



EXPLORATION DEVELOPMENT INCENTIVE: POLICY DESIGN RESPONSE TO TREASURY AND DEPARTMENT OF INDUSTRY

REPRESENTING THE AUSTRALIAN MINERALS INDUSTRY FOR AND ON BEHALF OF:
MINERALS COUNCIL OF AUSTRALIA
CHAMBER OF MINERALS AND ENERGY OF WESTERN AUSTRALIA
QUEENSLAND RESOURCES COUNCIL
NEW SOUTH WALES MINERALS COUNCIL
SOUTH AUSTRALIAN CHAMBER OF MINES AND ENERGY
VICTORIAN DIVISION OF THE MINERALS COUNCIL OF AUSTRALIA
TASMANIAN MINERALS COUNCIL
AND NORTHERN TERRITORY DIVISION OF THE MINERALS COUNCIL OF AUSTRALIA

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EXECUTIVE SUMMARY

The minerals industry welcomes the release of the *Exploration Development Incentive: Policy Design* discussion paper to facilitate introduction of the Exploration Development Incentive (EDI) in line with the Government's election commitment.

The industry supports the introduction of the EDI to help overcome the tax asymmetry whereby junior explorers with no taxable income are not able to access the immediate deduction for exploration.

The industry has supported the introduction of appropriate tax incentives for junior miners to encourage minerals exploration in recent years. This included a 2008 joint industry submission to the former Government on its "flow through shares" proposal and the Policy Transition Group following the *Australia's Future Tax System (AFTS) Review*.

Consistent with previous positions on tax measures to address that tax asymmetry for junior explorers, the industry is of the view that an effective tax measure should:

- Be available to **junior companies** with no taxable income against which exploration deductions are able to be claimed
- Be available directly to **investors/shareholders**
- **Minimise administrative costs** for companies, regulators and investors
- **Not introduce distortions** between shareholders or companies
- Utilise **existing definitions** and tax law concepts

In line with these principles, the industry offers suggestions to improve the effectiveness of the EDI and keep compliance costs to a minimum. The EDI should be as simple as possible to minimise tax compliance costs for explorers, investors and the ATO.

Exploration credits under the EDI should be available to all shareholders of eligible explorer companies rather than only to "new shares" which would introduce an unnecessary level of complexity into the EDI. Credits should be available at the shareholder to attract investor capital to fund exploration.

The draft discussion paper's narrow definition of eligible exploration expenditure is inconsistent with the existing definition of exploration for the immediate deduction for exploration. It would deny a credit for expenses incurred to find a resource that is commercially viable. While a narrow definition reflects the policy intention to quarantine the EDI to greenfield exploration by junior explorers, a new definition of "exploration" is not necessary to achieve the policy objective. The combination of the "no taxable income" and a "no mining activities" tests are adequate to ensure the EDI is targeted at junior explorers which predominantly undertake greenfield exploration.

Notwithstanding the definition of exploration, the EDI as outlined in the discussion paper would meet the policy intent to encourage exploration expenditure and meets the principles outlined above.

This submission's key principles are supported by:

- The Queensland Resources Council (QRC)
- The Chamber of Minerals and Energy of Western Australia (CME);
- The South Australian Chamber of Mines and Energy (SACOME);
- The New South Wales Minerals Council;
- Tasmanian Minerals Council;
- MCA Northern Territory and Victorian Divisions.

A number of state industry bodies are making additional submissions with further detail and issues relevant to the exploration environment in certain states.

BACKGROUND

Exploration tax reform

The release of the discussion paper is the next step towards implementation of the Government's election promise to introduce an EDI announced as part of the *Coalition's Policy for Resources and Energy* in September 2013. The Government's recognition of the need to reinvigorate Australia's exploration effort is welcomed.

Despite the fact that the need for such a tax measure is widely recognised, introduction of an incentive for exploration has been subject to a number of false starts over recent years. Labor's 2007 *Plan for a Stronger Resources Sector* proposed a "flow through" shares scheme for smaller explorers "to promote investment in exploration". The *Resource Exploration Rebate* (RER) was subsequently proposed in response to the AFTS Review (2010) which noted that the current treatment of tax losses puts smaller exploration companies at a disadvantage.

The industry engaged in consultation on the various proposals over the years taking a set of principles to government to inform development of a tax measure to assist smaller explorers. Throughout these processes the industry has advocated a simple and practical mechanism which:

- Encourages junior companies to undertake exploration;
- Is available directly to investors/shareholders;
- Minimises administrative costs for companies, regulators and investors; and
- Avoids distortions between shareholders or companies.

Importantly, the existing tax law concepts should be utilised to avoid introducing new concepts as far as possible to minimise compliance costs and distortions. The EDI broadly measures up well against these principles. Subject to issues raised below, the EDI model outlined in the discussion paper targets greenfield exploration by junior explorers unable to access the existing immediate deduction and will be available at the shareholder level.

The Coalition's *Policy for Resources and Energy* stated: "*The future prosperity of the mining sector and the Australian economy is dependent on our ability to make new minerals discoveries*". This is all the more important with a declining exploration activity in Australia and the need to ensure Australia can compete for exploration investment with jurisdictions such as Canada which offers a flow through shares (FTS) program.

Minerals exploration in Australia

Australia needs to improve its exploration effort if it is to secure future resource development. Longer term trends show a decline in the share of global exploration expenditure in Australia.

Australia's exploration expenditure has fallen markedly from its peak in the June quarter 2012. In nominal terms, minerals exploration expenditure declined by almost 31 per cent in 2013 to be just over \$2.5 billion compared with 2012. Quarterly expenditure in December quarter 2013 was 48 per cent lower than June quarter 2012. The number of metres drilled in December quarter 2013 was more than 44 per cent below the peak level reached in September 2011.

Declining exploration expenditure was evident across all commodities. The largest declines in 2013 were in exploration for uranium (47 per cent), copper and nickel/cobalt (46 per cent) and coal (38 per cent) as compared with 2012.

Australia's share of global exploration expenditure is also falling. An analysis of non-ferrous global exploration expenditure by SNL Metals Economics Group published in March 2013 found that Australia's share of global expenditure declined to 12 per cent, behind Latin America (25 per cent), Africa (17 per cent), Canada (16 per cent) and Eurasia (14 per cent).

On this measure, Australia's share of global expenditure has fallen 9 percentage points since the mid-1990s.

Increasing global competition and the high cost of exploration are key factors behind Australia's diminished attractiveness as an exploration investment destination. A high dollar and high input costs and an increasingly complex web of red and green tape are also weighing down Australia's minerals exploration effort. The Productivity Commission has recently highlighted rising costs, lower productivity and regulatory burdens for exploration.

The importance of ensuring Australia can compete for exploration expenditure with other jurisdictions is paramount. While there are a number of factors that impact on the attractiveness of Australia as an exploration destination, competitive tax arrangements are an important consideration. The Colorado School of Mines has observed:

"Both the rate and form of taxation affect the relative attractiveness of different countries or sub-national regions for investment in mineral exploration and development... Exploration is footloose in that explorers can redirect their activities to regions or countries with more favourable tax regimes."

Canada's FTS program allows tax deductions for investors against their taxable income for the exploration expenditure incurred by an eligible company. Canada is a key competitor nation for minerals exploration and development.

Tax uncertainty in Australia also harms Australia's competitiveness to attract investment. Taxation policy relating to exploration has been marked by ad-hoc tax changes in recent years including moves to curtail the immediate deduction for exploration expenditure as announced in the 2013 Budget.

Natural endowment is no guarantee of success. Australia's historical reliance on the strengths of political stability, geology and a skilled and educated workforce are no longer sufficient to secure the share of global exploration expenditure. The EDI will help provide an inducement to capital markets and improve the competitiveness of Australia's tax arrangements to increase investment in exploration.

RESPONSE TO DISCUSSION PAPER QUESTIONS

2. How to target junior minerals explorers?

- A “no taxable income” and “no mining activities” test will target the EDI at junior minerals explorers.
- For the purposes of the “no mining activities” test, the EDI should use the existing definition of “mining operations” in section 40-730 of the *Income Tax Assessment Act 1997* to limit access to the credit to juniors undertaking exploration only.

The “no taxable income” and “no mining activities” tests will ensure that only junior explorers are eligible for the EDI. The “no mining activities” test is necessary to target the EDI at junior explorers which are dedicated to searching for minerals. It will ensure that larger companies with mining operations which have a tax loss in any given year will not be able to access tax credits under the EDI.

The definition of “mining and quarrying operations” used in section 40-730(7) for the purposes of the immediate deduction for exploration should be relied upon to define “mining activities”. To ensure exploration companies in receipt of minor sources of income not attributable to mining operations are not excluded from the EDI, the “no mining activities” test could be refined further to appropriately target the EDI at explorers not undertaking mining operations. This may be achieved by utilising existing definitions in the tax law so that eligibility for the EDI would be restricted to explorers with no “ordinary income” from “carrying on a business” of mining operations.

3. Which investors will be able to receive exploration tax credits?

- Exploration credits under the EDI should be available to all shareholders and limited to Australian resident companies.
- Exploration credits should not be confined to “new shares”.

On the basis of reducing compliance costs, particularly for smaller explorers, credits should be available to all shareholders on the shareholder register of eligible exploration companies. Confining credits to “new shares” would introduce an unnecessary level of complexity into the EDI by requiring explorers to identify costs incurred by reference to a group of shareholders. Imposing differing classes of shares within a company – some allowing tax credits, others not, would also create distortions between shareholders.

Providing the credit to all shareholders ensures the policy intent of encouraging exploration investment by encouraging existing shareholders to maintain and increase shareholdings while also encouraging new investors to exploration companies. Limiting credits only to new investors would not necessarily be more effective in encouraging investment in exploration but would increase compliance costs.

Restricting the EDI to only to ASX listed companies would add a measure of integrity to the scheme. It would target only those explorers who operate under the ASX listing rules and therefore operate under greater regulatory scrutiny, corporate governance, and controls, than unlisted public and private companies.

4. How will “eligible expenditure” and “greenfields” be defined?

- The definition of exploration is narrow and inconsistent with the existing definition for the immediate deduction in the tax law.
- A new definition of “exploration” is not necessary to target the EDI at juniors or greenfield exploration.

“Exploration”

The draft discussion paper’s definition of eligible exploration expenditure for the purposes of the EDI is narrow and inconsistent with the existing definition for the immediate deduction for exploration in section 40-730 in the *Income Tax Assessment Act 1997*.

The definition of “exploration” proposed in the discussion paper captures drilling and mapping activities to discover the existence of a resource. It would not cover expenses incurred to evaluate whether a resource is commercially viable - including expenditure to assess economic and technical feasibility. This is inconsistent with the current definition of exploration in the tax law and inconsistent with the industry’s view of exploration. Assessing viability is an integral part of exploration.

Exploration is a process to identify potential resource reserves AND assess commercial viability of the resource – the two are inter-dependent

According to the draft discussion paper, the policy intent of this definition is to target the EDI to “greenfield” exploration by junior explorers. The policy intent therefore appears to be different to that of the immediate deduction for exploration which aims to encourage exploration generally and includes feasibility costs to determine prospects for economic extraction of a resource. While the EDI should only be available to junior explorers undertaking greenfield exploration, a new definition of “exploration” is not necessary to achieve this.

Should the Government exclude feasibility study expenditure captured by section 40-730(4)(c), there should be explicit recognition in the Explanatory Memorandum to the enacting legislation to recognise that the measure has a narrower application than exploration activities as defined for income tax purposes. To reduce compliance burdens associated with attempts to develop a new definition for exploration, the existing definition of exploration and prospecting in 40-730(4) could be relied upon - other than paragraphs 40-730(4)(d) and (c) which would exclude feasibility studies and mining information.

“Greenfield”

The “no taxable income test” should act to restrict the activities of junior exploration companies to greenfield exploration. This avoids the need to introduce a specific definition of “greenfield” which does not currently exist in the tax law.

If the Government is of the view that a definition is required to ensure the credit attaches only to “greenfield” exploration expenditure, eligible exploration expenditures should be restricted to those incurred on exploration leases.

There is no need for an additional test to ensure exclusion of “brownfields” exploration which would only add to complexity. Limiting eligibility for expenditure on a mineralisation that has been classified as “inferred” by the Joint Ore Reserves Committee (JORC) code would exclude expenditure on what would generally be regarded as “greenfield” areas because an “inferred mineral resource” is based on limited geological evidence and sampling. Such a definition of “brownfields” is not necessary and would set the bar too low with the effect of excluding significant amounts of exploration expenditure from eligibility for the EDI.

5. How will the modulation process work?

- The Ex-Post Modulation process involves less compliance costs than the other options and rapid commencement of the scheme.

The Ex-Post Modulation process involves less compliance costs than the other options proposed in the draft discussion paper. Under this approach the scheme can commence on 1 July 2014. While other options may provide greater certainty as to the amount of tax credit they would be entitled to, this is outweighed by the compliance costs that would be associated with ex-ante modulation for explorers. Consideration of other hybrid models may be appropriate to overcome limitations of the ex-post model – in particular the lack of information available to investors as to the amount of tax credit they might receive in any given year.

6. How will the exploration credit system work?

- There should not be a requirement for any entries to be posted to the explorer's imputation accounts.

The methodology suggested in the paper to convert tax losses into exploration credits adjusting companies' imputation accounts is unnecessary and would increase the compliance costs of the scheme to participants. As an incentive scheme, use of the EDI should be encouraged, not burdened with additional compliance. If different tax outcomes arise because an explorer chooses not to apply the EDI scheme, then that should encourage its take-up. Moreover, it would not increase the cost of the scheme to the Government, as that is already capped at \$100million over the forward estimates. Making adjustments to an explorer's imputation account and its EDI credit account would simply increase compliance costs to the explorers, as most explorers would not be maintaining an imputation account because they are not usually paying either tax or dividends.