. This issue is considered in more detail in the next section.

Issue 4 – Example 2.17 in the Explanatory Memorandum

The Explanatory Memorandum contains a number of examples across a variety of industries which are intended to illustrate the operation of the R&D activities tests. There seems to be a restrictive interpretation given to the scope of core R&D activities throughout these examples. However, we are particularly concerned with Example 2.17 – this being the only construction industry example.

While we accept that the example is theoretical and simplified, we feel that it is a poor one to be given as the only guidance for the construction industry. We feel that, on the basis of the facts provided, the logic and interpretation that has been adopted is flawed.

The example states that “The hypothesis being tested is that the modified anchor design will hold in this rock type when subjected to the design forces of the bridge. In this instance, the scientific approach is needed to determine whether this is so. Further, significant uncertainty remained after computer simulations.” The scientific approach required to verify the hypothesis requires all anchors to be installed, and subjected to the full loading of the bridge. The full load cannot be verified using other methods such as computer simulation, and so the bridge must be constructed to determine the performance of the anchors.

Hence, the building of the bridge is a key part of the experiment that will “lead, via the logical progression of work, to the experimental results”. Paragraph 2.22 of the Explanatory Memorandum confirms this approach and would define the building of the bridge as a core R&D activity.

However, this is contradicted in paragraph 2.20, which relates to dominant purpose. The dominant purpose of constructing the bridge is not to test the anchor design. However, there is no method of testing the anchor design in this application other than to subject it to the full load of the completed bridge. Therefore, the construction of the bridge forms an essential part of this experiment, and the anchor design cannot be verified without building the bridge.

There is also some confusion regarding the following statement from the example, “activities do not extend to installing and testing all of the anchors — only to the extent necessary to acquire the new knowledge about the improved product and related process (the new anchor design and its installation).” This part of the example has modified the scope of the original hypothesis from testing the performance of the anchors in-situ and under load, to the process of installing them. In fact all the anchors must be installed and placed under load to determine whether they will support the bridge structure in these particular rock conditions, so the “extent necessary to acquire the new knowledge” extends to all anchors as they share the entire load.

It is the view of the PCA and its members that this example creates confusion, does not reflect an accurate definition and classification of the R&D activities, and highlights several conflicting and contradictory statements contained within the Explanatory Memorandum. We recommend that a more thorough and better thought through example be provided.

Issue 5 – Clarification regarding expenditure that cannot be notionally deducted

Section 355-220 outlines certain expenditure that is excluded from the notional deduction and is therefore not subject to the credit. Of particular relevance to the property and construction industry is subsection 355-220(1)(a), which excludes 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

While this provision essentially mirrors an exclusion under the current legislation, it is one that has caused some confusion as to its application in the past. Thus, we recommend that

the section be clarified to make it clear that the exclusion does not apply where the construction itself is the R&D, and it is limited to situations where the building in question is to be used as an R&D facility.