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4 March 2020

Senate Standing Committee on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Delivered via email to: economics.sen@aph.gov.au

Dear Sir/Madam,

Re: Submission to the Senate Economics Legislation Committee on the Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019

On 6 February 2020, the Senate referred the provisions of the Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019 to the Senate Economics Legislation Committee (the Committee) for inquiry and report by 30 April 2020.

Brickworks Limited (Brickworks) is pleased to provide a submission in relation to the draft legislation, the Treasury Laws Amendment (Research and Development Tax Incentive) Bill 2019, and the accompanying Explanatory Materials (EM).

Brickworks previously wrote to the Treasury regarding the first version of the Bill known as the Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 [Provisions] and the accompanying Explanatory Materials (EM). Given the new Bill is largely unchanged from this version, our submission dated 24 July 2018 appears as Attachment 1 to this letter.

The 2018 Bill was referred to the Committee for inquiry. The Committee did not endorse Schedules 1 to 3 of the 2018 Bill relating to the R&D Tax Incentive (the Incentive). The Committee considered that the $4 million cap and the R&D premium intensity as currently drafted required further refinement. In particular, the Committee was concerned about the impact of the changes on existing investment decisions and the risk that the intensity premium could disadvantage businesses with Australian manufacturing compared to businesses that manufacture overseas. As a result, it was the unanimous view of the Senators that the Senate defer consideration of the Bill until further examination and analysis of the impact was undertaken.

<u>Response to the Changes Reflected in the New Bill</u>

Brickworks' comparison of the two versions of the Bill reveals the following differences only:

1. The start date of the Bill has been pushed back from 1 July 2018 to 1 July 2019 which means that, if enacted, it will have retrospective effect;

2. Modifications to the R&D intensity tiers and offset rates for the Non-Refundable R&D Tax Offset;

3. Changes to Part IVA (s 177) to individually identify the Refundable R&D Tax Offset and the Non-Refundable R&D Tax Offset. This means that, of all the offsets, only the foreign income tax offset, the

Brickworks Limited
ABN 17 000 028 526

738 - 780 Wallgrove Road, Horsley Park NSW 2175
PO Box 6550, Wetherill Park NSW 1851

T +61 (2) 9830 7800
F +61 (2) 9830 1328

info@brickworks.com.au
brickworks.com.au

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innovation tax offset (early stage venture capital limited partnerships and ESIC), the exploration credit and now R&D are specifically identified. There is no explanation of why this is needed and how this will separate behaviour changes inspired by the program and its compliance methods to get the tax benefit as opposed to inappropriate schemes to get the tax benefit; and

4. Minor and irrelevant corrections to the note in s 40-293, the titles in Subdivision 355-H on balancing adjustments and a renumbering of the claim publication provision from 3G to 3H in the Tax Administration Act 1953

Brickworks is extremely disappointed with the outcomes contained in the new Bill.

The retrospective nature of the legislation disrupts investment decisions made by Brickworks prior and subsequent to 1 July 2019. Suggestions that taxpayers knew the new Bill's benefit regime was coming and should have budgeted accordingly do not stand up, particularly in the light of the first Bill's unanimous rejection by the 2018 Senate Inquiry.

The changes to the R&D intensity rates of offset and tiers of support have not addressed any of the structural concerns raised by Brickworks in our previous submission. That submission outlined Brickworks' concerns that the R&D intensity premium created industry biases, risked unduly influencing business decision making and arbitrarily advantaged certain sectors and corporate structures. All these concerns remain with the new Bill.

In terms of the offset rates and R&D intensity limits, the offset base rate has been lifted by 0.5% to 34.5% and the intensity limit doubled to 4%. The nature of Brickworks' operations, being low profit margins and high operational expenses, means that Brickworks will only ever qualify for the base rate. When factoring in compliance costs, the net benefits available under the new regime are not attractive and will not drive Brickworks' R&D behaviour and plans.

Brickworks does not support the passage of the Bill in its current form.

Brickworks appreciates the opportunity to make this submission and respectfully wishes to be considered for an invitation to present at any public hearing.

Should you wish to discuss any aspect of the material contained herein, please do not hesitate to contact me.

Yours sincerely,

[redacted]

Robert Bakewell
Chief Financial Officer

Addendum to new submission attached on following page

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24 July 2018

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

Email: RnDamendments@treasury.gov.au

Dear Sir/Madam

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

Brickworks Limited's history of innovation and the R&D Tax Incentive

Brickworks Limited is an Australian owned and based group of companies engaged in the design, development, manufacturing, marketing, distribution, and sales of a variety of building materials. The business employs more than 1,500 staff, with operational manufacturing facilities spread across Australia.

For many years, Brickworks has availed itself of the Federal Government's R&D Tax Incentive ('RDTI') to support its ongoing R&D program. Brickworks' R&D program consists of a range of innovative activities targeting the development of new premium building products, environmental sustainability (including new fuel-efficient kilns and the use of alternative fuel sources) and innovative manufacturing strategies. The RDTI has assisted Brickworks to maintain this focus on innovation (one of the company's corporate values), with the flow on effects of minimising price increases to our customers, delivering significant value to shareholders and increasing the level of innovation within the Australian economy. In this respect, the RDTI has been an important cornerstone in assisting Brickworks to commit the appropriate resources to navigate its way through what can be an uncertain and dynamic building products market.

Brickworks spends approximately $27 million per annum on R&D projects that are supported by the RDTI and has a strong history of converting these projects and activities into successful commercial exploits. The benefit available under the RDTI acts to 'de-risk' such initiatives, giving Brickworks a safety net to explore a wider range of solutions and possibilities than it would otherwise pursue. The RDTI also provides us with an ability to pursue more innovative and novel options for longer periods of time, dramatically increasing the chance of successful technical and commercial outcomes.

Impact of the proposed R&D intensity test on Brickworks Limited's ability to make an R&D claim

Based on initial modelling following the release of the draft legislation, the proposed changes are likely to decrease the benefit available to Brickworks under the RDTI by 40% to 50%. In addition, the use of an intensity test on the basis of future R&D spend and future operating spend for the upcoming year will produce significant uncertainty and unpredictability in respect of the benefit available to Brickworks under the RDTI program, which could adversely impact Brickworks' decisions to engage in additional or technically risky R&D activities.

Brickworks supports efforts to better focus public R&D spend. However, it is our firm view that applying an intensity test (per the draft legislation) to calculate the benefit available to businesses like Brickworks, does not align with the Federal Government's stated objective of the proposed changes which was to restore the integrity of the program and reward businesses, like Brickworks, that invest in additional R&D activities. In accordance with the consultation questions, the below information discusses some of the

Brickworks Limited
ABN 17 000 028 526

738 - 780 Wallgrove Road, Horsley Park NSW 2175
PO Box 6550, Wetherill Park NSW 1851

T +61 (2) 9830 7800
F +61 (2) 9830 1328

info@brickworks.com.au
brickworks.com.au

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most important integrity risks, implementation issues and ongoing compliance challenges that Brickworks foresees could arise under the program.

Penalising corporate diversification

Brickworks has a diversified corporate structure that has delivered stability to shareholders over the long term. There are three divisions within the Brickworks group structure: Building Products, Property and Investments. In the 2017 financial year Building Products delivered earnings before interest and tax (EBIT) of $65 million, Property delivered $90.6 million and investments delivered $103.1 million. As such, Building Products contributed around 25% of Brickworks' total EBIT. Each year, 100% of Brickworks' R&D spend is incurred by the Building Products division.

Under an intensity model such as that proposed in the draft R&D legislation the existence of the Investments and Property divisions significantly dilutes the supposed 'R&D intensity' of the Building Products business. The effect of having to include the expenditure of the Investment and Property divisions in Brickworks' R&D intensity calculation will be to substantially reduce the benefit available to Brickworks under the proposed R&D Tax Incentive program, essentially penalising the business for adopting this diversified strategy. If Brickworks' businesses were structured differently, such that the Property and Investments divisions were separately held and/or unconsolidated, the R&D intensity of the Building Products division would be significantly higher. This is a clear integrity issue with the current draft legislation that Brickworks encourages Treasury to address.

Recommendation: To avoid disadvantaging diversified corporate structures, one solution may be to assess intensity on a company by company basis within consolidated groups. While this would not necessarily require registration with AusIndustry by each individual entity, the calculation of intensity in this manner would likely assist to remove any arbitrary advantage afforded to corporates that do not consolidate, and thus reduce the impact of the RDTI on structuring decisions.

Given the existing need to closely track and calculate both R&D and operating expenses on this basis for tax and accounting purposes, it is unlikely that such an approach would have a significant impact on compliance burden.

Arbitrarily targeting of businesses with high operational costs

Like many other stakeholders, Brickworks is concerned that the intensity test unfairly targets industries with low profit margins and high operational expenses. As a result, the proposed intensity test will create sectoral biases whereby certain businesses are advantaged (i.e. have a high R&D intensity) purely as a result of the cost base on which they operate.

For example, manufacturing, and building products manufacturing in particular, is a low margin and high expense industry, with materials, energy inputs, salaries and wages and transport accounting for a significant proportion of expenses. This high overall operating expenditure (which is incorporated in the denominator in the calculation of the R&D intensity test under the proposed arrangements) dilutes the benefit available to Brickworks, and inherently disadvantages the business. Conversely, a business with a lower cost base, is likely to have a higher R&D intensity (on the basis of R&D spend as a proportion of total spend) without necessarily undertaking a higher intensity of R&D activity.

The impact of this is evidenced by comparing a toll manufacturing arrangement (whereby a company provides raw materials to a third-party manufacturing service provider) to a business that manufactures on its own behalf. In such a scenario, while both businesses may undertake exactly the same level of R&D activity as a proportion of its manufacturing for the year (measured, for example, by units of output), the vastly lower expenses of the contract manufacturer (as it does not incur expenditure on raw materials) will result in a significantly higher R&D intensity, as the proportion of R&D spend to total expenditure is

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significantly higher for that toll manufacturer. Such a result is arbitrary and does not achieve the stated objectives related to the legislative changes, given that one of the stated purposes of the RDTI is to reward a higher intensity of R&D activity.

Additional uncertainty in an already volatile market

The construction industry, and the building products market as a result, is a cyclical sector of the economy. Brickworks' Building Products division has felt this over the past 24 months, as it has been an extremely challenging period in Western Australia. With residential building starts down 22% during the 2017 year, Brickworks was unfortunately forced to close four plants permanently. While this significant restructuring was required to manage the downturn in the market, it unfortunately resulted in the loss of 126 jobs across the business.

In addition to these challenging market conditions, new gas and electricity contracts took effect on the east coast from 1 January 2018. In total, gas and electricity price increases will add around $20 million per annum to Brickworks' manufacturing costs by 2019, on a business as usual basis.

The calculation of R&D intensity requires Brickworks to determine R&D spend as a proportion of 'total expenditure'. In the proposed legislation, inputs such as raw materials and energy are effectively precluded from the calculation of R&D expenditure for the purpose of calculating R&D intensity (by virtue of the feedstock provisions), but must be included in the calculation of total expenditure. As a result, increases in prices will increase the denominator in the R&D intensity calculation, but will not increase R&D spend (even if such inputs are used in R&D activities). The inclusion of one type of costs in total expenditure but not in R&D spend will act to dilute Brickworks' R&D intensity, particularly where there are significant increases in energy prices (as has recently been the case).

The fact that fluctuation in energy prices can have such a significant impact on the R&D intensity of a business indicates that there is an issue with the integrity of the proposed changes which Brickworks believes should be addressed before the final legislation is enacted.

For Brickworks, the impact that such fluctuations on 'total expenditure' and thus its R&D intensity also create significant unpredictability in the benefit available under the proposed model. This unpredictability of outcome will result in difficulties in predicting Brickworks' R&D intensity at the beginning of a financial period, which will have a knock-on effect in that it will not be possible to accurately calculate an internal rate of return on proposed R&D activities. Given the lack of predictability in available tax benefit, we are less likely to commit to the same level of R&D expenditure to projects as a result of such uncertainty, particularly projects that have a high potential for technical failure.

Recommendation: As a solution to the inequity posed by the inclusion of raw material and energy inputs in the R&D intensity calculation, Brickworks suggests the removal of these costs (that typically attract no benefit under the RDTI), from the calculation of 'total expenses' used to calculate R&D intensity. The impact of such a change would be to:

- Remove inequity between the benefit available to businesses based on the way in which they structure their manufacturing operations (e.g. toll manufacturing versus in house manufacturing).
- Remove some categories of costs that are not eligible for a net benefit under the RDTI intensity test because of clawback of benefit under the feedstock provisions, thus better matching the calculation of the intensity denominator (operating expenses) with the numerator (R&D expenses).

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Summary

It is our view that the introduction of the intensity threshold in its current form would run counter to the objectives of creating a more efficient and consistent RDTI program. While targeting R&D intensity is a sensible approach to achieving better 'bang for buck' in public R&D spend, the proposed legislation seeks to apply this methodology in a way that creates industry biases, risks unduly influencing business decision making and arbitrarily advantages certain sectors and corporate structures.

Two important considerations to ensure that such biases are removed prior to implementation of an intensity threshold are:

- Consideration of how to apply the intensity test on an entity by entity basis, given that structuring decisions (e.g. diversification) can arbitrarily impact the R&D intensity, as calculated under the proposed model; and
- Consideration of the amounts to be included in 'total expenditure' given the variation in cost base that can occur depending on industry and operating model.

I trust that you will consider these issues, and the company specific issues raised herein, in your deliberations.

Please do not hesitate to contact me should you require any further information on the impacts of changes to the RDTI on Brickworks and large, diversified manufacturers in Australia.

Yours sincerely,

[redacted]

Robert Bakewell

Chief Financial Officer