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Manager  
Small Business Entities & Industry Concessions Unit  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Dear Sir/Madam,

I am writing in relation to the proposed changes to the Federal Government's R&D Tax Incentive program, identified in the Exposure Draft released on 29 June 2018.

### Summary

Bradken welcomes changes that would increase compliance with and integrity of the R&D Tax Incentive program, however, we firmly believe the proposed changes will fail to meet the Government's objectives. We believe Bradken's, and other large Australian-based multinational companies', incentive to invest in R&D in Australia will be strongly diminished by these changes. Bradken is a diversified company with an operating base in Australia. We have a long history of R&D and strong patent registrations, and we do not agree with the proposed changes for the following reasons:

- **The use of 'total expenditure' in the R&D intensity calculation creates potential to favour multinationals conducting R&D in Australia, over Australian based multinationals conducting R&D. This appears inconsistent with supporting the growth of Australian businesses.**
- **The proposed changes lead to a lack of predictability in potential benefit, due to uncertainty in identifying Bradken's R&D intensity before the start of a financial year. This could potentially lead to reduced R&D activities in Australia.**
- **The propose tiered structure will result in a lack of incentive to increase innovation.**

We propose the following alternatives be considered:

- **Base R&D intensity on discretionary spend rather than total expenditure.**
- **Incentivise companies to conduct R&D in Australia by ensuring predictability in available benefits.**

The following information details the impact the proposed changes may have on Bradken Ltd.



## Bradken and R&D

Bradken Limited (Bradken) is a leading heavy engineering company, specialising in providing solutions and services the mining industry. We are best known for the manufacture of high quality castings and products and currently employ about 3,000 people across our operations including engineers, metallurgists, furnace and foundry operators, sales personnel, etc. Bradken also has significant operations in a number of overseas jurisdictions, including Malaysia, India, China, USA, Canada, South America and New Zealand.

On average, Bradken spends approximately \$20million per annum on R&D projects that are supported by the RDTI. We have a long history of converting these projects and activities into Intellectual Property that is then protected via patents and commercialised, either domestically or via export, for the benefit of the Australian economy.

Bradken has benefited from accessing the Federal Government's R&D Tax Incentive (RDTI) for a number of years. The program has supported a range of projects aimed at the development of innovative new products or processes such as the development of enhanced mechanical properties for products, extended product performance outcomes (a critical attribute for components in the mining industry) and productivity improvements for our clients like reduced downtime associated with changeout activities on worn equipment. As a result of our program of innovation Bradken has in excess of 160 patents, a result that demonstrates our dedication to innovation.

This program of works has enabled Bradken to remain competitive both domestically and internationally, despite contraction in the industry and market pressures from imported products from low cost countries.

## General comments regarding the proposed RDTI changes

Australia's R&D program has involved three different programs in operation over the past decade. There have also been multiple minor changes to the program during that time, including most recently reducing the R&D tax benefit for companies with an aggregate turnover of more than \$20million, from 10¢ in the dollar to 8.5¢ in the dollar.

In the proposed changes released on 29 June 2018, Treasury noted that the amendments are required to enhance the integrity and fiscal affordability of the RDTI program, whilst rewarding businesses that spend a higher proportion of total expenditure on R&D activities.

While it may be the Federal Government's intention to improve the integrity of the current program and ensure genuine R&D is rewarded, it is our firm view that the proposed changes **will not enable the Federal Government to achieve their objectives** and will in fact disincentivise large, mature and functionally diverse businesses (such as Bradken) to increase their level of R&D activities.

Bradken supports any changes to the current RDTI program that ensure the integrity of the program is maintained, and the benefits provide an incentive to companies engaged in genuine R&D activities, to the advantage of the Australian economy. With that said, we have significant concerns regarding the impact of some of the proposed changes, which we would like to specifically address in this response.



## **1. Use of 'total expenditure' in the 'R&D intensity' calculation and its potential to favour multinationals conducting R&D in Australia over Australian based multinationals.**

In seeking to achieve the Government's objectives, an 'R&D intensity' test has been developed with the aim of creating the ability to provide greater benefit for companies with a higher proportion of investment in R&D.

We believe using total expenditure as the denominator in this equation has significant potential to favour foreign owned companies, by providing a much higher potential R&D benefit for overseas based multinationals conducting R&D in Australia via Australian based subsidiaries, compared to the benefits available to Australian based multinationals conducting R&D in Australia.

In Bradken's case, the 'R&D entity' (i.e. the entity that submits its R&D Applications to AusIndustry) is 'Bradken Limited'. This is the head entity for a range of Australian and overseas based subsidiaries.

Under the proposed legislation, the 'total expenditure' associated with Bradken's R&D claim will include the sum total of the expenditure of all our operations (Australian and overseas) regardless of their involvement in our Australian based innovation projects.

The 'total expenditure' of a subsidiary of a foreign owned multinational operating in Australia would potentially only cover the Australian based operations, allowing them a much higher R&D intensity.

The result of combining the terms 'R&D entity' and 'total expenditure' is that Bradken's R&D intensity will fall into the 0% - 2% intensity bracket, which attracts an R&D tax benefit of 4%.

An R&D spend of about \$20 million would provide Bradken with a tax benefit of \$800,000 under the proposed regime, compared to \$1.7 million under the current 8.5¢ regime and \$2 million dollars under the former 10¢ in the dollar benefit.

Given the administrative burden involved in preparing and lodging an R&D Tax Incentive claim, it is unlikely that receiving a 4% R&D Tax benefit (which is the lowest in the OECD) would incentivise Bradken to conduct any additional R&D activities. Depending on the administration associated with making a claim under the proposed legislation, Bradken may consider ceasing to make any R&D tax claim in Australia.

We also believe using 'total expenditure' as the denominator in calculating an R&D intensity, is inherently incorrect and unfair for a manufacturing organisation like Bradken, because a number of factors can positively or negatively impact total expenditure.

While many of these factors are not within Bradken's control, they are capable of significantly impacting total expenditure and therefore, our R&D intensity and the rate of R&D benefit we are able to access. For example, one of the significant costs Bradken incurs in its day to day operations is natural gas. Natural gas is used to power the furnaces that enable Bradken to cast its range of products for both domestic and export customers.

Over the past 10 years, the cost and pricing volatility of natural gas and electricity has increased, as detailed in the following data.

Figure 1

Delivered gas price (\$2017) trends for large industrial customers on new gas supply agreements. Source: Oakley Greenwood, Gas Price Trends Review 2017 (March 2018)

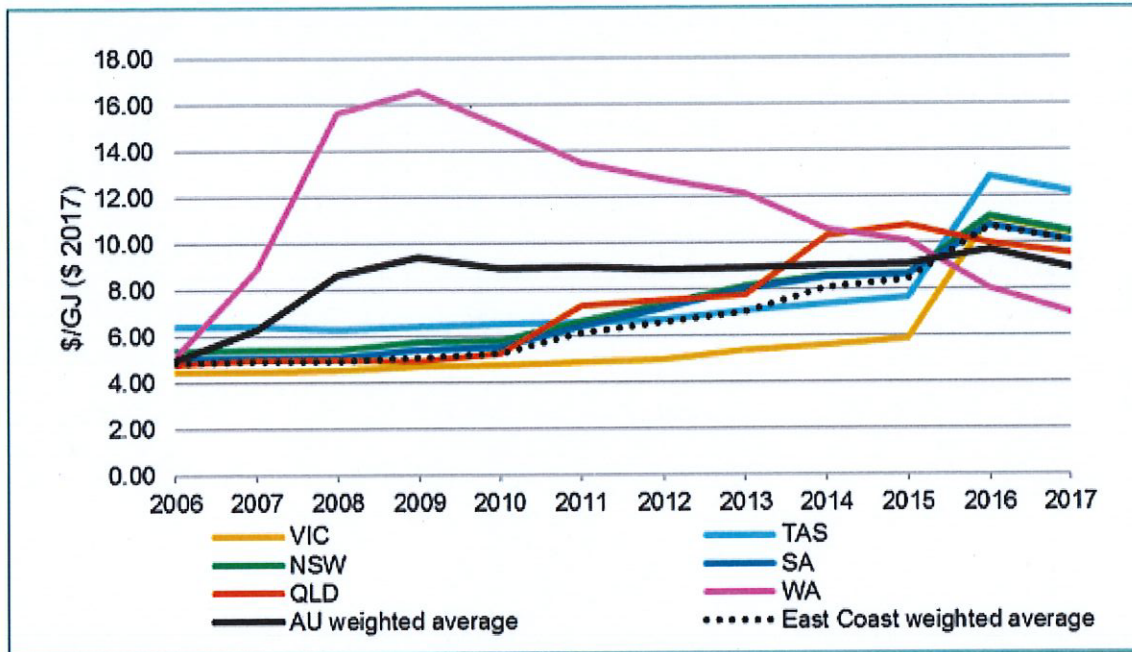
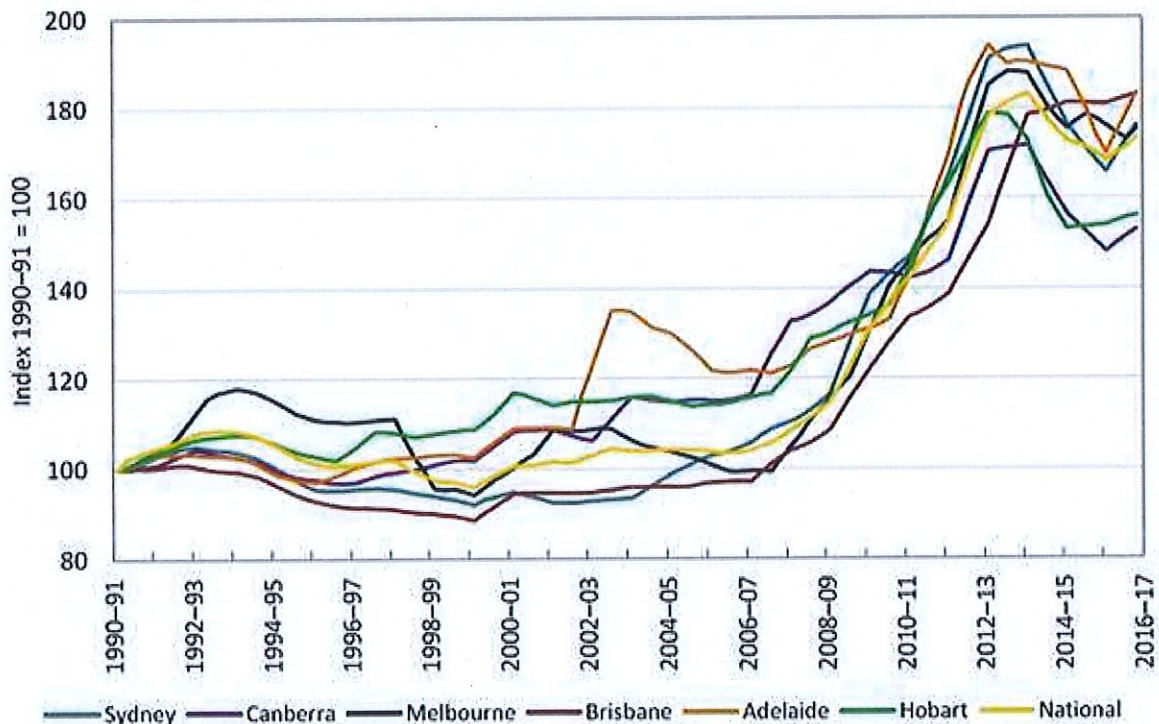


Figure 2

Retail price index (inflation adjusted) for Australian capital cities. Source: Australian Competition & Consumer Commission, Retail Electricity Pricing Inquiry (September 2017)





These price increases have led Bradken's total expenditure to increase by many millions of dollars and, under the proposed R&D intensity calculation, this would have a negative and adverse impact on Bradken's R&D intensity and the level of benefit it is able to access.

In developing an R&D policy that rewards companies who increase their R&D intensity (by increasing R&D spend as a proportion of total spend), it is our view that the volatility of inputs into the business (i.e. fuel, cost of metal, cost of labour, foreign exchange fluctuations, etc) should not be capable of materially impacting the R&D benefit available to the claimant.

Based on our reading of the material associated with the introduction of the proposed legislation, the Government is trying to incentivise companies to increase their R&D expenditure by offering an increase of benefit to companies with a higher R&D intensity.

We propose that using **discretionary expenditure** (i.e. total expenditure exclusive of costs of goods sold -COGS), rather than total expenditure would lead to a more accurate measurement of a company's R&D intensity. By avoiding the impacts of input volatility inherent in total expenditure on the R&D intensity, the program would incentivise companies to participate in Australian R&D activity. Using discretionary expenditure as the denominator allows a company complete control over R&D intensity rate.

## **2. Lack of predictability in identifying Bradken's R&D intensity before the start of the financial year**

One of the advantages of the current RDTI is the ability to confidently predict the benefit available from eligible R&D activities. This predictability enables Bradken to factor the RDTI benefit into its budget process and use it to inform decisions about what R&D activities or projects to pursue. In short, under the current RDTI, Bradken is confident that for every dollar invested in eligible R&D activities, it would receive a benefit of 8.5¢.

Despite explanatory documents suggesting the proposed calculation is 'straight forward and brings simplicity to the process', one of the fundamental problems with the proposed changes is the reality that there is no possible way for Bradken to accurately calculate its R&D intensity until after the relevant financial year.

While it may be possible to confirm the R&D expenditure for the year (i.e. the numerator in the intensity equation), as previously noted the effect of a range of factors which impact total expenditure makes it impossible to accurately calculate the R&D intensity until after the end of the financial year.

This means Bradken could potentially commit resources to R&D activities based on a predicted level of total expenditure (and therefore R&D intensity and R&D benefit) and, due to circumstances beyond its control, total actual expenditure may increase so significantly it will reduce the anticipated R&D benefit to a negligible amount.

For example, unpredictable events associated with natural disasters or a fire within a facility (as has happened at Bradken's Runcorn site) incur significantly higher total expenditure than predicted. This unpredictable event would then have an adverse impact on the benefit available to Bradken if it had occurred under the proposed RDTI.



We believe the potential lack of predictability, created by the use of total expenditure, will have the opposite impact intended by the Federal Government. It will act as a disincentive for companies to increase investment in R&D activities, because there is no guarantee or certainty around the benefit available to them. The benefit can only be calculated at the end of the financial year in which the R&D and total expenditure was incurred.

An alternative that the Federal Government could consider, is a regime that provides certainty around the benefit prior to expenditure being incurred. An example of such a regime is the proposed New Zealand R&D Tax program, which will establish a 12.5% tax credit for businesses undertaking R&D in New Zealand. The predictability of this regime, coupled with its high, accessible tax benefit, will no doubt cause many Australian companies with operations in New Zealand to relocate their R&D programs (often involving relocation of personnel) to New Zealand.

As an example of how predictability impacts decision making - under the proposed Australian RDTI, on a \$20 million R&D spend, Bradken assumes it may only have access to a tax benefit of \$800,000 (assuming an R&D intensity of less than 2%). If Bradken were to invest that \$20 million in R&D in New Zealand (where it has operations), it could accurately predict the receipt of \$2.5 million in R&D tax benefits. This is the type of information Bradken will need to factor into its decisions around its future innovation strategies.

### **3. Lack of Incentive to increase innovation due to the tiered structure**

We believe Bradken will fall into the R&D intensity category of between 0% - 2%, attracting a tax benefit of 4%, based on the definition of 'total expenditure'. As part of our research, we identified that the 4% tax benefit is the lowest R&D Tax Incentive available within the OECD.

We also identified that most other OECD countries have an innovation strategy that not only incentivises companies to be more innovative (with a predictable and higher tax benefit), they are also rewarded for keeping their innovations within the country the innovation was developed, via a form of 'Patent Box' regime.

Australia's gross expenditure on R&D as a percentage of GDP is 2.11%, well below the OECD average of 2.38%.<sup>1</sup> The introduction of an R&D Tax regime that offers a 4% tax benefit to many claimants, with limited ability to access the next tier will act as a disincentive for large, mature and disaggregated businesses and will likely result in a reduction in Australia's innovation reputation on the world stage.

R&D incentives are used by many countries to attract innovative businesses to their country, which contributes to the economic benefit of the overall economy. The proposed tiered structure offers companies like Bradken an R&D Tax benefit of 4% (compared to New Zealand's proposed 12.5%). Therefore, it is unlikely to draw innovative businesses or R&D investment into Australia and may actually drive Australian innovators offshore, to more innovation-friendly tax regimes.

In summary, Bradken supports any Government initiated measures to improve integrity and compliance with the RDTI program. However, after working through the impact of the draft legislation, it appears the main objective of the proposed changes to the RDTI program is to

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<sup>1</sup> "The McKell Institute – Committing to the Innovation Nation" [www.mckellinstitute.org.au/research/reports/committing-to-the-innovation-nation](http://www.mckellinstitute.org.au/research/reports/committing-to-the-innovation-nation) (2017)



reduce the benefit available to large companies such as Bradken by introducing an intensity test that is biased against companies with significant total expenditure that involves raw materials or energy. Under the proposed changes, Bradken would have no ability to access the top rate of 12.5%, due to the impact of the \$150million cap and its total expenditure.

The inability to predict Bradken's actual R&D intensity before the financial year, coupled with the extremely low rate of benefit available to Bradken under this program, is likely to cause Bradken to re-evaluate both its level of investment in R&D in Australia and the benefit of making a claim at all, given the administrative factors associated with making a claim.

Rather than increasing investment in Australian R&D, the proposed draft legislation will provide an incentive for companies to transfer R&D activities to jurisdictions that provide a more generous return on R&D investment. This will of course be to the detriment of the Australian economy.

Regards,

A handwritten signature in black ink, consisting of several overlapping loops and lines, positioned above the typed name.

**Simon Linge**  
**CEO**  
**Bradken Limited**