26 October 2009

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Submission on New R&D Tax Incentive

OneSteel

OneSteel Ltd ("OneSteel") welcomes the opportunity to make this submission in response to the Treasury's Consultation Paper, "The New Research and Development Tax Incentive" (the Paper). Most recently, we were a contributor to the Review of the National Innovation System in its assessment of tax and innovation.

Summary of Submission

In order for Australian manufacturing to be sustainable and compete fairly in domestic and international markets, the Australian corporate tax system needs to be competitive with international counterparts, especially those in our region. A broad-based R&D tax incentive that equally supports production R&D is an essential component in providing this environment. Efficient manufacturing processes are essential to the long term viability of manufacturers and production R&D underpins this.

OneSteel understands a desire to provide greater R&D support for SMEs. However, any change that limited or withdrew R&D support for production R&D would have a significant impact on the level of R&D support received by manufacturers large and small.

Changing the definition of eligible R&D and/or providing different treatment to 'support' activities is likely to raise significant ongoing administrative uncertainty and adversely impact SME claimants proportionally more. If cost control is deemed necessary, this is best achieved by either targeted exclusion or through changes to eligible expenditure.

Regards administrative certainty, OneSteel recommends that the entire R&D scheme be brought within the ATO rulings and related programs or that a similar system be applied to IR&D administered (eligibility) issues. The tax amendment period should also be brought into line with standard practice and R&D plans should be dropped as a compliance requirement as their role as such is meaningless.

Background to OneSteel

OneSteel is a vertically integrated mining, scrap recycling, steel manufacturing and metal products distribution company with annual revenues of over $6 billion. OneSteel employs more than 10,000 people in Australia.
The Australian steel industry in which OneSteel operates is characterised by substantial and growing levels of imports, with pricing of products set with a reference to import parity pricing. Imported steel products are sourced from countries including China, Japan, Thailand, South Korea, South Africa, Malaysia, Taiwan, Singapore, Vietnam and Indonesia.

OneSteel has always been an active participant in R&D. In order to compete domestically and internationally, OneSteel is continually investing in new plant, new products and in programs of continuous improvement to manufacturing efficiency. As a manufacturer, production R&D is critical and is the main focus of support currently provided by the existing R&D scheme.

Since 2000, OneSteel's R&D program has seen the development of many new and improved products and processes, including:

- Following the closure of steelmaking operations at Newcastle in the late 1990s a billet casting plant was installed at the Whyalla Steelworks to extend the range of products produced from a slab, structural and rail steel maker to include the feed material for the rolling mills in Newcastle. These included many different high-grade steels for local manufacturers whose products would otherwise have been imported.
- Environmental projects such as the elimination of coal tar contamination from fence posts on farms, the treatment and handling of waste materials to be suitable for reuse and the continuing reduction of dioxin emissions to world's best practice levels.
- The design and installation of a new type of heavy mining rope plant in Australia allowing OneSteel to continue to be a world leader in this specialist market.
- Ongoing development of grinding media for the world's resources industries which is another specialist market in which we are a world leader.
- New products such as the LiteSteel Beam which are expanding into the US and other international markets.
- Development of new mining techniques for iron ore.
- The extension of the life of Whyalla Steelworks with a major program to convert from hematite to magnetite as the source material for operations and at the same time to reduce significantly the impact of operations on the ambient dust levels in Whyalla. This program has also had major regional economic impact and secured the future of operations to at least 2027.

These developments have allowed OneSteel to continue to be a large scale Australian manufacturer. We supply many other manufacturers with products as well as delivering to the infrastructure, construction, mining and agricultural industries. Many of our plants and distribution centres are located in regional Australia. To maintain this type of domestic business, OneSteel has utilised the R&D tax concession.

The R&D tax concession is factored into project evaluations and, as such, contributes directly to the assessment of the viability of projects and acts as a variable in the decision as to whether to fund the developments.

THE NEW R&D TAX INCENTIVE DISCUSSION PAPER

The paper outlines a proposal to refocus R&D support by removing the current incremental (175%) claim and to replace the standard 125% support with an increased base rate at two levels with SMEs provided a greater level of support than larger claimants.

OneSteel broadly agrees with this proposal.

However, "THE CASE FOR REFORM" has points that are inconsistent with the points made under some of the Principles. For instance Point 9 has "…. the existing scheme of enhanced deductions will be replaced with a less complex and more predictable tax credits. Companies will no longer need to distinguish between their base and incremental expenditure on R&D in working out their claim." This contrasts with the discussion points under Principle 7 which now suggest that companies will have to distinguish between core and support activities in working out their claim. Point 10 has "…… both elements of the new R&D tax incentive are more generous than the current 125% R&D tax concession." While this is true it does not accurately portray the actual level of support from the scheme with the incremental 175% included. Nor does it compare with the level afforded by the scheme as operating in 1995. The Consultation Session in Sydney was told that in 2008 the BERD level was 1.27% of GDP which ranked us at 80% of the OECD average and highlighted the increase from the turn of century when our level of BERD was only 42% of the OECD average. There is no comment on how the proposed changes will impact on Australia's BERD. Point 12 has "More fundamentally, an effective R&D tax incentive needs to result in firms conducting R&D that they would otherwise not perform ……..". This statement ignores the position where the incentive allows R&D to be brought forward and the benefits to the company and Australia being introduced earlier than would be the case without support.

The paper then goes on to suggest changes designed to limit the scope of R&D support. Through the consultation process it was suggested these additional changes are required to ensure the new scheme is tax neutral. However, nothing has been provided in the paper to support this. This is important as these changes appear to have serious practical administrative implications at best and at worst to provide mechanisms that would significantly impact the level of support provided to manufacturers – large and small.

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OneSteel does not support the proposed requirement for both innovation AND high levels of technical risk (Principle 6). Nor does OneSteel support any form of differentiated support for core and support R&D (Principle 7). OneSteel submits that any areas of activity viewed as inadvertently captured within the defined eligibility criteria are best dealt with by exclusion (similar to software treatment now) or via changes to claimable expenditure rather than tampering with a definition that has gained broad support and understanding over a long period of time.

Focus of this Submission

This submission will focus on design principles 6 & 7 of the paper and make recommendation for consideration under Principle 4.

Principle 6

Innovation AND high levels of technical risk are indeed key aspects of R&D. However, that does not mean that they co-exist at all times. Production R&D typically has a technical problem the research on which involves technical risk. The development and implementation of an identified and innovative solution may only occur after some (at times considerable) period of trial based research. In this regard a question then arises as to what innovation means – innovative to what/whom for example: the situation, the company or the community.

If all such solutions are innovative in some respect then requiring AND seems meaningless and so should be abandoned. Alternatively, if innovation is to be in some way limited in scope or definition then that would foreseably create an area fertile for ongoing debate and uncertainty.

The rationale expressed in Point 52 "…… The absence of either of these factors reduces the likelihood the activity will produce spillover benefits and be addition to what would have otherwise occur." is subjective without supporting data. The definition used up till now has been accepted and has seen an increase in BERD this century.

Notwithstanding, any adoption of AND would require a broad based application, to say a taxpayer's whole R&D program rather than each R&D activity. Otherwise, for example, an ongoing program of linear activities may have the innovation present in say one activity but not in others and so make some, otherwise valid, activities ineligible.

Principal 7

OneSteel does not run a R&D only testing facility *per se* and submits that this is likely to be the case for most manufacturers. As such, the majority of OneSteel's R&D focus is on production based testing for new product designs and manufacturing processes. Any requirement to differentiate between core and support R&D then requires a common understanding of what is currently considered such. Having reviewed our recent claims with our advisers, OneSteel believes that the majority of its claims are for core (SIE) activities. If this is generally agreed and of standard applicability to all manufacturers then the proposed differentiation would have little impact and so be of no practical relevance.

However, question 4 of the paper clearly suggests that production based R&D is by and large support and not core R&D (refer question 4 (c)). A very immediate concern therefore is that as there has been no requirement to differentiate core and support under the current R&D scheme it may well be that there are significant undebated differences of view of what is core and what is support.

Any suggestion that production based R&D is not core R&D and/or not of equal importance to 'lab' based R&D is to misunderstand R&D in a manufacturing (commercial) context. Further, it suggests that research *per se* is more noteworthy than development.

In a manufacturing business, the production facility (for example in our case a blast furnace or a rolling mill or a mesh welding line etc.) itself is the R&D 'lab'. Significant investment in businesses that use large scale capital equipment is usually done on the basis of long term return. To ensure that large, costly assets are deployed to best effect, manufacturers are continually seeking ways to improve performance and gain greater efficiency; either through the creation of new products that can be produced with the equipment or from more effective production processes. To not do this is to fall behind competitors. In the case of the steel industry, competitors are represented by international players, many (if not all) in countries where Government support for manufacturing is present.

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Not all research leads to development. There are significant barriers to the commercialisation of successful research (including the ability to produce cost effectively). However, commercialisation is required in order for the community to get spillover benefits. Therefore, providing a lower level of support for development would add to the barriers for commercialisation.

Principle 4

Efficient and effective administration of the scheme is essential. The current scheme has been in existence for over 20 years and yet there are no comprehensive, generally accepted guidelines made available and no universal mechanism for seeking clarification – other than via audit or the courts.

Expenditure issues of the scheme are administered by the ATO. The ATO has a comprehensive series of guidance and rulings programs. Yet there are relatively few rulings issued on R&D. This may be because the significant area administered by the IR&D board is not covered by the ATO programs – eg eligibility.

Relevant ATO programs include; Practice Statements, which make ATO guidelines available to the community; rulings, which allow questions to be asked of the authority (private rulings program) and for the authority to signal a view on an issue of general concern (public rulings program) and Interpretative Decisions, which make public private rulings outcomes. As these programs are well developed and understood by taxpayers it makes sense for all aspects of the R&D scheme to be covered by them. This would certainly be in keeping with a view to allow a taxpayer to seek guidance (ask for a ruling) on any and all areas of tax compliance.

If the entire R&D scheme could not be brought within the ATO programs then mirror programs should be instituted for the IR&D administered aspects.

Currently there is no period of limitation that applies to amendment for R&D deductions under the relevant Act. This is abnormal and should be brought into line with general rules.

As a final administrative matter, OneSteel believes that the current requirement for R&D plans to form part of the compliance requirements adds nothing to the integrity of the scheme and that the requirement should therefore be dropped. In practice, R&D is conducted in a systematic and planned manner. The R&D plan compliance requirement adds nothing to the practice of R&D activity conducted by claimants and does nothing to distinguish between acceptable and unacceptable activities – it is simply an unnecessary compliance burden (a technicality).

Conclusion

OneSteel greatly appreciates the opportunity to make this submission in response to the Treasury's Consultation Paper and supports the current Federal Government's resolve to undertake a comprehensive review of support mechanisms for Australian business and innovation.

OneSteel is particularly concerned with any restriction to production based R&D and believes it would have an adverse impact on Australian manufacturers, large and small. We are fully available to participate in any consultative processes that occur following the submission closing date of October 26 2009.

If you have any queries, please call Damien Baxter, Group Tax Manager on (03) 9673 0419 or me on (02) 9239 6661.

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