



Submission to

**The Treasury - Business Tax Working
Group re The Tax Treatment of Losses**

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Appendix 1 – Exploration Tax Credit model recommended by AMEC

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Introduction

1. Thank you for the opportunity to provide input on the interim report on the tax treatment of losses.
2. The Association of Mining and Exploration Companies (AMEC) is the peak national industry body for mineral exploration and mining companies within Australia. The membership of AMEC comprises over 350 explorers, emerging miners and the companies servicing them.
3. A fundamental requirement of the mining and minerals exploration sector is clarity, certainty and a level playing field for business and investment decision making in what is the engine room of the Australian economy. It is therefore imperative that this is achieved through a long term stable public policy framework and fiscal regime.
4. In this regard, AMEC welcomes the report, particularly the following statements and acknowledgements contained therein¹:
 - *'the tax treatment of losses are designed to increase productivity, while also delivering tax relief to struggling businesses'*,
 - *'it is important that all policy settings, including tax, are designed so as not to hinder such risk taking and innovation'*,
 - *'that there are weaknesses in the tax system that exacerbate some of the current challenges facing business'*, and
 - *'the objective of the Business Tax Working Group is to examine the extent to which rules in the business tax system may hamper Australian businesses' ability to respond to these challenges and opportunities'*.

Background – industry structure and operation

5. The general structure of the resources industry is similar in Australia and around the globe.
6. In Australia it is made up of approximately 2,500 companies² (listed and unlisted); comprising:
 - A handful of major mature conglomerates that dominate market share;
 - A relatively low number of mid-tier and emerging miners in the middle; and
 - Thousands of small junior exploration companies at the other end, representing a significant proportion (in numbers) of the industry.
7. The distinction in size, capacity, ownership, commodity and maturity between these companies is an extremely important point, and re-inforces that *'one size does not fit all'*, and that not all companies make a profit (and in many instances, no profit at all).

¹ Interim report on the tax treatment of losses, pages v, vi and 1

² Government announcement re RSPT on 2nd May 2010

8. The Australian mining industry desperately needs a vibrant exploration and mid tier producer sector as they take the majority of the initial risk and attempt to prove up deposits and aspire to be large producers.
9. As further background to the Business Tax Working Group, small exploration companies do not pay any corporate taxation or royalties until such time as they have:
 - ✓ discovered an economically viable deposit;
 - ✓ subsequently constructed a mine;
 - ✓ commenced production;
 - ✓ sold their product;
 - ✓ earned income; and
 - ✓ generated a taxable profit.
10. During this long gestation period, eligible exploration expenditure is carried forward in the losses incurred and only become available for income tax deductibility when assessable income is received.
11. It is not unusual for this “*exploration to production*” cycle to cover a timeframe of 7 to 10 years, subject to the size of the deposit; nature and complexity of the mine; extent and complexity of land access (including cultural heritage, native title and environmental issues); approval and licensing barriers that are encountered during the long process.
12. In addition, the rate of discovery is low, to such an extent that the “*probability of finding an economic deposit on any piece of ground is 1/100, whereas one that is of world class is 1/1000*”.³
13. Prior to commencing these high risk exploration activities a company normally raises funding for the proposed project by way of equity financing (such as domestic or foreign investors, retail investors, superannuation funds etc). In many instances there is a mix of equity / joint ventures and, in the case of exploration success, the potential for debt financing in order to fund a project / company.
14. Minerals exploration is therefore considered to be a long term high risk activity, where exploration companies “*aspire*” to become successful miners after many years of activity and at significant cost – invariably many millions of dollars.
15. On the rare occasion that an exploration company is able to graduate and become a mining company and start producing product for domestic and international consumption and sale, the resultant income then becomes subject to Federal income tax and State / Territory royalty processes.
16. Until this time is reached, the accumulated ‘losses’ from exploration activities are “trapped” in the company and may never be able to be used as a deduction against taxable income. These “trapped” losses could “*in some regards represent a windfall gain for governments*”⁴.

³ Gold & Minerals Gazette, August 2008 – page 4

⁴ Interim report on the tax treatment of losses, page v

17. Reform of the tax treatment of losses in such circumstances will provide an ideal opportunity to address this asymmetric treatment of tax losses.

Current business and investment environment

18. Contrary to other community and government perceptions, the current business and investment environment is exacerbating this problem to such an extent that small exploration companies are already experiencing difficulty in accessing equity capital in which to finance their activities and hopefully discover the mines of tomorrow. Further unwarranted pressure could have serious consequences on individual business cases and future viability.
19. Analysis of the Initial Public Offer (IPO) data for 2011, shows that of the 78 new minerals IPO's 77% were below their 'issue price' at the end of the year, with only 23% having a positive return.⁵
20. Despite perceptions to the contrary, AMEC notes that a significant proportion of funds raised for minerals exploration purposes in Australia over the past 12 / 18 months are being directed to overseas jurisdictions, such as Africa, Canada and South America.
21. This does not just highlight the mobility of capital, it also results in Australia's human and intellectual capital being employed to expand the resource industries in other countries in competition and at the expense of Australia's future.
22. Australia's attractiveness as a place in which to invest is already being affected, and will be made worse should the current flow of capital overseas continues. It will also be extremely difficult to reverse that trend in future years.
23. Australia's international competitiveness is also under extreme pressure as a direct result of the increased effective tax rates caused by the proposed introduction of the Minerals Resource Rent Tax and the carbon tax.
24. All of these issues are having an accumulative and detrimental impact on the small emerging miners and junior exploration companies.

Global economic uncertainty

25. In addition to the current difficult investment environment and narrow government policies, Australian minerals exploration companies are extremely concerned about the impact of the problems being experienced in the global economy.
26. Late last year, the International Monetary Fund predicted the possibility of an extended global recession, where commodity prices, exchange rates and superannuation funds will be under enormous pressure. There are signs that this possibility is turning into reality.

⁵ MiningNews.net, Allan Trench article on 9 January 2012

27. Should this eventuate, the implications on the Australian economy should be at the forefront of strategic and budgetary planning, and in public policy development to ensure that Australia's strong economic and financial fundamentals and opportunities are maximised to the full extent.
28. The combined downstream effect of the:
- current global economic uncertainties and the precarious position of the United States and European economies;
 - potential shock wave should there be any further weakening in those economies; and
 - continued pursuit of the Australian Government's current public policy strategies (including the MRRT, carbon tax and other increasing barriers to minerals exploration and development)
- will be disastrous for local and regional economies.
29. It will also place the minerals exploration sector in a position where it will quickly lose its current capacity, strength and confidence in generating future growth, revenue, investment and jobs.
30. The subsequent detrimental impact on commodity and metal prices and exchange rates will have a direct and disastrous impact on the Australian mining sector, the Government's forecast revenue base and the Australian economy.

Need to sustain growth and development

31. As detailed in AMEC's submission to the 2012/13 Federal Budget process, the Australian Government should therefore respond with long term strategic policies for the resources sector that sustain growth, development and jobs; and not weaken the industry or make it vulnerable to external influences.
32. The Government should implement public policies that ensure Australia's reputation as a safe place in which to invest, and the resource industry's international competitiveness are not damaged in a very competitive global resources environment.
33. Australia is not the only country in the world with mineral resource potential.
34. A resources policy framework specifically focussed on the minerals exploration sector should therefore be adopted that provides companies and investors with the confidence to plan and invest in greenfields exploration programs that will contribute to the future development of mines and growth and productivity in the Australian economy.
35. Such a framework would:
- Be in the national interest,
 - Provide a further mechanism to protect the Australian economy from any economic shocks or a global recession,
 - Restore Australia's reputation as an exploration investment destination,
 - Remove the uncertainties and reduced confidence that currently prevails over the 'engine room' of the Australian economy, and

- Provide a significant government revenue stream and other social (including jobs) and economic dividends for the Australian community.

Broad based resources policy framework required

36. A resources policy framework focussed on minerals exploration should involve a combination of the following objectives:
- Significant improvements in land access and streamlining of the environmental and native title approval processes for minerals exploration and mining,
 - Stimulate investment in greenfields exploration by implementing an Exploration Tax Credit model,
 - Increase investment in regional infrastructure,
 - Implement initiatives that address forecast skilled labour shortages,
 - Full re-instatement of the diesel fuel credit under the Clean Energy Future Plan, and
 - Long term strategic tax reform, including removal of the Minerals Resource Rent Tax.
37. These objectives will have the result of stimulating investment and ultimately bringing forward and increasing general revenue from income tax, royalties and the myriad of other taxes and charges raised by respective Federal, State and Territory Governments.
38. AMEC is of the strong view that the Government should urgently implement appropriate initiatives to address the market failure that has lead to '*less minerals discoveries*'⁶ in Australia and ensure a level playing field for the after tax cost of exploration between those companies with revenue and those without.
39. While correcting this imbalance, there is also an opportunity to implement policies that attract investment into Australia and to promote much needed greenfields exploration.
40. Close analysis of the Australian Bureau of Statistics (ABS) data clearly indicates that strategic and public policy attention should be given to increasing greenfields exploration.
41. AMEC considers that a more accurate and appropriate measure of minerals exploration is by actual 'metres drilled', rather than exploration expenditure. Such a measure is not distorted by the type of drilling, location, terrain being drilled, general operating expenses, or the consumer price index; all of which directly influence the increasing cost of drilling per metre.
42. Although the ABS statistics show that overall minerals exploration expenditure has been increasing over the past few years, the actual amount of 'metres drilled' for greenfields exploration has been increasing at a much slower pace over the last decade. Unfortunately, as a proportion of the total metres drilled, the greenfields share has fallen from around 45% to just over 30% since 2003 (**Figure 1**). The growth in brownfields exploration around existing and known deposits, has obviously occurred due to the lower risk profile and increasing commodity prices (particularly in iron ore and gold). This brownfields exploration is also predominantly undertaken by the larger mature mining companies, rather than small junior exploration companies that generally target greenfields areas.

⁶ MinEx Consulting presentation at the 2011 AMEC Convention

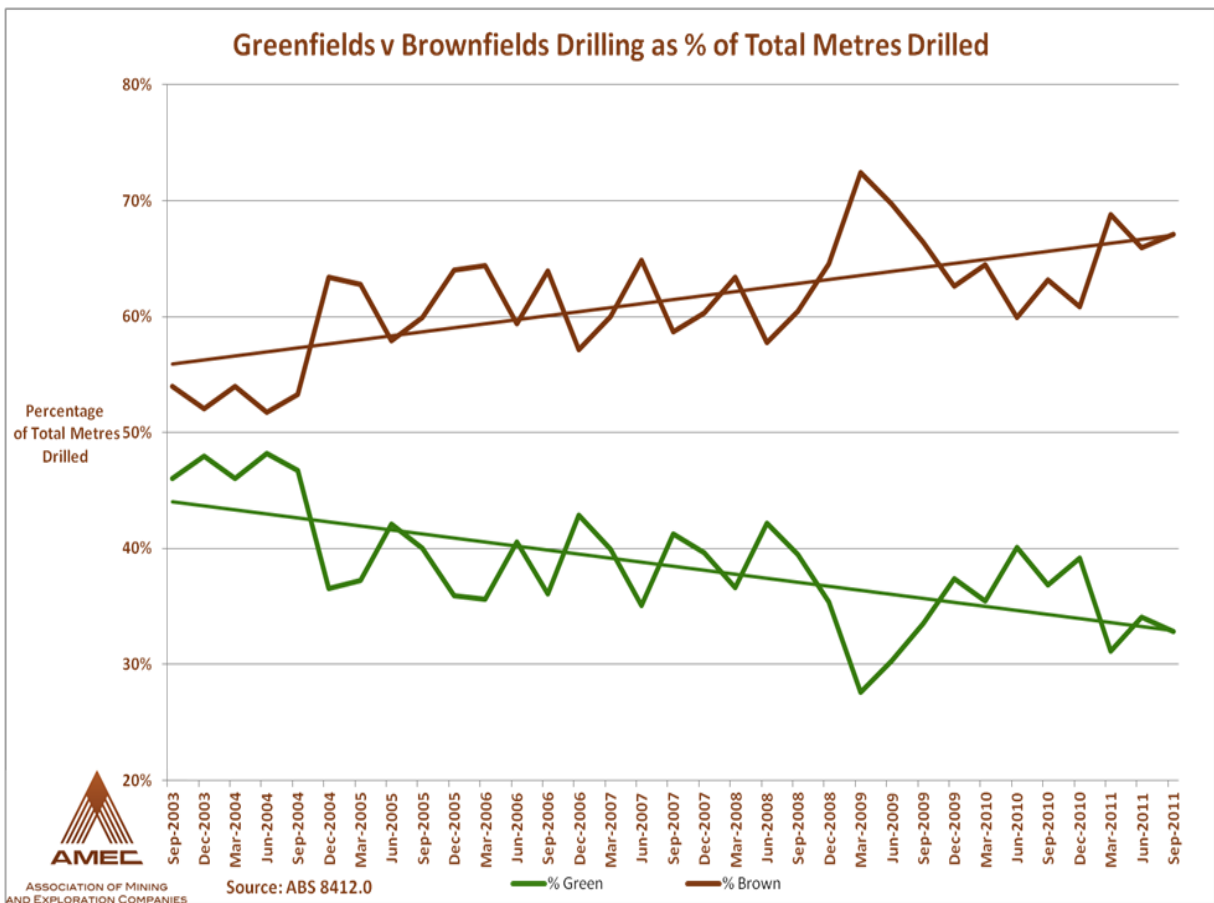


Figure 1 Graph showing the % share of total metres drilled, Greenfields v Brownfields

43. Analysis of data compiled by the Metals Economics Group also shows that Australia's share of global exploration expenditure (brownfields and greenfields) continues to fall in comparison to competitor jurisdictions, where Australia's share of exploration expenditure has gradually declined from a high of 15% in 2004 to 12% in 2010 (Figure 2).

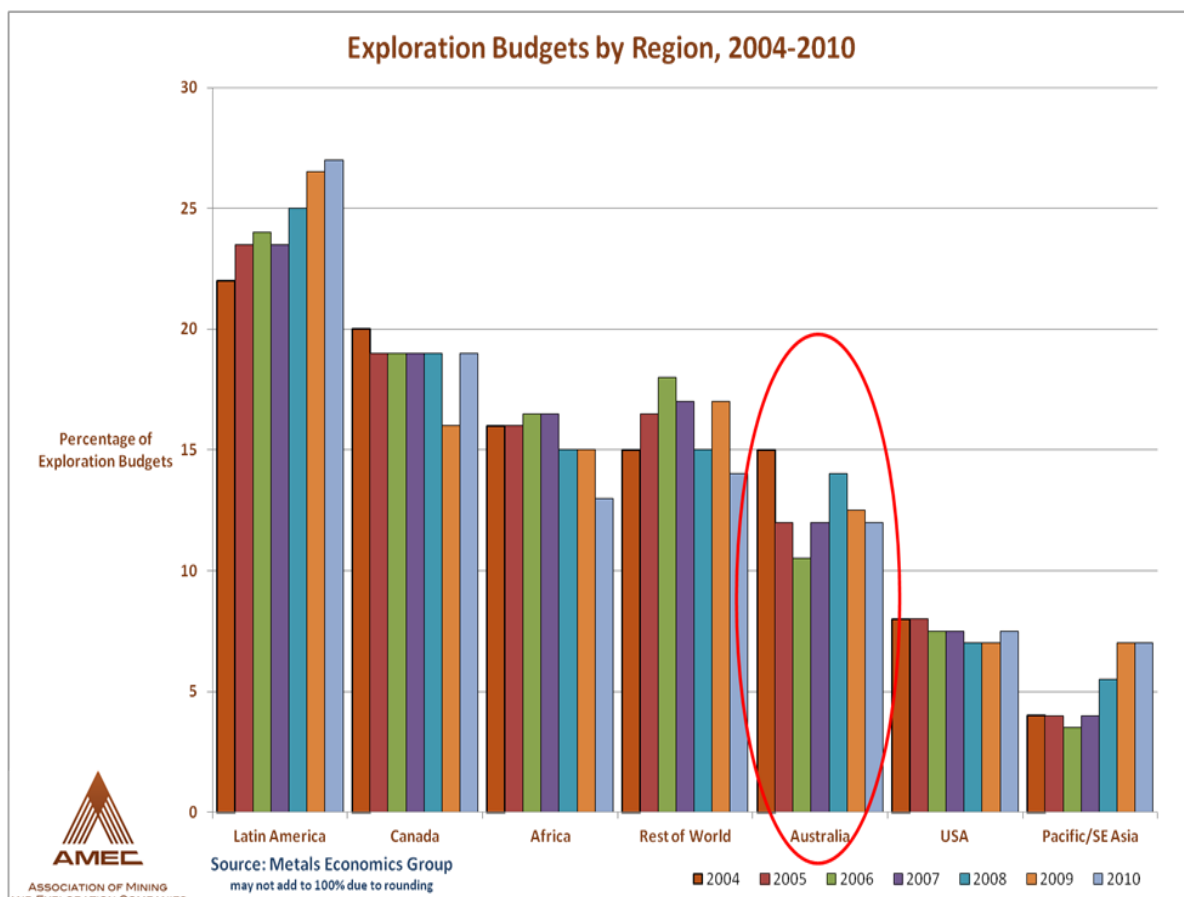


Figure 2 Percentage of exploration budgets by Region, 2004 to 2010

44. It should also be noted by policy makers that ‘*current mine production in Australia is largely from maturing mines that have mostly been discovered more than 20 years ago*’.⁷ More greenfields discoveries are therefore essential in the national interest.

45. These are significant trends that should not be overlooked by the government.

46. The current asymmetric treatment of tax losses puts small minerals exploration companies at a competitive disadvantage relative to larger, more diversified companies and to business investments in other sectors, and needs to be rectified by appropriate public policy.

Specific comment on the possible approach to reform

47. AMEC has noted the four Elements that the Working Group has provided as possible reform options, either individually or as a suite of reforms to improve the tax treatment of losses.

48. In this regard, AMEC notes:

- Element A (remove the COT and SBT, introduce an alternative integrity test), and
- Element C (introduce a time limited form of loss carry back).

⁷ Ibid

49. AMEC also notes Element B (allow losses to be refunded), and that the Working Group does not propose immediate refundability as a viable option for the foreseeable future.
50. AMEC does however fully endorse Element D (apply an uplift factor). In supporting this Element, AMEC agrees with the observations by the Working Group that:
- *'applying an uplift factor would provide the greatest benefit to those companies undertaking projects with a long lead time between up-front capital costs and subsequent revenue'*⁸, and
 - *'this would also benefit start-up companies, other companies considering restructuring or innovating and other initially capital-intensive businesses'*⁹
51. These astute observations particularly apply to the exploration and mining sector where the "exploration to production" cycle could cover a timeframe of 7 to 10 years or longer.
52. AMEC recommends that the Working Group also consider the following option in order to specifically deal with the treatment of tax losses in the minerals exploration sector.

Exploration Tax Credit model

53. In order to:
- Remedy market failure;
 - Promote investment in junior mineral exploration companies;
 - Promote greenfields exploration expenditure by junior minerals exploration companies in Australia; and
 - Address tax asymmetries
54. AMEC has advocated adoption of an Exploration Tax Credit (ETC) model, with the result that the government recommended in 2011 that the Productivity Commission should undertake an examination of regulatory barriers faced by exploration companies and present its report to the COAG for action by Australian jurisdictions.
55. The issue of the declining mineral discovery rate and declining share of global exploration expenditure in Australia as well as the market failure in the exploration sector was recognised by the ALP government that led to its 2007 election policy position to introduce a tax credit incentive through a "Flow Through Shares" model. This policy position was correct in 2007 and is still appropriate today.
56. The ETC model recommended by AMEC (**Appendix 1**), and other industry bodies, is a hybrid of the Flow Through Shares model, Australia's franking system and a tax credit. The model proposed that accumulated losses that are incurred by companies with 'no assessable' income could voluntarily pass those losses, by way of the tax credit, through to their shareholders at the company rate by using a system that is based on Australia's well known franking system. Shareholders would therefore receive a benefit, rather than the losses being 'trapped' in the company for many years or never used at all.

⁸ Interim report on the tax treatment of losses, page 23

⁹ Ibid

57. AMEC considers that is a very worthy public policy initiative that should be urgently addressed, and not wait for the outcomes of a protracted and irrelevant Productivity Commission review, as it is in the national interest to promote future minerals exploration activities (particularly greenfields) throughout Australia. Failure to do so will create significant delays in new mine site development and subsequent revenue streams.
58. In recommending the Exploration Tax Credit model, AMEC notes the Business Tax Working Group Terms of Reference requires that the costs of any reform options will be offset by savings from business taxation measures to achieve a revenue neutral package¹⁰. The cost benefit analysis conducted by Synergies Economic Consulting (detailed in Appendix 3) clearly shows the proposed costs of the ETC would be far outweighed by the significant social (including jobs) and economic benefits.
59. AMEC notes that '*further analysis and broad consultations will be conducted before making final recommendations on the reform options for the treatment of tax losses*'¹¹, and awaits further consultation. However in the meantime, I would be pleased to meet with the Business Tax Working Group to further discuss the Exploartion Tax Credit model described above, or other proposed reform options.

¹⁰ Interim report on the tax treatment of losses, page vi

¹¹ Ibid, page vi

Appendix 1 – Exploration Tax Credit (ETC) model recommended by AMEC

Background

In November 2008, a joint industry submission was presented to the Federal Government on a proposal to introduce a Flow Through Shares / Exploration Tax Credit (ETC) model in order to promote exploration in Australia. That submission was subsequently referred to the Henry Tax Review, and apparently not supported by Government.

In hindsight, it may have been more prudent for industry to not have used any reference to the “Flow Through Shares” terminology in that submission, as the November 2008 model was a hybrid of a Flow Through Shares model, Australia’s franking system, and an exploration tax credit concept.

AMEC still considers that the November 2008 ETC model (incorporating the franking system) provides a number of significant benefits, as follows:

1. It is well understood by investors and relevant stakeholders,
2. It is embedded in taxation law,
3. It has a proven track record having operated successfully in Australia for 20+ years,
4. It is simple and workable,
5. Administrative and management costs are minimized for companies, regulators and investors,
6. Tax compliance costs are minimized as existing franking style systems are already in place,
7. Risk for investors and regulators is minimized, and
8. Compliance and audit processes already exist, are well established, easily managed and policed.

The following **Exploration Tax Credit model** (based on the November 2008 model) would meet the following objectives:

- Remedy market failure;
- Promote investment in junior mineral exploration companies;
- Promote greenfields exploration expenditure by junior minerals exploration companies in Australia; and
- Address tax asymmetries

Eligibility:

1. An exploration franking / tax credit will be allowed to Australian resident shareholders of Australian companies, only in respect of eligible exploration expenditure incurred by those companies in Australia,
2. A ‘no taxable income’ test will ensure that the Program is only available to junior explorers,
3. The franking credit will apply to all exploration expenditure in Australia incurred after the date of commencement of the Program,

4. All taxpayers would be entitled to the franking credit (currently based on the 30% company tax rate), regardless of their own marginal tax rate – including superannuation funds with a 15% tax rate and individuals on low or nil tax rates. Taxpayers unable to use the franking credit against their tax liability would be entitled to a refund, on the same basis as other franking credits are refundable,
5. The Program is voluntary, noting that exploration companies can already retain their exploration deductions for their own future use if they wished to do so for strategic reasons. An appropriate declaration would need to be made to the capital market prior to the issue of any such share,

Mechanism:

6. Participating companies will be able to claim 'eligible exploration expenditure' using existing income tax law definitions,
7. The eligible company will identify the proposed franking credit through a special 'share class'. In the case of new capital raisings, it may be possible for a company to direct the franking credits to the new shareholders rather than all existing shareholders, via the use of different share classes,
8. The existing franking credit mechanism would be utilised to provide a credit to eligible shareholders,
9. The franking credit could be available to all shareholders for a discrete capital raising for eligible expenditure (such a credit could be transferred if the share is sold),
10. The franking credit would be available to all shareholders on the register on the day that the credit was 'declared',
11. Shareholders who sell out early (for example, short term IPO speculators) will not receive the franking credit until the 'declaration date',
12. The franking credit will be available at the prevailing company tax rate (currently 30%),
13. No time limits should apply on the use of the franking credit,
14. Eligible companies will have flexibility in the timing of passing on the credit, using a franking-account-like mechanism. Any shareholder on the register at the company's declared record date for distribution of the franking credit would receive it,
15. Consistent with the uplift factor in research and development programs, a 25% - 75% uplift in the credit would be available (such an uplift would reflect the high front end risk, and significant long term future dividends payable to all Australians that flow from mineral exploration, which are comparable to those relating to R&D investment),

Compliance:

16. All relevant terms are defined under current tax law, and would be adopted unchanged for this Program,

17. A number of well tested and existing Australian tax compliance mechanisms would operate to ensure that there was no double deduction of exploration expenditure either by the company, or for shareholder capital gains tax purposes,
18. All anti-avoidance provisions existing in the franking law would also apply to the Program, such as the anti-streaming rules, and the 45 day rule. A simple amendment would ensure that these provisions were mirrored in this Program,
19. A company (or corporate group) would not be permitted to choose to pay tax itself and instead use its exploration expenditure to distribute franking credits to shareholders. If the company has net taxable income after all expenses and prior year losses have been deducted, it would be required to use its own exploration expenditure to reduce its taxable income to \$nil. This provision is made as a further integrity measure in ensuring that the Program is contained to junior explorers,
20. The taxable income test would be considered from a corporate consolidated group perspective. Where companies have elected to be a consolidated group for tax purposes, the group as a whole must be in tax losses for any franking credits to be passed to shareholders,
21. In the event that a company distributes a franking credit, and it is later determined that its expenditure does not meet the eligible exploration definitions, this should be dealt with at the *corporate* level rather than at the shareholder level,
22. Appropriate penalty provisions should apply for any non compliance,

Implementation and review:

23. Specific details of the Program will be determined in consultation with peak representative bodies, such as AMEC, MCA, AusIMM. (If required, AMEC would be pleased to facilitate this process, and /or participate in a joint industry / government agency implementation working group).

Simple example of the calculation methodology:

Discrete capital raisings through an IPO of \$10m (50,000,000 shares @ 20 cents)

Eligible exploration expenditure of \$7.5m – available for tax credit purposes

Company tax rate of 30%

Uplift factor of 25%

Calculation:

$\$7.5\text{m} \times 30\% \times 125\% = \$2,812,500$ available for tax credit purposes to 50,000,000 shareholders = \$0.05625 cents per share (representing 28.125% per share).

NOTE: The credit is deferred and only becomes available once the expenditure has been incurred, the credit 'declared', and the tax return lodged.

Cost v benefit analysis:

Following the November 2008 submission, Synergies Economic Consulting prepared a robust cost benefit analysis in May 2009, and identified that the costs of the proposed ETC scheme were far outweighed by the significant social and economic benefits.

The Report indicated the immediate implementation of an ETC scheme for Australian junior exploration companies would result in **increased exploration expenditure up to around 30 per cent.**

Coupled with high labour intensities, few impediments and significant spare capacity in exploration and supporting industries, the report concluded that an Australian ETC would deliver a significant boost to the domestic economy.

The analysis specifically concluded that the immediate implementation of an ETC scheme would be a very worthwhile measure, delivering significant short term socio-economic benefits across Australia at an estimated cost to government of **approximately \$130m per year.**

Over a four year period, the report concluded that a FTS / ETC scheme could generate immediate **socio-economic benefits** across Australia of:

- **4,196 new jobs,**
- **\$114.4m in additional Gross Domestic Product,**
- **\$191.2m in additional real private consumption,**
- **\$965.1m in additional real investment.**

It is noted that the analysis did not attempt to quantify **the substantial 'flow-on' of economic benefits** beyond the initial four year period, particularly when more exploration is translated into more discoveries, and in turn, new mines and increased minerals production.

In this regard, compared with other industries often promoted as vehicles for generating increased economic activity, 'mining exploration' ranks #1 in terms of value adding and #3 behind 'residential construction' and 'financial services' in terms of employment generation.¹²

¹²

http://www.amec.org.au/media/docs/Communique_Final_Flow_Through_Shares_Scheme_May_2009.pdf