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OneSteel Submission on Second Exposure Draft on Tax Laws Amendment (Research and Development) Bill 2010

OneSteel Ltd ("OneSteel") welcomes the opportunity to make this submission in response to the released second exposure draft legislation Tax Laws Amendment (Research and Development) Bill 2010 ("the draft legislation").

However, the time given for review of the draft legislation was extremely short. As such, OneSteel has provided comment on those aspects identified in the limited time available as being of most significance.

Summary Of Submission

1. To defer the draft legislation commencement date to 1 July 2011, to allow thorough and considered consultation with all stakeholders. The draft legislation contains new, unique and unheralded concepts and definitions.
2. Accept removal of the current incremental claim (175%) claim from 1 July 2010.
3. To redefine the definition of 'core R&D activities'; remove the support activities dominant purpose test and expand the technical objectives to allow for meaningful support of development activities.
4. That the immediate impact for Australian manufacturing is a severe drop in support from the R&D program. Long term, the draft legislation taken together with the loss of the accelerated depreciation regime represents a significant disincentive to pursue manufacturing in Australia.
5. That the R&D program acts as a real incentive to manufacturers to strive to make their business more efficient and competitive.

OneSteel submits that the draft legislation should be deferred for one year to allow for thoughtful and thorough consideration of what the new R&D draft legislation should consist of. The draft legislation is incomplete, ambiguous, and provides little detail on the proposed administrative powers for AusIndustry. Further it is a major shift from the existing R&D program, so different as to represent a totally new R&D program with new definition of eligible R&D and a bias towards research at the expense of development. OneSteel's R&D activities occur on normal production lines and have a bias towards development.

The result of all of these factors means that it would take away the R&D program support currently provided for manufacturers large and small, amongst others, and is likely to result in a dramatic drop in their participation in the program. Indeed, the possible drop of support would be so severe as to bring into question whether OneSteel remained active in the program at all. This drop of support would occur at a number of levels.

The draft legislation proposes a fundamental change in the definition of "core R&D activities". The narrowing of the eligibility definition for Core R&D will result in most production based activities being significantly limited in terms of R&D support.

Where activities are considered Support R&D, the dominant purpose test will apply to remove most of the support currently provided as much of the R&D conducted by OneSteel is production based experimentation of either products or processes that result in saleable product. The 'feedstock' rule too is yet to be released and against the background of the draft legislation provided, OneSteel anticipates that the current 'feedstock' rule restriction is likely to be expanded.

The much reduced level of R&D program support provided is then subject to increased administrative uncertainty in the application of new definition requirements for Core and Support: with the Support activities dominant purpose test likely to be highly contentious for R&D conducted in a live manufacturing process.

OneSteel's position is to maintain the current definition of R&D and adopt the new R&D tax credit. Onesteel supports the removal of the 175% incremental claim from 1 July 2010. However, OneSteel submits that the remaining provisions of the draft legislation should be deferred at least one year to allow for a thorough consultative process to create a R&D program that is broader based and which provides meaningful support for development activities.

In order for Australian manufacturers to compete fairly in domestic and international markets, the Australian corporate tax system needs to be competitive with international counterparts, especially those in our region. Internationally comparable capital write-off regimes and a broad-based R&D tax incentive are essential components in providing this environment. If manufacturing domestically proves uncompetitive, global Australian businesses such as OneSteel face the decision of locating new manufacturing operations offshore in countries with lower cost structures including more competitive tax regimes.

Australia already has an uncompetitive capital allowance regime compared to competitor countries.¹ A capital allowance regime however is a passive support mechanism, whilst the R&D program is a positive incentive in that it is only available to those businesses that actively seek through R&D activities to improve their business.

Once operations move offshore, OneSteel submits that knowledge follows, causing an inevitable drain of domestic manufacturing expertise, a reduction in diversity of the Australian economy and consequent losses of jobs and future innovation opportunities.

Global challenges such as carbon reduction and water availability are environmental challenges that Australian business will need to respond to and do so via focussed R&D activities. Surely now is a time to consider expansion of the R&D program and not its restriction.

The draft legislation does not provide an Impact Financial Statement to support the proposition that the proposed R&D credit program is revenue neutral. It is understood that if the R&D program is revenue neutral, there is \$1.4 billion to be spent on this program. The public has not been provided with how this draft legislation is revenue neutral.

Background on OneSteel's R&D Activities

OneSteel is a vertically integrated mining, scrap recycling, steel manufacturing and metal products distribution company with annual revenues of over \$7 billion. OneSteel employs more than 10,000 people in Australia.

The Australian steel industry is a mature industry with highly developed technologies and is continually striving for improvement in efficiencies with its operations to stay competitive in a global economy and to make the best use of scarce resources available to it. The undertaking of R&D activities is required to sustain and regenerate a mature business. The R&D activities are conducted by highly skilled personnel and encompass highly scientific properties. It is critical that a manufacturer like OneSteel continue this work. There are both basic and applied elements of research and experimental development work undertaken. A broad based R&D program that supports this work is required to facilitate the continuation of process improvements and new product developments.

¹ For example, research conducted for OneSteel by Ernst & Young in early 2007 found that the mean depreciation period for steel producing countries was 8.47 years, compared to 13.33 for Australia.

For example, many of the operating plants at OneSteel have had further extension of their effective life by the conduct of R&D activities that are developmental R&D. This has been a benefit to OneSteel as resources are deployed efficiently. A mature industry requires this support to continue its business.

THE DRAFT LEGISLATION

The objects clause in the Explanatory Memorandum [EM] to the draft legislation states that the new R&D definition centres on the activities that are most likely to produce spillover benefits that might not go ahead because of their cost and uncertain outcome. Basic and applied research is not even half of R&D equation². Development work is the essential element. Development work requires scientific analysis and also faces scientific and technical uncertainty. Focussing on research underestimates the many challenges on the road to commercialisation. Further and of most direct relevance to mature manufacturing businesses, the research focus fails to understand the importance of continuous process and product development required in order to make our manufacturing sector world competitive.

Core R&D Definition

OneSteel submits that the proposed definition of Core R&D activities does not meaningfully support development R&D activities in a manufacturing environment. The existing definition of Core R&D activities consists of 11 technical objectives of which only one is new knowledge, as opposed to the proposed definition which consists of 1 technical objective, that of gaining new knowledge. The proposed definition begins with the requirement of experimental activities, which is a higher platform to meet than the existing Systematic, Investigative and Experimental ("SIE") activities. Genuine R&D is broader than the 1 technical objective stated and it involves non experimental activities that form part of the hypothesis.

The EM suggests that a failed experiment or series of such may not qualify as Core R&D if it is considered to be a 'trial and error' approach. A series of experiments to establish a hypothesis may encompass what appears 'trial and error' as the activities endeavour to eliminate for example alternate variables. Such activities are certainly able to qualify as SIE but may be ineligible under the narrower Core R&D definition.

At para 2.11 it is stated that "experiments take place in a range of settings, from a separate laboratory to an otherwise normal production run". However, in order for the definition to be met, normal production runs with genuine R&D may fail the test because para 2.16 requires experiments to be linked with something that is not known globally. OneSteel submits that knowledge in the steel industry is not shared or published readily. Each steel mill is different in terms of grades of steel, chemistry and proprietary of the steel product.

The EM also suggests that the "purpose" for Core R&D must be the "dominant purpose". Refer para 2.20. This further limits the definition regards production based manufacturing R&D.

OneSteel submits that the definition be reconsidered and redrafted to a broad based definition that meaningfully include developmental R&D.

Support R&D & Dominant Purpose Test

The [EM] at para 2.28, stated, "it is not intended that the R&D tax incentive cross-subsidise normal production activities. Accordingly, production activities will only be eligible where the dominant purpose for conducting them is to support core R&D." This fails to understand the practicality of R&D conducted by manufacturers. It is normal practise for manufacturers to conduct R&D in live production settings.

Such R&D is typically a steady program of experimentation and development of process and product improvement. This developmental R&D is needed to ensure that our manufacturers remain efficient and competitive, especially regards overseas competition. To remove effective support for this type of R&D leaves a significant proportion of Australian R&D unsupported by the Government's R&D program.

It may be argued that para 2.30 of the [EM] confirms support for commercial R&D. Para 2.30 states, "an activity that serves both R&D and a commercial objective does not preclude it from qualifying a support R&D.". However, the

² We understand that previous studies show that BERD is 5% basic research, 25% Applied research and 70% development.

examples make clear that this is only so where there is not significant uncertainty as to how marketable the finished products would be. Effectively the dominant purpose test acts as a 'not at risk' test that eliminates support for the majority of production based R&D.

Feedstock Rule

Notwithstanding that the draft legislation is a second release, the feedstock rule remains outstanding. This is a significant omission in legislation proposed to be implemented as of 1 July 2010. OneSteel submits that it is concerned as to the time table for consideration of any feedstock rule.

Administrative Uncertainty and Powers

As per our previous submission of 6 February, OneSteel submits that the draft legislation increases the program's complexity and will lead to administrative uncertainty. The proposals to differentiate between Core and Support and to establish dominant purpose for Support activities will, as noted, be sources of that uncertainty. Against this, it is a major concern that the draft legislation allows for registrations to be rejected purely on the content of the submitted form. The registration process has been made more complicated and companies are running the risk of rejection every time they submit their R&D. This is not a very encouraging environment to operate in. To allow for a registration to be rejected without a proper review mechanism puts effective discretionary power into the hands of the administrator and puts more pressure on companies to spend increased administration time adding extra detail to the registration in order to prevent ad-hoc rejection.

Indeed, the proposed administrative powers to be provided to AusIndustry means that to a significant degree the actual administration of the new R&D program will be determined by AusIndustry and that details of administrative practice will therefore only be available in the future following a rulings type AusIndustry program. It is noted that AusIndustry does not have a history of conducting an active and expansive rulings program. To leave 'the administrative detail' to such a possible program in the future is perhaps merely to store up the ambiguities for future disagreement and so lessen the reliance and understanding that can be derived from the draft legislation itself.

Conclusion

OneSteel appreciates the opportunity to make this submission in response to the draft legislation. We fully support Senator Carr's intention to provide a better targeted, more generous, more predictable and less complex R&D Program. We also appreciate the Minister's resolve that, to the extent the draft legislation is not delivering this intent, it will be changed. We submit that the draft legislation will require change to meet the Minister's objective.

OneSteel is particularly concerned with the effective exclusion of successful production based R&D and believes it would have an adverse impact on Australian manufacturers, large and small. Support for production based R&D is not a general subsidy for innovation. This type of R&D faces all the challenges that a scientific based R&D program faces.

We note from your letter dated 31 March your invitation to meet with you to discuss the draft legislation and OneSteel's submission. We would like to accept that offer to meet with you at a mutually agreed time to be arranged. Please call Steve Ashe on (02) 9239 6616, or Damien Baxter, Group Tax Manager on (03) 9673 0419 or me on (02) 9239 6661 to agree a suitable time.

Leo Selleck
Executive General Manager - Technology, Safety & Services On