



MINERALS COUNCIL OF AUSTRALIA

SUBMISSION ON THE CONSULTATION PAPER FOR THE NEW RESEARCH AND DEVELOPMENT TAX INCENTIVE

26 OCTOBER 2009

The Minerals Council of Australia

The Minerals Council of Australia (MCA) represents Australia's exploration, mining and minerals processing industry, nationally and internationally, in its contribution to sustainable development and society. MCA member companies produce more than 85 per cent of Australia's annual minerals output, and will account for about 60 per cent of Australia's merchandise exports in the year to 30 June 2009.

The MCA's strategic objective is to advocate public policy and operational practice for a world-class industry that is safe, profitable, innovative, and environmentally and socially responsible attuned to its communities' needs and expectations.

The minerals industry recognises that its past success and future prosperity is dependent on a sound and expanding national economy, an educated and cohesive society and a sustainable natural environment. For this reason, the minerals sector supports public policy settings aimed at the following objectives:

- sustainable economic growth characterised by low inflation, low interest rates, fiscal prudence, and a skilled and productive workforce;
- a sound, fair and stable society, where effort is encouraged and rewarded and a helping hand extended to those in need; and
- a sustainable natural environment, reflecting national consistency and balance in policy settings.

The MCA recognises that the future of the Australian minerals industry is inseparable from the global pursuit of sustainable development. Through the integration of economic progress, responsible social development and effective environmental management, the industry is committed to contributing to the sustained growth and prosperity of current and future generations.

The Australian minerals industry is an industry of considerable size and economic and social significance, benefiting all Australians both directly and indirectly. The mining and minerals processing sector:

- underpins vitally important supply and demand relationships with the Australian manufacturing, construction, banking and financial, process engineering, property and transport sectors;
- has contributed over \$600 billion directly to Australia's wealth over the past 20 years;
- is in the top five producers of most of the world's key minerals commodities, including:
 - the world's leading producer of bauxite, alumina, rutile, ilmenite, zircon and tantalum;
 - the second largest producer of uranium, lead, zinc and lithium;
 - the third largest producer of gold, diamonds, iron ore, manganese, nickel and niobium;
 - the fourth largest producer of black coal and silver; and
 - the fifth largest producer of aluminium, brown coal and copper.
- directly and indirectly employs some 320,000 Australians, many of whom are in sparsely populated, remote and regional Australia;
- is responsible for significant infrastructure development – since 1967, the industry has built 26 towns, 12 ports and additional port bulk handling infrastructure at many existing ports, 25 airfields and over 2,000 kilometres of railway line.

TABLE OF CONTENTS

<u>1. EXECUTIVE SUMMARY: CHANGING THE DEFINITION OF R&D - A CUT TOO FAR</u>	<u>1</u>
<u>2. OVERVIEW OF THE AUSTRALIAN MINERALS INDUSTRY</u>	<u>3</u>
<u>3. THE IMPORTANCE OF INNOVATION TO THE AUSTRALIAN MINERALS INDUSTRY</u>	<u>5</u>
<u>4. IS THERE ANYTHE NEED TO CHANGE THE DEFINITION OF R&D?</u>	<u>7</u>
<u>5. DOES TREASURY MAKE OUT ITS CASE FOR DEFINITIONAL CHANGE?</u>	<u>9</u>
<u>6. INTERNATIONAL COMPETITIVENESS</u>	<u>13</u>
<u>7. IMPACTS OF THE PROPOSED CHANGES TO THE DEFINITION OF R&D</u>	<u>15</u>
<u>8. OTHER ISSUES</u>	<u>19</u>
<u>9.. CONCLUSION</u>	<u>21</u>

1. EXECUTIVE SUMMARY: CHANGING THE DEFINITION OF R&D - A CUT TOO FAR

The Federal Government announced the introduction of a new Research and Development (R&D) Tax Credit (the Credit) on Budget Night, 12 May 2009, via a Joint Media Release from the Treasurer and the Minister for Innovation, Industry, Science and Research.

The stated objective was to simplify and enhance the existing R&D Tax Concession by implementing a Credit that "...provide(s) certainty for business and its operation will align with international best practice. Under this simpler system, businesses will be able to invest in R&D with confidence." It was also announced that "...eligibility criteria will be tightened...supporting only genuine R&D."

A promised consultation paper arrived in September 2009 entitled "The new research and development tax incentive" (the Paper). On this occasion, there was not a joint release. Rather, the Paper was delivered by The Treasury alone.

The Paper details a number of features announced in the Budget. Many of these features reflect an approach summarised at Paragraph 10 which states "...the new R&D tax incentive intentionally redistributes support in favour of small and medium sized businesses...".

The MCA submission is written in the context that Australia's miners contributed \$21 billion of taxes in 2008/9, whilst the taxpayer R&D support for the most recent year of data (2006/7) was \$110 million.

The MCA acknowledges the policy aim of favouring small and medium sized business in the decision to award a higher rate of credit (15 cents cf. 10 cents) to small to medium sized enterprises (SMEs) defined as those with a group turnover of less than \$20 million per annum. It also acknowledges the decision to provide these firms with access to a refundable credit which may ultimately deliver an "above the line" operational impact.

Further, the MCA accepts the abolition of the Premium Concession and International Premium as a Government cost measure, despite these programs incentivising incremental R&D spend and generating considerable benefit to MCA members in recent years.

However, the MCA sees the Paper's announcement of a "tightening" of the current definition of eligible R&D activities as unwarranted and unacceptable.

The Treasury's case for reform is not made out by the arguments led in the Paper, nor is the need for definitional change in order to achieve announced "revenue neutral" budget outcomes demonstrated by any financial analysis or modelling.

In our view, the removal of the premium and proposed definitional changes and restrictions will materially reduce the size of R&D claims (including for some SMEs) – and as such the changes are expected to curb business R&D spend (BERD).

The MCA submits the current definition of “research and development activities” contained in subsection 73B(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) has brought **stability and relative certainty** since the commencement of the program in 1985. It is the fundamental building block upon which companies incorporate the tax incentive in their R&D projects, and it is an accurate reflection of the nature of the activities that constitute business R&D.

The MCA contends that the notion of “additionality” and “spillovers” must not form part of the legislation – even via an Objects clause – due to the likely negative impact such action would have on R&D claims.

The MCA sees the proposed rewriting of the definition of R&D, splitting activities into “core” and “supporting” categories with new restrictions applying to both, as counter to the overall objectives of the new program. Instead of heralding a simplified and enhanced incentive, the Credit would introduce an unprecedented level of complexity and uncertainty surrounding the most fundamental question in the program – what is eligible R&D?

Add this to the low levels of confidence surrounding recent performance of the administration in eligibility assessments, MCA members will face a significantly increased compliance burden in the making and supporting of significantly reduced claims.

In summary, the MCA believes the proposed changes to the definition of R&D will remove support from many of the key technical challenges facing the mining industry – carbon capture and reduction; operational safety; liberation of lower-grade and more inaccessible deposits – at a most inopportune time.

The changes proposed in the Treasury paper are, indeed, a cut too far.

2. OVERVIEW OF THE AUSTRALIAN MINERALS INDUSTRY

The Australian minerals industry is a significant investor in innovation in Australia, through direct spending, funding of engineering and mining science undergraduate and postgraduate courses and programs and through the employment of professionals who operate in research networks in Australia and around the world. The minerals industry has wide experience of the innovation system generally and relies on research outcomes to remain globally competitive.

The mining industry's commitment to R&D is of such magnitude that it far outstrips the proportion of its share of the economy. This is amply demonstrated in recently-released figures on business R&D supplied by the Australian Bureau of Statistics (ABS) for the 2007/08 year.

Making up 8 per cent of the gross domestic product, the sector provides 22.8 per cent or \$3.38 billion of business spending on R&D. This commitment to spending has increased over the past three years: recording 17.3 per cent, or \$1.8 billion, of spending in 2005/6 and 22.1 per cent or \$2.77 billion in 2006/7.¹

The proportion of government funds for R&D directed to the mining sector is a significantly lower figure in comparison to the sector's R&D expenditure contributions. In the last available data, 2006/7, the sector received 14 per cent or \$110 million of the share of government's pool of \$815 million administered under the R&D tax concession system despite, as noted above, making up 22.1 per cent of spending.²

These figures should be seen in the context of the minerals industry's overall taxation contribution. The minerals sector's contribution to taxation revenues is substantial. Work undertaken by Access Economics for the MCA examining the mining sector's contribution to both State and Federal Budgets showed tax and other revenues (direct and indirect, corporate and individual) accelerated dramatically over recent years.

The total tax paid by companies (in royalties, income tax, payroll tax and fringe benefits tax) and individuals working in the mining sector is estimated to reach \$21 billion in 2008/9, a 61% rise over the previous financial year (\$13 billion). Access Economics projections on royalties income suggested payments rose by almost 75% in 2008/9 to \$7.1 billion.

Today's modern minerals industry considers its future inseparable from the global pursuit of sustainable development. This approach is founded on five key platforms:

1. that the safety and health of its workforce and the surrounding community is its number one value and priority commitment; not subordinate to productivity, and not a factor of competitive differentiation;

¹ Australian Bureau of Statistics, *Research and Experimental Development, Business Australia – 2007/8*, 8104.

² Productivity Commission, *Trade and Assistance Review: 2006/7*, AGPS, p A.12.

2. that corporate social responsibility is not an adjunct to the business – it is the business. The core function of the minerals industry is to convert natural endowment to societal capital, and that can only be achieved sustainably when there are real mutually beneficial considerations of the environment, host communities, the rights and interests of indigenous peoples and shareholders;
3. that the intergenerational benefits to communities and the nation as a whole of natural resource development should endure across generations and extend beyond the life of mine;
4. that the industry should aspire to continuous improvement and not merely regulatory compliance; and
5. that comparative advantage does not automatically equate to competitive strength – there is no guarantee that Australia's natural endowment of resources is alone sufficient to attract the necessary investment of global companies supplying converging global markets.

This commitment in practice places the industry at the vanguard of industrial application of sustainable development. To maintain this pre-eminent position, the Australian minerals industry must continue to innovate and to do so requires tax incentives that do not discriminate on project size or R&D spend.

3. THE IMPORTANCE OF INNOVATION TO THE AUSTRALIAN MINERALS INDUSTRY

The Minerals Council of Australia considers that the innovation it supports transcends the single dimension of economic impacts and captures the wider dimensions through potential and actual contributions to sustainable development.

This necessarily entails consideration of the integration of, and balance between, the social, environmental and financial ‘dividends’ of innovation.

In line with this approach, the Australian minerals industry has worked collaboratively with several key research institutions to ensure the alignment of the industry’s overarching commitment to sustainable development with the design and establishment of research objectives and the assessment of performance outcomes for industry sponsored and/or supported innovation. R&D “spillover” benefits resulting from the communication of successful R&D outcomes are prevalent in the Australian mining industry.

The industry is financially committed to developing innovative and leading-edge mining practitioners. The MCA has spent more than \$18 million since 2000 sponsoring mining engineering and science courses, for example. Member companies contribute to precompetitive research programs through Cooperative Research Centres such as the CRC for Mining, the Parker Centre for Integrated Hydrometallurgy Solutions, the Centre for Sustainable Resource Processing and the CO₂ CRC as well as funding other collaborative and one-on-one research initiatives with some 21 other specialist research centres and organisations including the CSIRO.

Constant innovation has provided the Australian mining industry with the ability to grow new markets and respond quickly to changing markets. This innovation has helped nurture a rapidly growing minerals technology and services industry which is also committed to exports – estimated at \$2 billion in 2007.³ Ongoing innovation has resulted in the Australian mining industry being a world leader in numerous mining activities and processes. Yet the challenge is immense. Despite the surge in production from 2002 to 2007, Australia lost global market share to ambitious foreign competitors, often comprising new greenfield projects where state-of-the-art technology and techniques can be employed from the start.

The huge scale of this growth has been driven by global demand, and Australia’s ability to respond has been achieved by remarkable innovations in technology, process improvements, organisation and education and training. These innovations have been augmented by equally impressive changes in the industry’s management and workplace cultures and practices, with respect to health, safety, environment and community relations – especially with indigenous communities – and the broader issues of sustainability. In these areas, the Australian minerals industry is a recognised global leader.

In Australia, **with well established resource provinces**, the challenge for the industry is to secure ore from more difficult places – typically lower grade ore from deeper locations. The need for innovation to drive productivity under such conditions is paramount.

³ Austmine, www.austmine.com.au, 2008.

Headline national productivity has declined in recent years. After strong growth in the 1990s, at an average of 2.3 per cent, largely driven by micro-economic reform, it has declined to 1.1 per cent in this decade. The headline mining sector multifactor productivity contributed significantly to this decline, falling 8.8 per cent in 2005/6 alone. Some decline in the sector was to be expected as it was a time of significant increases in capital and labour, both of which mathematically detract from the headline rate. The Productivity Commission has now uncovered a further significant factor which, until recently, had been left out of the calculations – resource depletion. This depletion means that it is more difficult to secure the same productivity from labour and capital. Adjusting for that factor, mining productivity, which is ultimately driven by innovation, **is an average of 2.3 per cent from the period 1974/75 to 2006/7, rather than the headline 0.1 per cent for that period.**

In summary, in less than forty years the minerals industry has changed almost beyond recognition in scale, technology and culture. These changes have all been directly dependent on constant innovation.

These contributions have been noted by Government. As Innovation, Industry, Science and Research Minister, Senator Kim Carr, summed up in 2008:

Australia's mining industry is one of the most technologically advanced in the world. It is a major exporter of mining technology and services. Mining these days is a knowledge-based activity, using advanced ICT for everything from ore body evaluation, 3-D blast and mine design, mineral sampling, seismic monitoring and geological sensing, through to managing data and monitoring the condition of equipment.⁴

Senator Carr added that mining innovation was a key driver of industrial activity in other sectors of the economy:

It is surely no accident that manufacturing is booming in Queensland and Western Australia, the two states richest in minerals resources.⁵

⁴ Senator the Hon. Kim Carr, Minister for Innovation, Industry Science and Research, *Address at the launch of Minerals Down Under National Research Flagship*. Canberra, 27 May 2008.

⁵ Ibid.

4. IS THERE ANY NEED TO CHANGE THE DEFINITION OF R&D?

Given the issues described above, the MCA believes that the proposed changes to the definition of R&D contained in the Paper are a profound disappointment. The unfounded and misguided analysis of the mining sector that first emerged in part of the report that resulted from the Review of the National Innovation System (led by Dr Terry Cutler), “Venturous Australia”, permeates the commentary on the proposed changes.

On the basis of no evidence other than the fact that apparently in mining some claims tend to be larger in dollar value than in other sectors, the Paper suggests an overhaul of the fundamental definition of R&D that will only serve to complicate the scheme.

The Paper justifies these moves with a fictitious example (Example 1 in Attachment A of the Paper) which, on the basis of the evidence presented, MCA members contend would not be allowed as an R&D claim in the first place.

There is no detailed costing/modelling data released to justify the proposed changes, other than a prescribed desire for “revenue neutrality” of the \$1.4 billion scheme. On the basis of the limited publicly available data, the MCA believes that abolition of the 175 per cent rate Incremental Concessions will deliver significant savings for the scheme – our preliminary investigations suggest a saving of approximately \$612 million over four years – which will assist the Australian Government in achieving its policy aim of providing additional funds for SMEs (through the refundable 15 cents Credit) – without the need to change the definition of R&D.

As argued above, mining makes a significant contribution to business spending on R&D. This contribution is part of the sector’s commitment to sustainability, innovation and competitiveness, but also reflects the unique circumstances that apply in developing innovations in large capital projects. Any move seeking to constrain projects on vague principles fails to reward and encourage the private sector undertaking innovative projects that involve both high risks and high costs.

Like the Cutler Review before it, the Paper appears to misunderstand the nature and challenges of introducing innovation into mining practices. The scale of mining operations means that trialling innovations can often only be done within the operation. In other words, there is not the same scope for small-scale trials that might apply in other sectors. This fact, by its nature, increases the risks involved in adopting or developing innovations. Eligible technical investigations or innovative activities are many and varied. Some examples – provided here as illustration and not as an exhaustive list – include:

- Conceptual Design incorporating pre-feasibility studies and flow sheet development;
- Front-end Engineering and Design;
- Post-Final Investment Decision involving discrete R&D to prove the models developed;
- Discrete elements of Pilot Studies and Proof-of-Concept work;
- Module Trials; and
- Commissioning Trials that are required for ramp up and feedback R&D.

The changes proposed in the Paper appear to single out two sectors - mining and civil engineering. In the MCA's view, R&D policy settings should be neutral in terms of sectoral coverage.

Both AusIndustry and the Australian Taxation Office (the ATO) conduct rigorous assessment of mining industry claims and mining companies provide detailed information in support of claims. The eligibility of large operational claims has been established over more than two decades and this was directly acknowledged in "Venturous Australia".

Given the described nature of mining R&D activities, dollar claims may seem large at first glance. And the integration of R&D into the commercial operations – the driving philosophy of R&D practices over recent decades – means the inclusion of some production-related items may initially raise questions. Such appearances are simply misleading. The reality is that these so-called large claims involve very modest proportions of overall operating expenditure when you consider the total end to end mining process, and life of the mines involved.

The R&D Tax Concession has played a vital function in supporting this R&D effort and the MCA is keen that the new Credit is appropriately designed so that it may play a similar incentivising and supporting role.

The MCA welcomes this opportunity to contribute to the development of the new R&D tax incentive. In light of the above, this submission outlines the following MCA concerns:

- the removal of the uncertainty of firms being required to distinguish between base and incremental spending, will be dwarfed by the high levels of complexity and uncertainty that will be imposed upon the sector by the new requirement to distinguish between 'core' and 'supporting' activities;
- the changing of the definition from 'risky or innovative' to 'risky and innovative' introduces unnecessary complexity and ambiguity – it appears to be a distinction searching for a difference, and has previously been rejected by two prior attempts of definitional change;
- the various limitations proposed on supporting activities all represent a severe curtailing of support for legitimate business R&D, and run the risk of damaging Australia's immediate BERD (Business Expenditure on Research and Development) performance;
- there is no firm commitment to limit what is at present an unlimited ability for the ATO, working on advice from AusIndustry, to review make amendments to previous R&D claims; and
- there is no commentary regarding the introduction of a mechanism to facilitate more efficient R&D claims for Australian consolidated tax groups.

5. DOES TREASURY MAKE OUT ITS CASE FOR DEFINITIONAL CHANGE?

The heart of the Treasury's reasoning for the need to significantly restrict the definition of eligible R&D activities is contained in Paragraphs 8–14 of the Paper.

Paragraph 9 recognises that the new Credit was a direct result of the NIS Review whose findings were summarised in Dr Cutler's "Venturous Australia" report.

The Paper's case for changing the definition of R&D is put forward by arguments that the current definition supports activities where there is not a strong rationale for public support (Paragraph 11), and that an effective R&D tax incentive is one that causes firms to conduct R&D that they would otherwise not do because they cannot sufficiently capture the benefits in a context of 'spillover' (Paragraph 12) – the so-called 'additionality and spillovers' test.

The Paper also claims that the NIS Review recommended reviewing the definition of eligible R&D activity (Paragraph 13).

Underpinning the changes is the position in Paragraph 14 that "(o)n an underlying cash basis, implementation of the new R&D tax incentive is to be revenue neutral over its first four years of operation".

In analysing the above arguments, the MCA has concluded that the Treasury fails to make out its case for reform in terms of changing the definition of R&D.

Achieving Revenue Neutrality

Turning first to the purported need to restrict the definition to achieve revenue neutrality, no financial modelling of the impacts of the announced reforms has been provided by Australian Government.

Simply put, everything else being equal, the higher base rates of the Credit along with the introduction of claims associated with foreign-owned IP will add cost when compared with the current R&D Tax Concession. Offsetting this, the closing of the Premium Concession and International Premium will remove a significant cost element of the current incentive. Then, the various changes mooted to the R&D definition will act to reduce claims by restricting the expenditure subject to the incentive.

No data is put forward to support the proposition that some form of change to the definition of R&D in addition to the other reforms is necessary to achieve the desired Budget outcome. Treasury asks that the need for changing the definition, the consequences of which are explored later in this submission, be taken essentially on faith. The MCA submits that such a major change to the fundamental fabric of the R&D tax incentive cannot be accepted on such an unsubstantiated basis.

Modelling to help better understand these changes appears essential, particularly if one begins to factor in matters such as the recent global economic crisis which restrict a company's capability to carry out R&D.

The MCA is being told by its members that R&D budgets are being curtailed in the current economic climate. However, no member has been contacted about this matter in the consultation process to date so the MCA is not confident that such issues have been taken into account when considering the cost impacts of the proposed changes.

Additionality and Spillover

The initial round of public consultations following the release of the Paper has seen Government officials reassure stakeholders that “additionality” and “spillover” are design principles only and will not be specifically legislated. Later Government consultation sessions indicate that these concepts may be contained in the Objects clauses of new legislation.

The Government explains the “additionality” test at paragraph 12 of the Paper as “an effective R&D tax incentive (that) results in firms conducting R&D that they would otherwise not perform because they cannot capture sufficient benefits from the activity to justify the investment”. On a literal application, no profit based company would spend discretionary funds on R&D just to obtain the R&D incentive – as they remain out of pocket by 90 cents in the dollar. Such notions have no application to commercial business operations. The MCA contends that these concepts must not be legislated, even by way of an Objects clause, due to the likelihood that such action will deny eligibility of qualifying R&D spend.

The MCA notes that these principles underpinned the findings of the 2007 Productivity Commission Research Report into Public Support for Science and Innovation which recommended an incremental-only R&D tax incentive for large companies that emphasised business research at the expense of commercially focused development.

Yet, neither the Cutler Review nor the resulting Credit followed the Productivity Commission’s principal recommendation to move to an incremental-only option for large firms. However, the Paper is now pushing for a restricted definition of R&D that requires ‘core’ activities to be both innovative and highly risky.

The MCA believes that extreme caution should be applied in seeking to utilise these design principles and that, equally, they do not make out the case for altering the established definition of business R&D.

The MCA believes that limiting the definition to focus support on applied and basic research within companies, as opposed to experimental development, plays away from the strengths of Australian companies who are active in the research community. MCA members perform research, usually in conjunction with academic and research institutions, and they occasionally invent. However, they continuously innovate and those innovations are constant sources of spillover, and have been significantly enhanced by access to an R&D tax incentive that contains a definition that rewards this work on an equal basis, whether the activities are best regarded as ‘core’ or ‘supporting’.

The MCA is concerned that the proposed changes will result in a scientific, as opposed to an industrial, definition of R&D, and that the innovation outcomes associated with previously-claimable R&D will be severely curtailed.

Rationale for Public Support

The Paper seems to target ‘supporting’ activities under the current definition of R&D as those with a weaker rationale for public support.

The Paper asserts that a small amount of ‘core’ R&D can trigger an entitlement to claim large amounts of ‘supporting’ activities which attract subsidies that are out of proportion to the public benefit.

Again, little evidence is offered to support the contention that ‘supporting’ activities are less critical to R&D projects and therefore less deserving of public support.

The first two example projects in Attachment A of the Paper are put forward as representative of the sorts of claims of “questionable merit” that are allowed under the current scheme, thereby supposedly establishing the argument that the existing definition allows claims for activities where there is not a strong rationale for public support.

The MCA views these examples with a high degree of scepticism, particularly the first example relating to the “progressive implementation of new mine, mill and waste management processes” involving a claim made up of “blended” core and supporting activities.

The MCA believes that these projects, as described in Attachment A, would not automatically qualify under the current R&D Tax Concession criteria as is suggested in the Paper. Whilst it is possible that some aspects of these projects may be eligible, considerably more detail would need to be provided to establish eligibility definitively.

The MCA believes that the example projects in no way contribute positively to the Treasury’s case for reform.

The Cutler Recommendations

There is no doubt that the current review of the definition of R&D stemmed in part from the recommendations of the Cutler Review. However, the Paper’s statement that the Review recommended a review of the definition of eligible R&D activity is a gross simplification of what was said in those recommendations.

It is worth highlighting exactly what was said in the Cutler Review regarding the introduction of a tax credit.

Recommendation 8.7 called for **refinements** [emphasis added] to clarify the activities to be supported by the new Credit. Much has already been said about the unfortunate depiction of ‘whole of mine’ claims in the report. The MCA dealt with this at the time and was grateful for the supporting response from Senator Carr that it received at the time.

Rather than reopening this discussion, the MCA notes that the Cutler Review's concerns with large "one-off" projects could not be satisfactorily resolved by the Review Panel in the time available. The Review Panel suggested that these concerns may be addressed by reviewing the definition of R&D but commented that the matter may not be able to be "...satisfactorily dealt with by **refining** [emphasis added] the definition of R&D,..." and went on to list the possibilities of capping projects or restricting the extent of claimable 'directly related costs'.

The MCA submits that the Cutler Report talked about possible refinements to the definition of R&D and the fact that definitional change may not provide the answer. Yet Treasury cites the support of the Dr Cutler's National Innovation System Review in seeking to make wholesale changes to the definition.

The Paper appears to have dispensed with one other key recommendation of the Cutler Review.

In setting its analytical framework regarding tax and innovation, Dr Cutler endorsed the overall objectives contained in the Second Reading Speech that introduced the original R&D Tax Concession as still valid, namely:

- to provide an incentive for greater levels of R&D in Australia;
- to concentrate new R&D efforts in industry by greater business investment in, and responsibility for, R&D;
- to provide positive support for R&D activities in industry, on the basis that significant benefits accrue both to industry and to the wider community through enhanced competitiveness of industry;
- to provide mechanisms for encouraging effective use of Australia's existing R&D expertise; and
- to encourage capacity in industry to be aware of, and exploit, technological developments occurring in other countries.

The Cutler Review was informed by these principles in its analysis and recommendations, particularly in the making of Recommendation 8.1 which requested that any of his recommendations that "...may lead to cost-saving not be adopted in isolation from recommendations to restore the value of incentives to firms."

Yet, the MCA believes that this is the exact consequence of Treasury's proposals to change the definition of R&D. The change will result in cost savings at the expense of the institutional understanding of a workable definition of R&D that has stood the test of time for almost 25 years and has assisted in delivering R&D outcomes in line with the principles listed above.

By way of contrast, the Paper seeks to make a fundamental change in the name of budgetary requirements without paying any real regard to the impacts such a change will have on the institutional understanding of business R&D incentives or to the guiding principles deliberately restated and adopted by the Cutler Review.

The Treasury has failed to make its case for definitional change.

6. INTERNATIONAL COMPETITIVENESS

The tax credit should be internationally competitive, particularly with the changes to international participation and the internal global competition within firms which places a greater discipline and focus on all research and development and business activities.

The following table highlights the diminishing after tax value of Australia's R&D tax concession following successive reductions in company tax rates and headline R&D deduction rates;

Year	Company tax rate	R&D deduction	Net benefit
1985	49%	150%	24.5%
1996	30%	125%	7.5%
2009 (proposed)	30%	40% credit	10.0%
2009 (proposed)	30%	50% credit	20.0%

* 2001 introduced the 175% premium rate for incremental R&D spend over a 3 year period.

The Review proposes to apply the refundable 50% tax credit to small companies (with turnover of less than \$50m), with a non-refundable 40% tax credit for large companies. The 50% & 40% tax credits equate to equivalent tax deductions of 167% & 133% respectively.

The need to maintain regional competitiveness is a key message of the Review. A comparison with the following countries⁶ indicates that the 40% R&D credit, creating a net benefit of 10 per cent does not meet this test.

Country	Effective support
Korea	40%
Taiwan	35% and 50%
France	30%
Canada	20% and 35%
Ireland	20%
Singapore	20%
Japan	15%
Australia (proposed 40% credit)	10 %
Australia (existing)	7.5% and 22.5% (incremental)

A fundamental objective of the R&D concession is to stimulate additional investment in R&D activity. This objective is enhanced when the cost/benefit of an investment in this activity is improved. The rate of support provided by the concession directly affects this. MCA agrees with accounting firm Deloitte in its submission that “when viewed in a global context it is clear that we are not approaching best practice.” The proposed changes still leave Australia lagging behind regional competitors.

The attractiveness of the R&D tax concession will also form part of an international mining company’s analysis when comparing the Net Present Value of competing projects in various countries.

⁶ Deloitte, Submission to Cutler Review, April 2008, p 16.

7. IMPACTS OF THE PROPOSED CHANGES TO THE DEFINITION OF R&D

The previous section analysed Treasury's case for reform of the definition of R&D and found it to be wanting.

The MCA wishes to also look closely at the discussion that occurs at Paragraphs 48 to 78 of the Paper regarding specific comments made about changing the definition of eligible R&D activity. In doing so, the MCA has assumed that the only changes being considered are those contained in the Paper. The following discussion assumes that existing definitions of concepts such as 'innovation' and 'high levels of technical risk' continue to apply.

Subsection 73B(1) of the ITAA 1936 provides a pluralistic definition of "research and development activities" whereby activities may be eligible if they fall into one of two categories – 'systematic, investigative and experimental (SIE)' activities and 'directly related' activities.

Significantly, the same concessional treatment applies irrespective of which category individual activities best fall under. The activities have been claimed jointly as R&D projects and the distinction has not been critical in the making of eligible claims. The key distinction that taxpayers are asked to assess is between eligible activities and 'excluded activities' as per Subsection 73B (2) of the ITAA 1936. Excluded activities are specific activities that are deemed ineligible on the basis that they can never qualify as SIE and may only be claimable as directly related activities in limited circumstances. The internal distinction between SIE and directly related activities has only been required in certain administrative contexts and has no impact on eligibility.

The Paper focuses on separating eligible activities into two distinct categories, labelling them 'core' and 'supporting' R&D in the process, thereby reviving terminology that was dropped from the program almost a decade ago. This appears to be a clear move away from the pluralistic definition as the Paper goes on to recommend that the benefits conferred by the Credit are directly affected by the taxpayer's classification (and, subsequently, the administrators' determination) of activities as either 'core' or 'supporting'.

The MCA is concerned that this is an attempt to legislate an administrative practice of AusIndustry known as 'mosaicing', whereby activities are sought to be continuously broken down into smaller and smaller components with a view to losing their SIE and/or directly related character.

The MCA strongly advocates that a pluralistic definition of R&D activities be retained, and that the same rate of benefit applies to all eligible activities.

Core R&D

Turning to the discussion regarding *Core R&D* in Paragraphs 52 to 55, the main concern relates to the introduction of the requirement that core R&D activities will be required to be both innovative and technically risky.

The policy arguments for the change made at Paragraph 53 repeat the unsupported contentions made earlier under the *Case For Reform* section of the Paper. The MCA sees no evidence that supports the assertions made regarding activities that only contain one of the two elements. The MCA would like to see what these R&D projects actually look like and, if they exist, why they should be excluded from the Credit.

The MCA is aware of the great deal of consternation that has already been publicly expressed regarding this proposal. It precisely echoes the debate that occurred following the attempt to make this legislative change as part of the previous Federal Government's Innovation Action Plan in 2001.

There is real concern that currently eligible activities will be excluded without any guidance being offered in the Paper as to what those activities might be. In addition, there is no guidance as to how the two qualities will be assessed.

This gives rise to a myriad of questions. Will each individual core activity need to contain both elements in order to qualify on a stand-alone assessment basis? Can individual activities reflect only one of the qualities of innovation or high levels of technical risk but still be eligible if they occur in combination with other activities that reflect the other quality? What is crystal clear is that the change from 'or' to 'and' will **greatly add to program uncertainty and complexity**. It is also immediately apparent that a **significant compliance burden** will be placed on taxpayers, as they will need to support and defend their decisions regarding claims in general and their allocations of activities into core and supporting categories in particular.

The MCA has real concerns with the performance of AusIndustry and the Board in the conduct of assessments under the current R&D Tax Concession. These concerns will be heightened with the introduction of the proposed restrictions whatever the mooted improvements to program delivery and administration actually take place.

Finally, the MCA disputes the Paper's contention that the change would mean that the Credit would be better aligned with the Frascati Manual and international practice.

In terms of the Frascati Manual, its definition of R&D makes no direct mention of the elements of innovation or technical risk. It simply sets out the three commonly understood aspects of R&D – basic research; applied research; and experimental development. The fact that no direct mention of innovation or technical risk appears in the Frascati definition is mirrored in many of the definitions of R&D used in overseas tax jurisdictions.

The MCA submits that the current definition of R&D already directly aligns with the definition set down in the Frascati Manual.

The Manual does go on to comment at Paragraph 2.3.1 that R&D is distinguished from related activities by the basic criterion of an appreciable degree of novelty (read 'innovation') and the resolution of scientific and/or technological uncertainty (read 'technical risk') without exploring whether one or both elements are needed to make the distinction.

This falls a long way short of making up a direct component of the Frascati definition of R&D.

Furthermore, the statement that Australia "...has one of the broadest definitions of R&D..." compared to other jurisdictions is simplistic in the extreme. For example, Australia has more restrictive capital provisions than several jurisdictions as well as tighter rules regarding software R&D.

The MCA also notes that eligibility of R&D in the production environment is a consistent feature of most jurisdictions.

The Treasury statements regarding the Frascati Manual and other jurisdictions should be approached with extreme caution.

Supporting R&D

Companies are not currently required to distinguish between "core" and "supporting" activities when submitting their R&D claims. In practice, the distinction between these two broad categories of activities is often difficult to make – and subjective & artificial evaluations would be required under the proposed regime. Such classifications would almost certainly lead to disputes with Government.

The Paper attacks the current level of support received by 'supporting' activities on grounds of lower spillover and value-add.

The MCA contends that the overall grouping of R&D activities that contain 'core' and/or 'supporting' elements under the existing definition are of equal importance to the successful prosecution of an R&D project and therefore merit equal support. To remove or restrict the incentive attached to 'supporting' activities, however defined and delivered administratively, would be to severely impact the ability of the Credit to influence R&D investment decision making at its critical juncture – the time at which decisions are made to incur the potential expenditures.

The pluralistic definition of R&D has accommodated the large emphasis that the mining industry has on experimental development that occurs within the production environment. The restrictions proposed around supporting activities would run counter to the high value-add R&D that the industry undertakes in the field as a matter of technical necessity.

The MCA does not wish to conduct a detailed refutation of the possibilities canvassed in Design Question 4. It is opposed to expenditure capping, sole/dominant/non-production tests and differential rates of support. It is particularly concerned about initiatives that only provide access to the Credit on a 'net expenditure' basis as this is surely a case of incentivising failure, and completely removing the ability of the Credit to influence any business R&D expenditure decisions made in a commercial context.

As with the changes to 'core' R&D, **all the options canvassed add uncertainty, complexity and compliance burdens. Most significantly, they all would greatly remove support from the R&D projects conducted by MCA members and other taxpayers.**

Impact on BERD

The last time a major restriction was introduced to the R&D tax regime was in 1996 when the concessional rate was dropped from 150% to 125% at the same time that the feedstock offset provisions were introduced.

The immediate result was a significant drop in program registrants and this was soon followed by the first fall in BERD in 20 years. Continuing falls in BERD then triggered the National Innovation Summit in 2000 which resulted in the legislative package that ultimately emerged from the 2001 Innovation Action Plan.

In recent years, BERD as a proportion of Gross Domestic Product (GDP) has been steadily rising – from 0.92% in 2003/4 to 1.27% in 2007/08 – according to Australian Bureau of Statistics (ABS) figures. These rises have occurred in buoyant economic terms and the MCA notes a matching trend in increasing Premium claims by its members.

It can certainly be said that ABS BERD figures do move in step with R&D tax claims.

The introduction of the definitional changes immediately threatens Australia's BERD future. The ABS data shows that investments in R&D depend strongly on the size of the business. Most of BERD (70%) is contributed by larger sized businesses (> 200 employees). A relationship is also apparent between size and indicators such as innovative activity and information technology uptake in Australian businesses.

A recent ABS survey found that the proportion of innovation-active businesses increased significantly with the size of the business from 37% for businesses with 0-4 employees to 71% for businesses with more than 200 employees.

Whatever extra incentive the Credit delivers to SMEs, restricting the claims of large businesses will translate to a lower BERD result. MCA members complete their ABS returns based on their R&D tax claims. As in 1996, reducing the support for large businesses will lead to a direct fall in BERD.

This surely cannot be the intention of the Federal Government.

8. OTHER ISSUES

The MCA would like to comment on two other design features of the new Credit.

Unlimited Amendment Periods

The ability of the Commissioner of Taxation (the Commissioner) to amend R&D claims contained in tax returns at any time has been an ongoing source of concern.

MCA members report that R&D eligibility assessments are taking years to resolve, given that the Board is under no time constraint in making its initial decision when conducting assessments of R&D activities. The ATO does not apparently exert any pressure on the Board to reach a decision as it is able to amend taxpayer R&D claims at any time.

The MCA wishes to call, in the strongest terms possible, for the removal of the Commissioner's unlimited amendment powers with respect to R&D tax claims. This would, in turn, place an additional obligation on AusIndustry to perform its required assessments in a timely and disciplined manner.

The straightforward response would be the introduction of a four year limit that operates throughout the Australian tax system. The MCA notes, however, shorter timeframes in which taxation authorities can challenge R&D eligibility in other jurisdictions such as the United Kingdom and Canada.

Tax Consolidations

The current R&D Tax Concession is needlessly complicated in that it fails to recognise Australian tax consolidated groups. The introduction of the Credit offers the opportunity to correct this. Providing suitable mechanisms that recognise tax consolidation will simplify the management, reporting and registration of R&D activities within a consolidated group.

Currently, each R&D company within a consolidated group must register with AusIndustry separately. However, under tax consolidations, there is only one recognised taxpayer - the head company or the nominated head company in a foreign owned Multiple Entry Group. Therefore, the R&D claim must be made in the head company's income tax return.

A mechanism to enable registration of a consolidated group should be introduced. This would provide a means of dealing with a number of problems associated with the current Concession:

- There are complexities associated with the "on own behalf" rules. Where R&D is performed within a consolidation group by a number of members, the group currently has to split costs and activities for registration;
- The separate registration by each company creates the possibility that projects are broken up and activities performed by one of the companies may become ineligible. This is a horizontal inequity where these activities would be otherwise claimable except for the artificial breakup by legal entity, especially when income tax law does not recognise this breakup; and

- Frequently, there is a necessity for financial transactions to transfer costs within a group that serve no other benefit than to meet the registration requirements. These transactions then have to be eliminated in the tax return to meet the consolidations law.

Facilitating the registration of Australian tax consolidated groups would make a significant contribution towards the achievement of the simplification objectives of the Credit.

9. CONCLUSION

We are now in a changed economic environment. Economic slowdown is putting pressure on global R&D budgets. Yet the Federal Government continues to call for technological innovation to drive initiatives in areas of vital public interest such as climate change.

The MCA acknowledges the budgetary pressures in play and willingly accepts a number of the proposed changes associated with the Credit. However, it cannot accept the proposed definitional changes which will directly reduce government support for the commercially applicable R&D that it is being demanded of Australian industry to address the technical challenges of the 21st century.

The new Credit increases the base rate of R&D support but, in doing so, introduces a split regime of support between SMEs and large companies. The MCA accepts this development and appreciates the raising of the base rate for large companies from 7.5 cents to 10 cents.

Further, the MCA accepts the closure of the Premium Concession and the International Premium as part of the Government's objective of cost neutrality of the R&D incentive.

The MCA acknowledges the stated aim of revenue neutrality in the cost of the Credit in the next four years but, in the absence of any supporting evidence, it does not accept that the proposed changes to the definition of R&D are necessary to achieve the cost targets.

The case to move from the established definition, and equal treatment of supporting activities, has not been made. **The proposed changes will significantly add to program uncertainty, complexity and compliance costs.** This would be counter to the Government's overall stated aims in introducing a simplified and enhanced R&D tax incentive.

The restrictions will arguably remove so much support from legitimate business R&D that it could be 1996 all over again. BERD is set to fall directly as a result of the proposed change to the definition. That is a result for Australia that is surely not worth contemplating.