4 April 2014

Manager
Not for Profit and Industry Concessions Unit
Small Business Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

ATTN: Antony Pietsch

Dear Sir / Madam

Exploration Development Incentive: Policy Design Discussion Paper March 2014

Thank you for the opportunity to provide comment on the *Exploration Development Incentive: Policy Design Discussion Paper* dated March 2014.

As the largest peak industry body for mineral exploration and mining companies within Australia, the Association of Mining and Exploration Companies (AMEC) strongly supports the Exploration Development Incentive (EDI) commitment within the *Coalition's Policy and Resources Energy Policy*, dated September 2013.

Since that announcement, AMEC has sincerely appreciated the opportunity to work closely with the Department of Industry and Treasury on the policy design of the EDI in readiness for implementation on 1 July 2014. AMEC considers that the EDI is a mechanism which will encourage much needed investment in greenfield mineral exploration in Australia.

Attached for your consideration is AMEC's response to the various questions posed in the Discussion Paper.

The response also contains self-explanatory Appendices on the treatment of share capital, definitions, the proposed policy design, timelines and examples.

AMEC looks forward to continued engagement as the lead industry body on this excellent policy initiative. Please let me or Graham Short know if you have any specific queries on the content of the submission.

Yours sincerely

Simon Bennison
Chief Executive Officer

Cc Hon Ian Macfarlane, Minister for Industry
Hon Joe Hockey, Treasurer
Hon Sen Mathias Cormann, Acting Assistant Treasurer and Minister for Finance

Association of Mining and Exploration Companies
info@amec.org.au | www.amec.org.au

Perth Head Office:
6 Ord Street, West Perth WA 6005
PO Box 948, West Perth WA 6872
P: 1300 738 184 | F: 1300 738 185

Queensland Office:
Level 7, Suite 39, 320 Adelaide Street
Brisbane QLD 4000
P: 07 3010 9287 | M: 0402 142 367

New South Wales Office:
Level 3, 66 Hunter Street
Sydney NSW 2000
P:1300 738 184 | F:1300 738 185

EXPLORATION DEVELOPMENT INCENTIVE : POLICY DESIGN

Discussion Paper March 2014

Page no.	**Chapter**	**Question no.**	**Question**	**AMEC response** **(*Reference should be made to the self explanatory model at Appendix 4 which has been developed and recently refined to reflect the Government`s policy objective*)**
2	2	1	Will a 'no taxable income test' and a 'no mining activities test' effectively target the measure to junior minerals explorers who are not able to utilise their tax losses?	1. Combined with a restriction to 'greenfield' exploration, the proposed 'no taxable income test', and a 'no mining activities test', the EDI will be restricted to junior mineral explorers and not mining companies. 2. As a further suggestion however to increase the integrity of the model, consideration should be given to limiting access to mineral exploration within exploration tenements (such as prospecting and exploration permits or licences), and not to mining leases or other mining titles.
2	2	2	How should the 'no mining activities' test operate to ensure the incentive targets small mineral exploration companies?	1. AMEC considers that point 2 above will go most of the way in ensuring the incentive is targeted at small mineral exploration companies. 2. AMEC does not support a *de minimis* market cap $ threshold. 3. The EDI should not apply to MLs but only to ELs. 4. Under state and territory mining laws 'mining activities' can include a broad range of activities conducted under the auspices of exploration that those unfamiliar with the industry may classify as mining, such as test pits, trenches, or excavations. To limit confusion, 'mining activities' for the purposes of the EDI should be restricted to those activities that generate revenue and subsequent profit in order to allow legitimate exploration activity and expenditure to occur.

2	2	3	Could the approach to restrict eligibility to Australian resident companies that are widely held prevent some junior minerals explorers from accessing the incentive?	1. AMEC does not support the definition 'widely held' as described in paragraph 6 of the Discussion Paper. AMEC supports the use of the term 'disclosing entity' as defined in Section 111AC of the Corporations Act. 2. AMEC's support for the use of 'disclosing entity' is based on the improved integrity and transparency the Government would gain by adopting this measure. A disclosing entity is required to prepare an audited annual financial report and half yearly report that comply with accounting standards and lodge the report with ASIC and, if listed, an Australian stock exchange (annual reports must also be provided directly to members). The public reporting increases the discipline and integrity of the financial statements and importantly the Profit and Loss Statement, and capitalised expenditure is disclosed. Disclosing entities are also subject to the continuous disclosure regime. Not all 'widely held companies' are disclosing entities and therefore not subject to the same public scrutiny of financial accounts or continuous disclosure obligations. In theory, should the Government wish, it could obtain financial records from all 'disclosing entity' recipients of the credit and reconcile whether the company, and indeed the whole industry, has passed on the credit to shareholders as intended. This task would be significantly harder for widely held companies.
3	3	1	What are the pros and cons of companies distributing exploration credits to all shareholders compared to the alternative approach of requiring new share issues? Which is the preferred option?	1. AMEC considers that the tax credit should be made available to **all** eligible Australian resident shareholders. 2. This acknowledges that: a) the tax credit available to new investors will be diluted by its availability for existing shareholders; and b) existing shareholders' entitlement to a tax credit will be diluted in circumstances where they choose not to participate in a rights issue. 3. It is considered that an exploration company would want to

				reward its existing shareholders in any event to lower the cost of capital for exploration over the medium / long term in line with the exploration process and encourage them to remain as shareholders of the company. 4. If the tax credit was not available to all shares it would be necessary to create a separate share class in order to identify those shares eligible for a tax credit and those that are not. 5. Creation of a separate class of shares would add an administrative and compliance burden on the government, the ASX, share registries and industry, and create confusion between investors with tax credit shares and those without.
5	4	1	Should the Exploration Development Incentive be available to companies exploring for quarry materials? Why/why not?	1. Although this is a policy decision for government AMEC does not consider that it was the original intent of the policy announcement to include 'quarrying' activities in the scheme. Therefore quarrying should be excluded from the EDI. 2. AMEC understands that the policy intent was to promote exploration activities for bulk and base metals in order to develop mines for the future and not the provision of material for road and other construction purposes. 3. AMEC does however note that the definition of 'exploration or prospecting' in section 40-730(4)(a)(i) of the ITAA includes 'quarrying' and would need to be removed.
5	4	2	Would the proposed approach of aligning the definition with subparagraph 40-730(4)(a)(i) of the ITAA potentially exclude activities that are, by nature, the search for new discoveries? If so, please provide examples.	1. AMEC supports the proposal to align the definition of 'eligible exploration expenditure' to section 40-730(4)(a)(i) – (subject to the exclusion of 'quarrying' activities – refer response to question 4.1). In Appendix 3 AMEC sets out an alternative definition for the purposes of the EDI which is a modification of the definitions for exploration expenditure contained in section 40.730(4)(a)(i), (4)(a)(ii), and (4)(c) of the ITAA). This would require amendment to the current legislation.

				AMEC strongly suggests that the definition should be included in regulation and not in legislation so that should the definition require fine-tuning in the future it is a simpler process to change. 2. A key point is that the EDI legislation must have the power to make regulation.
5	4	3	Conversely, would this definition capture exploration activities that are evaluating the economic viability of a known resource?	1. The limitations contained in section 40-730(4)(a)(i) would exclude activities associated with evaluating the economic viability of a known resource.
7	5	1	Under ex-post modulation, will exploration companies be able to provide investors with an indication of the likely value of the exploration credit based on existing information sources about both their own and the sector's exploration intentions?	1. AMEC notes that the Paper indicates the ex-post modulation process minimises reporting requirements, maximises credits and commences on 1 July 2014. 2. AMEC considers that the ex-post modulation process will provide simplicity, appropriate assurance and be extremely valuable to industry and investors. 3. AMEC does not favour the ex-ante modulation process as it will create additional administrative and compliance costs, and will not significantly change investor certainty. Investors investing in greenfields focused exploration companies by their nature have a greater appreciation for risk than the average investor. 4. It is essential that the EDI encourages investment into greenfield mineral exploration activity in Australia as a matter of urgency. 5. It is for these reasons that AMEC favours the ex-post modulation process. 6. In doing so, AMEC suggests in order to maximise the spread of benefits across Australia, and in addition to the cap of $100 million over the forward estimates, that an annual cap of $1m be placed on the amount of tax credit that could become

				available at an individual company level. Such an annual cap would represent approximately $3m in eligible exploration expenditure for any year. Such an approach would also increase the integrity and equity of the model and ensure that the scheme was targeted at greenfield explorers. It would also avoid a circumstance where expenditure on one large project by one company consumes a large percentage of the available credit. A company that has the ability to raise and spend say $25m on exploration in a year is not the main target of the policy. 7. AMEC considers that the suggested 1 March cut-off date (para 33 refers) is too long and will create an untenable delay in the announcement of the tax credit. 8. For expediency purposes, and in order to increase investor certainty, it is suggested that companies should be required to lodge an ‘eligible mineral exploration expenditure statement’ with the ATO by 30th September (as distinct from a tax return). A similar statement is made to the ASIC and the ASX. 9. On the assumption that the calculation of the modulation factor by the ATO is based on the ‘ex-post’ method, the ATO should advise eligible companies by 31st October or sooner of the proportion of their eligible expenditure they will be entitled to provide to shareholders as exploration credits. 10. Record date: Declaration by the company any time after 31st October and before 30th June. 11. AMEC considers that this process through the ATO must be undertaken expeditiously and without any delay, and therefore these timeframes should be formalised. 12. AMEC considers that once a company submits its application for the tax credit to the ATO it is legally bound by that application to pass on the credit to its shareholders. Should a company be allowed to choose whether or not to pass it on post the modulation process, the result will be an erosion of the credit that may have otherwise been taken up by another company.

				13. It is intended that any penalties for identified non-compliance are at the 'corporate / company' level rather than at the shareholder level. 14. When lodging the proposed 'eligible mineral exploration expenditure statement' the company will also need to consider in their calculations the fact that any non resident Australian shareholders will be ineligible for the EDI. Research undertaken by KPMG on behalf of AMEC (*Impact of the Mineral Exploration Tax Credit – July 2013)* indicates from an analysis of 187 companies there is approximately 10% foreign shareholding in mineral exploration companies. The ATO should factor in the non resident ineligibility such that the full $100m of EDI is utilised.
8	5	2	Is the greater certainty under an ex-ante modulation approach desirable, noting the trade-offs (greater regulatory burden, not fully utilising the cap and potential delay in starting the scheme)?	1. AMEC does not favour the ex-ante modulation process as it will create additional administrative and compliance costs, and will not significantly improve investor certainty. 2. It is essential that the EDI encourages investment into mineral exploration activity in Australia as a matter of urgency.
8	5	3	Is the greater certainty under an ex-post and ex-ante modulation approach desirable, noting the trade-offs (greater regulatory burden and potential delay in starting the scheme)?	1. Refer to the comments above under questions 5.1 and 5.2.
11	6	1	Subchapter 6.2 illustrates one way of ensuring companies that provide their shareholders with exploration credits give up the	1. Refer to **Appendix 1 and 2** regarding Share Capital Tainting and a proposed alternative adjustment mechanism.

			economic benefit of tax losses. Is there a simpler or better way to achieve this?	
Other issues			Definitions	1. It is crucial for the integrity, and purposes, of the EDI that all relevant definitions are prescriptive, unambiguous and provide clarity and certainty for all stakeholders. These are detailed in **Appendix 3.** 2. Definition – ‘greenfield’ 3. Definition – ‘mineral’ 4. Definition – ‘eligible exploration expenditure’ 5. Definition – ‘Australian resident company’
			Proposed EDI policy design	1. Following consideration of issues raised in the Discussion Paper a Proposed Policy Design for the EDI is detailed at **Appendix 4**.
			Timelines	**Appendix 5.**
			Examples	**Appendix 6.**

APPENDIX 1

1. **Share capital tainting**

It is likely that an accounting entry will be required to be booked by companies who choose to forfeit their tax loss to pass the EDI credit to their shareholders. This accounting entry may result in an amount being "transferred" into the share capital account of the company, which could anomalously "taint" the share capital account of the company due to the operation of Division 197 of the Income Tax Assessment Act 1997.

This would be as a result of accounting treating the forfeit of the loss as a cost of raising equity. If the share capital account becomes tainted all future returns of capital will be treated as unfranked dividends, unless the company pays "untainting tax". Clearly this would be an unintended outcome, and accordingly AMEC recommends that specific carve outs from the tainting rules should be incorporated into the design of the EDI for any accounting entries required to record the forfeiture of losses.

2. **Adjustment mechanism**

Paragraphs 56 - 66 of the Discussion Paper outline what Treasury considers to be an inappropriate outcome under the design of the EDI unless adjustments are made.

AMEC suggests that the simplistic example proposed by Treasury whereby a company makes a loss in Year 1 followed by a profit in Year 2 is merely theoretical and would be unlikely to occur in practice. However, it is acknowledged that in this example, the total tax payable on the $100 of income would be less under the EDI scheme than would otherwise apply had a company not eligible for the EDI simply made $100 in income and paid an unfranked dividend to its shareholders.

Attached at **Appendix 2** is a worked example of how AMEC understands the mechanism and proposed adjustment to work. This example is based upon a single shareholder who is a resident Australian individual shareholder who is subject to the top marginal tax rate of 46.5%. Please note that under Example 2 the total tax payable is only $18, as opposed to $46.50 under Example 3.

AMEC`s concern with the proposed adjustment under Example 3, is that it dilutes the value of the EDI in year 1 for the shareholder, as it subjects the shareholder to tax on the value of the offset. This, when combined with the use of the ex-post modulation approach could dilute the value of the EDI to such a significant extent that it does not stimulate investment in the mineral exploration sector. Investors in exploration companies may not see dividends for many years (if at all if exploration is unsuccessful). It is considered inappropriate to tax the shareholders on the value of the EDI offset on the chance that they may receive a franked dividend sometime in the future.

In the attached example, AMEC has proposed an alternative mechanism whereby the shareholder simply does not get the value of franking in a later year, but retains full access to the value of the EDI offset in year 1. AMEC considers that this preserves the integrity of the tax base, but does not dilute the upfront value of the EDI.

In this alternative, companies eligible for the EDI could only offer an offset for franking once the franking balance exceeds the EDI offsets provided to shareholders.

AMEC considers that this alternative will retain the upfront benefit for investors from receiving a tax offset, while still addressing any concerns on the tax outcome where a franked dividend may subsequently be paid.

APPENDIX 2 – Proposed alternative adjustment mechanism

Shareholder is a resident individual subject to tax at 46.5%

Example 2			
Year 1	**Individual**		**Net tax payable**
	Tax offset received	(28.50)	
	Tax refund	(28.50)	(28.50)
	Company		
	Taxable income	-	
	(Losses forfeited)		
Year 2	**Individual**		
	Dividend received	71.50	
	Gross-up for franking	28.50	
	Taxable income	100.00	
	Tax payable	46.50	
	Less franking offset	(28.50)	
	Tax payable	18.00	18.00
	Company		
	Taxable income	100.00	
	Tax payable	28.50	28.50
TOTAL OVER TWO YEARS			**18.00**

Example 3			
Year 1	**Individual**		**Net tax payable**
	Tax offset assessable	28.50	
	Tax payable	13.25	
	Less tax offset received	(28.50)	
	Tax refund	(15.25)	(15.25)
	Company		
	Taxable income	-	
	(Losses forfeited)		
Year 2	**Individual**		
	Dividend received	71.50	
	Gross-up for franking	-	
	Taxable income	71.50	
	Tax payable	33.25	
	Less franking offset	-	
	Tax payable	33.25	33.25
	Company		
	Taxable income	100.00	
	Tax payable	28.50	28.50
			46.50

Possible alternative			
Year 1	**Individual**		**Net tax payable**
	Tax offset received	(28.50)	
	Tax refund	(28.50)	(28.50)
	Company		
	Taxable income	-	
	(Losses forfeited)		
Year 2	**Individual**		
	Dividend received	71.50	
	Gross-up for franking	28.50	
	Taxable income	100.00	
	Tax payable	46.50	
	Less franking offset	-	
	Tax payable	46.50	46.50
	Company		
	Taxable income	100.00	
	Tax payable	28.50	28.50
			46.50

APPENDIX 3 – Definitions

1. **'Mineral'** as defined by the ABS – publication 8412.0 – (**AMEC NOTE:** If quarrying is not eligible then reference to gravel and sand should be deleted for the purposes of the EDI)

   "A naturally occurring inorganic element or compound having an orderly internal structure and characteristic chemical composition, crystal form, and physical properties. Examples comprise metallic minerals, such as copper, silver, lead-zinc, nickel, cobalt, gold, iron ore, mineral sands, uranium and non-metallic minerals such as coal, diamonds and other precious and semi-precious stones". ~~and construction materials (e.g. gravel and sand).~~

2. **'Greenfield'** – (**AMEC NOTE:** For the purposes of the EDI, the following definition is a modification of the definitions for exploration expenditure contained in section 40.730(4)(a)(i), (4)(a)(ii), and (4)(c) of the ITAA)

   "Geological mapping, geophysical surveys, systematic search for areas containing minerals, and search by drilling or other means for such minerals within those areas, and
   excludes search for ore within, or near, an ore body by drives, shafts, cross-cuts, winzes, rises and drilling, and
   excludes feasibility studies to evaluate the economic feasibility of mining minerals once they have been discovered".

   "Ore Body" – a body of mineralisation over which a current or historical mineral resource has been calculated.
   "Near" – within 500 metres.

   AMEC NOTE: Exploration expenditure on mineral leases will not qualify for the EDI. It is recommended that the EDI be confined to Exploration and Prospecting leases.

3. **'Eligible exploration expenditure'**
   As defined by section 40-730(4)(a)(i) of the ITAA – excluding 'quarrying' activities.

4. **'Australian resident company'**
   As defined by section 111AC of the Corporations Act - 'disclosing entity'.

APPENDIX 4 - Proposed EDI tax credit policy design:

Eligibility:

a) A tax credit will be allowed to Australian resident shareholders of Australian resident companies that are a 'disclosing entity' as defined in section 111AC of the Corporations Act, only in respect of eligible exploration expenditure incurred in Australia,

b) A 'no taxable income' test will ensure that the EDI is only available to junior explorers. Companies with 'assessable income' from mining activities will be excluded from the model. Participating mineral exploration companies must also be those exploring within exploration tenements and hold a prospecting or exploration licence / permit, and not mining leases,

c) A tax credit will apply to all eligible mineral exploration expenditure in Australia incurred after the date of commencement of 1 July 2014,

d) All resident taxpayers would be entitled to the tax 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,

e) Taxpayers unable to use the tax credit against their tax liability would be entitled to a cash refund, on the same basis as franking credits are refundable,

f) The model is voluntary, noting that exploration companies can retain their exploration deductions for their own future use if they wished to do so for strategic reasons. Where the company is listed, an appropriate declaration would need to be made as to whether the company proposes to participate in the EDI scheme,

g) Notwithstanding the EDI scheme is voluntary, once a company submits its application (this will be completed through an 'eligible mineral exploration expenditure statement') for the tax credit to the ATO it is legally bound by that application to pass on the credit to its shareholders. The credit must be distributed by the 30th June. In the case of the 'eligible exploration expenditure' for the 2014/15 year the distribution must be made by the 30th June 2016,

Mechanism:

h) Participating companies will be able to claim 'eligible exploration expenditure' using the existing income tax law definition - ITAA Section 40.730(4)(a)(i) – excluding 'quarrying' activities,

i) The existing franking credit concept would be utilised to provide the tax credit to eligible shareholders,

j) The tax credit will be available to all resident shareholders for eligible exploration,

k) The tax credit would be available to all resident shareholders on the register on the day that the credit is 'declared' ('Record Date'). A new class of share will not be required. Shares will then commence trading cum dividend,

l) The tax credit will be available at the prevailing company tax rate (currently 30% and reducing to 28.5% from 1 July 2015),

m) The tax credit must be passed onto shareholders by the company in the year in which it becomes available,

Compliance

n) All relevant terms are defined under current tax law, and refined where appropriate,

o) A number of well tested and existing Australian tax compliance mechanisms would operate to ensure that there was no double deduction of minerals exploration expenditure,

p) All anti-avoidance provisions existing in the franking law would also apply to the EDI scheme, such as the anti-streaming rules, and the 45 day rule,

q) A company (or corporate group) would not be permitted to choose to pay tax itself and instead use its exploration expenditure to distribute the tax credit 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,

r) 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 to be entitled to apply for the tax credit,

s) In the event that a company distributes a tax 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,

t) Appropriate penalty provisions should apply for any non-compliance.

u) Any Research and Development expenditure which is also eligible for the EDI should not result in a ‘loss’ that could be passed onto shareholders as that expenditure is effectively treated as non-deductible for tax purposes.

APPENDIX 5 - Timeline

1st July - 30th June Year 1	30th September	<31st October	<30th June Year2	Year 3
Eligible Exploration Expenditure Year 1	Company submits EDI Application / Eligible exploration expenditure statement	ATO Announces Modulation outcome	Company makes declaration and passes on EDI credit to eligible shareholders	Shareholder submits tax return claiming EDI credit.
	Company announces it has applied for EDI			

APPENDIX 6 – Examples

Example 1 – New IPO

A new IPO of $3m of which 75% is eligible exploration expenditure and 10% of shareholders are non resident and ineligible for the credit

A new capital raising of $3m (15million shares at 20c) of which $2.25m (75%) is deemed to be 'eligible exploration expenditure' x 30% tax rate = $675,000 available for tax credit purposes.

As 10% of the shareholders are ineligible for the EDI, the remaining **$607,500** eligible exploration expenditure ($675,000 less 10%) will be distributed to each of the **13.5 million** eligible shareholders (15m less 10% ineligible) = **$0.045** cents per share (representing a tax credit of **22.5%** on the 20 cent share).

Note: The tax credit % will change in accordance with the % of eligible exploration expenditure and the % of non resident investors

Example 2 – A Rights Issue

A rights issue of $3m of which 75% is eligible exploration expenditure and 10% of total shareholders are non resident and ineligible for the credit. There 20 million existing shareholders

A rights issue of $3m (15million shares at 20c) of which $2.25m (75%) is deemed to be 'eligible exploration expenditure' x 30% tax rate = $675,000 available for tax credit purposes, less 10% for non resident shareholders.

As 10% of the shareholders are ineligible for the EDI, the remaining **$607,500** will be available for distribution to eligible shareholders.

This will be distributed to each of the **31.5 million** eligible shareholders (represented by 15 million rights issue shareholders **PLUS** 20 million existing shareholders, less 10% non resident) = **$0.0193** cents per share (representing a tax credit of **9.6%** on the 20 cent share).

Note: The tax credit % will change in accordance with the % of eligible exploration expenditure, the number of existing shareholders investors, and the % of non resident investors.

Summary

Based on the above scenarios for a new IPO and a Rights Issue (subject to variables described in the Notes above), the EDI tax credit represents an approximate **return to the shareholder** of:

- **22.5% for a New IPO,** and
- **10% in the case of a Rights Issue**.

Note: The 30% corporate tax rate on which the EDI credit is based is proposed to be changed to 28.5% on 1 July 2015.