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SUBMISSION ON THE POLICY DESIGN FOR THE EXPLORATION DEVELOPMENT INCENTIVE (EDI)

The South Australian Chamber of Mines and Energy (SACOME) represents over 330 members in the resources and energy sectors in South Australia. We welcome the opportunity to provide comments on the discussion paper for the Exploration Development Incentive.

Since 2008 SACOME and other relevant stakeholders have been in direct consultation with the Government at the time to develop a Minerals Exploration Tax Credit. The announcement by Minister Macfarlane to introduce an Exploration Development Incentive is a most welcome step in implementing this critical policy.

The South Australian exploration sector is one where approximately 90% of all companies that hold an Exploration Licence do not have a Mining operation. Recent trends in mineral exploration in South Australia have shown 53% drop in mineral exploration compared to the previous year. As a matter of fact 2013 total is lower than the total mineral exploration expenditure at the height of the global financial crisis. This policy is critically needed to stimulate investment in the Exploration sector.

While SACOME applauds the policy proposed the Chamber still has reservations on the \$100 million cap. Through consultation with our members and tax advisors, the consensus is the cap has introduced complexity through the resulting necessity to develop methodologies for modulation. Modulation creates challenges that manifest uncertainty for companies and shareholders eligible for the incentive, potential increased regulatory burden, uncertainty of the actual date of credit award, and the overall use of the incentive.

Nevertheless SACOME has provided comments on this proposal providing a technical discussion on the issues the Treasury is seeking to resolve through this policy discussion paper. Attached is a technical discussion authored by SACOME vice-president Alice McCleary from the result of industry consultation and a workshop to each of the questions the Treasury has proposed.

If you have any further questions or comments please contact Jason Kuchel on (08)8202 9999 or jkuchel@sacome.org.au, or alternatively Dayne Eckermann on (08) 8202 9999 or deckermann@sacome.org.au.

Yours Faithfully,

SIGNED

Jason Kuchel
Chief Executive

SACOME's response to the specific issues raised in the "Exploration Development Incentive: Policy Design" Discussion Paper released in March 2014

[Text in *bold italics* is a reference to Discussion Paper (DP) questions and paragraphs]

How to target junior minerals explorers?

Question 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. SACOME supports the 'no taxable income' test of distribution of EDIs. The DP proposes this be a current year taxable income test, without consideration of prior-year losses. *(¶5)*
2. The most common ways a junior explorer would earn assessable income in excess of its allowable deductions (and thus have taxable income in that year) would be due to:
 - selling a significant tenement. If the sale of the tenement results in overall taxable income for the year, the company should have sufficient funding for its exploration without requiring the EDI incentive. See further below, however.
 - carrying on mining operations. The latter activity should, conceptually, end entitlement to EDIs.
3. Accordingly, the 'no taxable income' test seems reasonable and is simple to administer.
4. It should however be noted that the test will cause shareholder discontent in years when EDIs were anticipated to flow but a major unexpected event occurs which leads to taxable income for the company. Companies will have to handle such events very carefully, including prompt disclosure to the ASX. Shareholder litigation is possible.
5. SACOME does *not* support the "no mining activities" test as described in *¶5*, but has an alternate suggestion – see below; point 9 – as an additional test to the 'no taxable income' test.
6. The "no mining activities" test – more fully described as 'no assessable income from mining activities' – would mean complete loss of EDIs to exploration companies with just \$1 of mining-related gross income. Examples of mining-related income earned by many juniors include earning a small royalty from sale of a tenement, a refund of a regulatory bond, provision of minor geological or drilling services to other explorers, leasing of drill rigs and specialist equipment to other explorers, reimbursements for joint survey work from adjoining explorers, sale of second-hand equipment, and so on.
7. Tax law does not generally contain all-or-nothing eligibility tests such as this. The proposed 'no mining activities' test would encourage uncommercial behaviour and potentially lead to explorers avoiding minor income streams so as not to jeopardise their EDI entitlement and the expectations of shareholders. This would be counter-productive from a policy perspective.
8. If the 'no mining activities' test was to be retained in the proposed form, it would be vital to confirm that profits arising from the sale of an exploration company's assets would NOT constitute 'assessable income from mining activities'. A major source of funding for many juniors – one of the very few sources of funding at present – is to sell tenements. If such sales were to automatically cause explorers to become ineligible for EDIs, the incentive would be ineffective. If an explorer sold a tenement for a very large amount of money, the company

would likely breach the ‘no taxable income’ test anyway and thus be ineligible for EDIs (see above) – but smaller tenement sales should not automatically deny access.

Question 2.2 - How should the ‘no mining activities’ test operate to ensure the incentive targets small mineral exploration companies?

9. The desired policy outcome could be achieved by adopting a test of ‘**no ordinary income from carrying on a business of mining operations**’, rather than ‘no assessable income from mining activities’. Such a test would ensure that juniors with minor amounts of incidental income related to their exploration activities could still qualify for EDIs, but that those which had moved onto actual mining operations would not. ‘Ordinary income’ and ‘carrying on a business’ are well-understood tax concepts with considerable case law defining its meaning. ‘Mining operations’ is defined in s40-730(7) of ITAA 1997, and is also well understood.
10. It would be important to explicitly clarify the status of capital gains from the sale of assets used in exploration – see above. In SACOME’s view, the sale of confidential information or equipment, the receipt of option fees - of itself - does not amount to carrying on a business of mining operations.
11. Both the ‘no taxable income’ test and the ‘no ordinary income from carrying on a business of mining operations’ would presumably be applied on a consolidated basis. This would ensure that the concession was only available to junior explorers.
12. We understand that virtually all, if not all, large (and small) public company groups consolidate for tax purposes. For this reason the ‘related entity’ test canvassed in ¶7 would be unnecessary. All the above tests would be applied on a consolidated group basis, thus excluding large mining entities.

Question 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?

13. Yes. Those excluded include privately-owned company explorers and non-resident companies. This seems to be intentional and seems reasonable given the policy intent of the measure.
14. Smaller unlisted public companies (those with less than 50 members) would also be excluded. SACOME is not aware of how many such explorers exist, but would not want the proposal to be delayed while this issue alone is further investigated. Perhaps they could be included in the scheme at a later date, when the number of affected companies is better understood?
15. Wholly-owned subsidiaries of public companies would be included with consolidated groups, so would not require specific rules. However, to the extent that there are unconsolidated junior corporate groups, SACOME sees no mischief in allowing 100% subsidiaries of widely held companies to access EDIs. The EDIs would presumably flow up to the holding company, and then out to the shareholders of the widely held entity in exactly the same way as if the holding company had incurred the exploration expenditure itself.
16. In this respect, ¶49 requires clarification: “corporate shareholders would also receive a benefit [from exploration credits], but as with the imputation system, this may not be an offset”. What is the nature of the “benefit” envisaged for the corporate shareholder? In imputation, no benefit is received by a company passing on franking credits. It may be that the word “benefit” used here was generic, rather than implying some sort of specific tax benefit?

17. Incorporated joint ventures are another type of company which would be excluded, not being widely held. JVs are usually unincorporated, but incorporated JVs do exist. If such JVs are wholly owned by widely-held companies, SACOME sees no conceptual reason why they should be excluded from EDIs if they meet the other tests. However, it is recognised that there would be some complexity in implementing this suggestion: for example, where a 50-50 JV company was owned by a large mining company and a small junior explorer. In that case, the EDI tests might be applied both to the JV company itself, and to both of the widely-held shareholders. Only the junior shareholder would meet the “no taxable income” test and the “no ordinary income from carrying on a business of mining operations” test, and thus access EDIs.
18. Given the low numbers of such entities, SACOME would prefer the measures to initially proceed without consideration of incorporated JVs if this would cause a delay.
19. For the avoidance of doubt, SACOME requests confirmation that exploration expenditure made by a widely held company through an unincorporated joint venture *would* qualify for EDIs, provided that the company itself met the EDI eligibility tests.

Which investors will be able to receive Exploration Credits - all shareholders, or new shareholder only?

Question 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?

20. Both models have significant advantages and disadvantages.
21. SACOME cannot support the New Shares model proposed, even though there are disadvantages of adopting the All Shares model.

All shares

22. Pros and cons of the All Shares model include:

<u>Pros – All Shares</u>	<u>Cons – All Shares</u>
<ul style="list-style-type: none"> • Very simple to administer 	<ul style="list-style-type: none"> • There will be dilution of the EDI, which will be spread across all shareholders, so the amount per share is less than if only new shares received EDIs. Whether this is significant will differ for each company, depending on the number of shares on issue and the size of proposed new issues. But see left, and below.
<ul style="list-style-type: none"> • When share prices are falling, the dilution is going the “right” way, in favour of new shareholders. See below. 	
<ul style="list-style-type: none"> • Cheap to administer – no new share classes or new listings 	
<ul style="list-style-type: none"> • No price distortions since all shareholders get equal EDIs 	
<ul style="list-style-type: none"> • No particular ATO, ASX or ASIC problems envisaged 	
<ul style="list-style-type: none"> • Eligibility based on being on the register on “distribution date” – easy for shareholders to understand 	

23. Dilution of the EDI is the only significant disadvantage of the All Shares model. However, in a falling share price environment, a bigger reward will still accrue to new shareholders than to older shareholders in “yield” terms. For example, assume a company issued 20m old IPO shares at \$1 each, and now seeks to raise \$5m at its current share price of 20c (being 25m shares). When distributing its exploration expenditure of (say) \$4m as an EDI, the calculation is as follows:

$$\$4\text{m exp} \times 28.5\% / 45\text{m shs} = 2.5\text{c per share} \quad [\text{assumes } 100\% \text{ modulation}]$$

This provides a small return of 2.5% for the IPO shareholders on their \$1 investment, but a **very significant 12.5% return for the new shareholders on their 20c cost.**

24. Although the yield will obviously differ from company to company, it is clear that in a falling market the EDI would still be a major incentive for shareholders - in the above case providing a return on investment well in excess of that which could be obtained from many other investments.
25. In a rising share market, the need for the EDI incentive would be less, and companies would need to discount their new issue prices far less. In the above example, if the company issued 5m shares at \$1 to raise its \$5m of new capital into a good market, the EDI calculation would be:

$\$4\text{m exp} \times 28.5\% / 25\text{m shs} = 4.5\text{c per share}$ [assumes 100% modulation]

This still provides a respectable 4.5% yield for both old and new shareholders – certainly sufficient to induce the take-up of the new issue.

26. Accordingly, although dilution is recognised as a disadvantage of the All Shares model, SACOME considers that the advantages overwhelm the disadvantages. Dilution is not severe enough to dissipate the investment incentive aspects of the EDI, particularly in the market conditions junior explorers now face.

New Shares

27. Pros and cons of EDIs applying to New Shares only include:

Pros – New Shares	Cons – New Shares
<ul style="list-style-type: none"> Theoretically provides a direct correlation between shareholders being induced to invest because of the EDI concession, and successful capital raising. (But this correlation is largely negated by the “modulation” options – see over). 	<ul style="list-style-type: none"> Much more complex to administer, with a new share class being issued every year that a company wishes to explore.
	<ul style="list-style-type: none"> More expensive to administer, with prospectus and new-code ASX listing costs each year for the new share class, and merging of last year’s share class back into the main listing as its EDI benefits are paid out.
<ul style="list-style-type: none"> No dilution of EDIs to shareholders who have not contributed directly to the current year’s exploration effort. 	<ul style="list-style-type: none"> Significant “churning” of shareholders, out of the old shares (at a loss because they would be “dumped”, with the loss being claimable for tax) and into the new EDI class each year.
	<ul style="list-style-type: none"> Share registry fees are based on the number of sale transactions, so these costs would rise with churning.
	<ul style="list-style-type: none"> Exploration work would become wholly governed by the EDI rules, with annual fundraisings required each July; and all programs finishing by the following June. Proper long-term planning for exploration could not occur. See below.
	<ul style="list-style-type: none"> In existing companies, it rewards those who take the <i>least</i> risk (ie those who are topping up funding for an established company). The IPO shareholders who took the greatest risk to establish the company, receive nothing.
	<ul style="list-style-type: none"> IPOs could not access EDIs for their initial listing, as prospectus rules requires new companies to put forward a 3 years budget rather than a single year’s budget. See further below.
	<ul style="list-style-type: none"> Share prices for old shares in existing companies are likely to collapse, as investors chase EDI shares. This will artificially devalue Australian explorers compared to international peers.

	<ul style="list-style-type: none"> • Increasing foreign ownership of juniors, as foreign investors buy up the cheap old shares each year to allow Australian residents to take up the new EDI shares. This will lead to a gradual transfer of ownership towards foreigners, who cannot use EDIs. This is a genuinely likely outcome.
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28. The New Shares model outlined in the DP has a number of fatal flaws. Some of these could be remedied by different policy choices, but not all.
29. The most problematic aspect of the DP New Shares model is the suggestion that EDIs would only be available to “holders of shares issued in the expenditure year”. (¶12.)
30. Thus the exploration and the fund raising must happen in the same year. The reason for this restriction is not clear to SACOME: since modulation calculations have nothing to do with capital raisings per se, and only take into account exploration expenditure in a particular tax year, why is there any need to link capital raising with any single year’s exploration expenditure? If companies raise more capital than they need in a particular year, they will simply carry it forward to future years (as they currently do) and submit it for EDI calculations at that time. If the scheme is no longer in operation, or offers a vastly different EDI percentage in the later year, so be it. As far as providing a known incentive to potential investors, the ex-ante method of modulation (see below) is the only one which provides any certainty to investors and that has many practical problems inherent in it. All other modulation methods involve shareholders guessing what the final EDI percentage for a particular year might be, so having to guess the percentages for several years after the share issue is no more difficult.
31. In practice, the proposed New Share model would mean that every explorer in Australia would have to try to raise funds in July each year, and have all of the exploration expenditure relating to that fundraising completed by the following June. This would lock explorers into 11 month exploration programs, with no ability to forecast whether there will be any funds the following year to continue or complete long-term programs. Effectively, it will guarantee short-termism in the sector. This is the antithesis of good exploration planning and execution.
32. This would have flow-on effects for costs, with contractor and employee costs likely to be at very high levels in the first half of each financial year, but trailing off in the Mar-Jun quarter each year as explorers finish up their annual exploration cycles. Costs would all go back up on 1 July, and it would all start again. There would be no ability for an explorer to take advantage of low contractor prices in May and June, because “ideally” they would have used up all their funding by then.
33. If market conditions are poor in July, the whole industry will slump simultaneously as all failed to raise funds. Contractors, employees and exploration companies themselves are all likely to fail at approximately the same time, as the EDI rules will have guaranteed that companies have no carry-forward funding left over from last year.
34. The opposite might happen when market conditions are good in July – with all wages and contractor prices being driven up in the flurry to spend the large amounts explorers have been able to raise. And unless it is all spent in that tax year, the company will be disadvantaged by the EDI rules – so shareholder pressure to just get it all spent as quickly as possible will be intense. Poor value-for-money decisions might be expected as year-end looms.

35. This cannot possibly be the intended policy outcome of the incentive.
36. In addition, IPOs could not access EDIs for their initial raising, as the single year funding model is contrary to the prospectus rules for new listings. Three year budgets must be presented in IPO prospectuses, and loading all the funds raised into the first year's budget (to meet EDI requirements) would be unlikely to be approved.
37. An unrelated matter also arises in ¶12, where it is suggested that EDIs could also possibly be available to exploration expenditure in the "prior year" to the raising of funds. It is difficult to understand the policy reason for this suggestion:
 - New shareholders in the current year have not made any contribution to exploration funding for the prior year, so why should they be rewarded? They are economic "free-loaders", getting a benefit from someone else's contribution.
 - It will not fit with the annual fund-raising cycle set up by the rest of the proposal – the prior year's expenditure would have been credited to the prior year's new shareholders at that time.
 - It will make proper long-term exploration planning even more difficult.
38. If the New Shares model instead did not require annual fundraising, and allowed *future* year's expenditure to be counted towards EDI credits in those future years, the proposal might be worth reconsidering.
39. Further, the New Shares model will only provide an incentive to shareholders if the 'ex-ante' modulation model is adopted (see below), and then only if the ATO is able to announce the modulation percentage by 30 May of the preceding year at the very latest. This timing would be essential to enable all prospectus due diligence and ASX approvals to be completed before 30 June, so public fund-raising can commence on 1 July of each year.
40. SACOME cannot support the New Share model in its current form.

Hybrid model

41. SACOME has done some preliminary work on a hybrid model which would allow all shareholders to participate in EDIs, but where eligible expenditure is capped to the capital raised after the EDI system is introduced. This would ensure that the EDI is truly an incentive to new fund-raising, but would not entail the complexity of the New Shares model proposed. We would be happy to explore this further if desired.

Meaning of “Eligible Expenditure” and “Greenfields”

Question 4.1 - Should the Exploration Development Incentive be available to companies exploring for quarry materials? Why/why not?

42. SACOME supports EDIs being available to quarrying companies on the same basis as other minerals exploration companies. Excluding quarrying companies will require the amendment of existing legislation and that for the purposes of simplicity it is easier to include them. The uptake of EDIs by quarrying companies will be negligible and more than likely negated by the no mining test as deposits are well known and developed for purpose.

Question 4.2 - Would the proposed approach of aligning the definition with subparagraph 40- 730(4)(a)(i) of the ITAA 1997 potentially exclude activities that are, by nature, the search for new discoveries? If so, please provide examples.

43. The proposed definition is limited to: “geological mapping, geophysical surveys, systematic search for areas containing minerals (except petroleum) or quarry materials, and search by drilling or other means for such minerals or materials within those areas”. The definition is confined to what might be called “geology and field costs”, but this only a subset of the genuine exploration work which is necessary in early-stage exploration.
44. Many costs which are necessary *precursors* to the work covered in s40-730 would be excluded. These include:

- Land access costs such as:
 - native title negotiations and compensation payments,
 - Heritage Act (SA) negotiations (which can exist even where native title is extinguished) and compensation payments,
 - Environmental surveys,
 - landholder (eg farmer) access and compensation payments

It is not possible for explorers to enter their own tenements and begin even the most preliminary work without incurring some or all of these costs. They are absolutely critical exploration costs.

- Community engagement costs. Recent events indicate how critical this part of the exploration process is, and without it the whole exploration program on a tenement could be jeopardised. It is best practice (now almost universally accepted) to commence community engagement as soon as possible in the exploration cycle, at the same time as native title, heritage and landholder discussions commence (if not before).
- Other costs of maintaining the tenement in good standing, up until the time when the exploration phase concludes (however defined).
- *Technical* feasibility is a critical part of exploration, and is quite distinct from the economic feasibility mentioned later in the s40-730 definition and which is proposed to be excluded from the EDI. Technical feasibility involves evaluating the outcomes of exploration programs, and includes on-site mineral testing, assays, literature reviews, metallurgy, and so on. It is integral to the exploration effort as a metallurgical test will determine if the core from a preliminary drilling program indicates further drilling. Much of this type of work occurs in the field, but considerable costs are also incurred on technical feasibility in

laboratories etc in conjunction with drilling and other exploration programs. SACOME considers that technical feasibility costs *are* covered by the proposed definition, and should remain so. The DP's assumption that this is linked to economic feasibility is incorrect – the two are quite separate, and occur at different phases of a project.

- The status of coal exploration needs to be made explicit, in view of the exclusion for oil and gas exploration.
45. The definition outlined in s40-730(4) of the ITAA Act 1997 is sufficient to describe the activities that should be covered for exploration and should not be reduced for the purposes of EDI, except in the case of oil and gas exploration. If there is a policy shift to exclude parts of the definition in s30-730(4) it should recognise there are feasibility and information expenses that are an essential component of Greenfield early-exploration as outlined above and below.

Greenfields discussion

46. We note there are no questions in the DP about this issue. ¶25 proposed two alternative tests to help ensure that only 'greenfields' exploration qualifies for EDIs.
47. The first greenfields suggestion is that expenditure relating to 'a mine that has come into production or to a potential or actual extension of a mine' be excluded. SACOME agrees with the broad sentiment of this statement, but considers that the latter phrase "a potential or actual extension of a mine" will be difficult for both explorers and the ATO to administer, especially in real time. For example, work done on a tenement which is found some years later to have been part of the same mineralised system as an existing mine might be retrospectively disallowed, even though at the time any connection was not expected or known.
48. The second suggestion is that exploration work carried out on any mineralisation classified as a JORC Inferred Mineral Resource is excluded. An Inferred Resource is the very lowest JORC classification, and applies to the least certain of all classified discoveries. There has been much professional debate about whether JORC should even recognise Inferred Resources, given their low level of certainty. Imposing such a restriction would mean that EDIs would apply to only the most *un*successful explorers. And success in the field could be seen by investors as a negative outcome – they would lose the EDIs they were expecting! This would be especially the case where the share price did not rise significantly on the news of a JORC Inferred Resource announcement – something which is common at present. Again, shareholder litigation might be expected relating to the timing of JORC announcements vis a vis EDI entitlements, especially in poor market conditions.
49. SACOME believes that the majority of South Australian-based explorers have JORC Inferred Resources, and would thus not qualify for EDIs. SACOME has identified a data supplier who could provide precise statistics on this matter, but has not had sufficient time to pursue this within the DP public comment period. We would be happy to provide the supplier's details to Treasury for this information to be acquired to fully inform the policy development.
50. There is a commercial incentive for explorers to announce discoveries as JORC Inferred Resources as soon as conceivably possible, since having a JORC resource usually drives share prices up in normal market conditions. Using this as a test to cut off EDIs to the company will put pressure on companies to delay this announcement as long as possible – and certainly until after the end of the current EDI year – to safeguard shareholder EDI expectations for that year.

Driving tax behaviour in a different direction to commercial behaviour is not a good policy outcome.

51. SACOME therefore suggests that if a 'Greenfields' test is considered necessary, it be based on a simple evidence-based test: when the company is granted a *mining* licence from its State regulator, (as opposed to an exploration licence), the EDI entitlement should cease. This gives practical effect to the first DP suggestion, without the negative aspects of the JORC suggestion. EDI eligibility would still turn on undertaking genuine exploration activity as defined, which would not include any expenditure relating to commencing mining. Where a company continues exploration on a tenement covered by a mining licence, it would not be eligible for EDIs. This is the natural commercial flow of a discovery, and the tax treatment would reflect that.
52. If however there is a decision to use a JORC test, SACOME strongly urges that the Indicated Resource classification be used, not the Inferred Resource classification. SACOME does not support use of the Inferred classification for cutting off EDI entitlements.

Modulation Methodologies

53. This issue is without doubt the most difficult aspect of the EDI proposals, and in SACOME's view could render the proposals ineffective from the perspective of providing an incentive to investors. Whilst government assistance in exploration is always welcome, the modulation processes proposed could render EDIs only marginally effective in providing an incentive to investors, at best.
54. SACOME is sympathetic to the government's budgetary constraints, but is of the view that the modulation models proposed will all have poor policy outcomes to a greater or lesser degree. We propose some alternative suggestions which may be acceptable to government.
55. Modulation turns on a ratio between a particular company's exploration expenditure, and the whole industry's exploration expenditure, in a particular tax year. Determining the latter amount in particular, within suitable timeframes, is the underlying cause of the problems involved in finding a suitable modulation process. Modulation is only necessary where there is a specific upper limit, or cap, on the tax cost of an incentive, and as far as we are aware this has not been attempted before for a tax-based incentive.
56. We set out below some of our observations about each proposed model.

Ex-post

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?

57. The ex-post method provides no EDI information to investors at the date of fund-raising, so it is unlikely to be a factor in encouraging them to invest in mining exploration. It would be difficult for companies to use EDI as a marketing tool in raising funds, since anything said in a prospectus might be found to be misleading in retrospect. A bland prospectus statement such as "EDIs may be available for this investment" is not a strong marketing message.
58. It is not possible for investors to make an educated guess as to the EDI percentage which might eventually be declared under the ex-post method, since they cannot know the industry's total exploration expenditure. If Treasury cannot estimate it, it is unreasonable to think private investors would be able to do so.
59. The problem is especially acute if combined with the New Shares proposal, which would mean that all new share issues would be done in July, and the ex-post EDI announcement could not be made until May (or so) of the tax year *after* next – ie approximately 22 months after the funds were raised. EDIs would actually flow into shareholders' hands in the tax year following that – a minimum of 24 months after the funds were raised.
60. The uncertainty of the EDI amount, combined with the delay of receiving any benefit, make the ex-post method fairly ineffective in incentivising shareholders to invest in exploration.
61. It is possible, however, that the potential of EDIs being available might add buoyancy to the market for exploration company shares. This might lead to greater funds flowing into the industry. Quantifying this would be difficult, if not impossible.
62. The other advantage of the ex-post method (for shareholders) is that the whole of the budgeted cap would be used each year. Since all data is known at the time the modulation calculation is made, the whole of the budgeted EDI amount can be distributed to shareholders.

63. The early start date proposed for the ex-post method is desirable.

Ex-ante

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)?

64. The ex-ante method relies on companies making estimates of their intended exploration expenditure for the following tax year, and those estimates being used to calculate the EDI percentage in advance of the tax year commencing.
65. As previously outlined, if the ex-ante method was combined with the New Shares model, the timing of the modulation process would need to be accelerated. All estimates would need to be provided to the ATO early enough for the modulation percentage to be announced by 30 May at the latest, so that share prospectuses could be finalised and approved by ASIC and the ASX before fund-raising commenced on 1 July of the new tax year.
66. The most difficult aspect of this method would be ensuring that exploration estimates were accurate. Unless the estimates were accurate, the modulation percentage would not use up all the EDIs budgeted for that year and could severely underestimate the ‘real’ percentage. The DP suggests that companies would be limited to their estimate, and this would certainly work to ensure there was no *over-spend* of the budgeted EDI amount.
67. However, poor estimating could severely impact the reputation of the incentive from an investor perspective, especially if the EDI modulation percentage proved to be wildly inaccurate over time. SACOME cannot think of a workable means of ensuring this, since there are many genuine and plausible reasons why companies may find that they have overestimated their future expenditure on exploration:
- Geology, such as rock which turns out to be too hard, too slow or too difficult to drill; unexpectedly “empty” drill holes which mean that drilling program has to be abandoned, moved or re-done; successful drilling which leads to the geological model for the program being changed dramatically. Exploration is just that, and the unexpected happens continually.
 - Poor weather such as excessive rain, cyclones, flooding, heat – which mean exploration is delayed into another tax year – often for worker safety reasons.
 - Exploration being dependent on fund-raising, which does not eventuate due to market conditions. This is especially prevalent at present.
 - International market sentiment turning against a particular mineral, so that the planned exploration program for that mineral would not be commercially sensible. Again, there are many current examples of this in the present environment.
 - A year is a long time in exploration, as in all other undertakings. Things can change.
68. There are also less-benign reasons for estimates being wrong. There would be an undoubted incentive for companies to over-state their expected exploration costs, knowing that they have thus set the upper limit of what could potentially be claimed by them in future. Of course, if all explorers over-estimated by the same amount there would be no change to the modulation percentage and no harm would be done. However, if some explorers honestly estimate, and other intentionally over-estimate, the honest companies will be disadvantaged in the modulation calculation. This is not a reasonable policy outcome.

69. Imposing penalties on explorers for over-estimations could only work if there is a clear list of actions which would give rise to a penalty, and genuine overestimates were completely excluded from those penalties. Given the inherent uncertainty of exploration, companies would be unlikely to participate in the EDI estimate process if penalties are imposed as a matter of course, regardless of reasons.
70. SACOME is unable to devise a test to distinguishing “genuine” overestimates from opportunistic overestimates. Unless a practical solution can be found, the ex-ante method may be unworkable for this reason alone.
71. Consideration will need to be given for explorers with Substituted Accounting Periods (SAPs) for tax purposes. SACOME expects that there are relatively few SAPs among junior explorers.
72. The ex-ante method, combined with the New Shares model, will be problematic for IPOs. To be able to put forward an estimate of its first year’s exploration program to the ATO, the company will need to be in existence well before the end of the tax year. That means that the IPO itself must have occurred before that time – that is, the new shares would not have been issued ‘in the expenditure year’ but instead in the preceding year. Only a second capital raising by the IPO company could qualify.
73. This might be solved by making the ‘widely held’ test applicable from the time the *exploration expenditure* is incurred, rather than at the time of making its estimate. The IPO company could then be incorporated prior to year end, with a small amount of non-EDI capital, and submit its estimated exploration budget to the ATO (obviously, subject to capital raising). After 1 July, the IPO could occur and that new capital would qualify. The result would be that not only are all existing companies going to be trying to raise capital in July, but all mining IPOs would also be launched in that month. (Of course, this assumes that the “IPO prospectus 3 year budget” issue raised under New Shares can be solved as well.)
74. As far as providing an incentive for those investing in exploration, the ex-ante method is the only proposed method which would give investors real-time certain knowledge of exactly what the EDI percentage will be in relation to their investment. Companies could confidently announce the EDI percentage in prospectuses, with the usual caveats that entitlement turns on the company meeting the other criteria of the incentive. SACOME believes that this investor certainty would bring more investment money into the sector. However, the overestimation problem remains.
75. The delayed start-date for the ex-ante method is not desirable. Perhaps the first year of its implementation could be done in real time during the 2014-15 tax year, with the full ex-ante method commencing later in that tax year for the following year? We think more consideration should be given to how these measures could be implemented from the 2014-5 year, when the industry’s need for them is so great.
76. If the delay of a year is retained, would the Budget caps for each year of the EDI program be delayed a year, or would the final year simply be abolished? That is, does the ex-ante method mean that EDIs would only cover 2 years of exploration rather than 3 years?

Mixed modulation method

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)?

77. We assume that under the mixed method, companies would submit an estimate of their exploration in the year prior to the tax year, and the 'interim' EDI percentage announced by the ATO would be the *minimum* which might ultimately be permitted. (At the same time, we assume that the estimated exploration amount submitted by each company would be the *maximum* that they could claim?) The interim EDI percentage would be announced before the beginning of the relevant tax year. Then, in the year following the tax year, the 'final' EDI percentage would be calculated by the ATO. EDI distributions would then be made to shareholders based on actual exploration expenditure by each company in that prior year - but capped at their original estimate.
78. This method has the advantage of giving some certainty to investors in fund-raising during the tax year. However, some negative aspects of both methods remain:
- There would be a 22 month wait before the final modulation percentage is known. If the interim percentage announced was very small (eg because of overestimation by companies) that might even *deter* shareholder investment during the tax year, even if the final modulation percentage was later found to be much higher. This is much more likely under the New Shares model, given its critical timing of fund-raising so early in the tax year.
 - The ex-ante incentive to intentionally overestimate by individual companies would remain.
79. The administration of the mixed method is higher than under ex-post, but approximately the same as the ex-ante method. SACOME considers this an insignificant additional cost of introducing a much-needed incentive.
80. The ability to use all of the budgeted cap each year is a good outcome of the mixed method.
81. The delay in commencing the scheme under this mixed modulation method is unfortunate. Again, perhaps the first year of its implementation could be done in real time during the 2014-15 tax year, with the full mixed method commencing later in that tax year for the following year?

Alternative proposal

82. It is clear that the modulation process, designed to place specific annual limits on government expenditure over the 3 years of the forward estimates, is highly problematic. The problems are so severe that it may be that none of the methods are workable in actually providing an incentive to investors to invest.
83. In addition, the delay on commencing the ex-ante method – the method which provides the most investor certainty but which has other major flaws – is very disappointing. The exploration sector is currently haemorrhaging, and a further 15 month delay on starting the scheme may be too late.
84. SACOME therefore submits that the EDI scheme be commenced in 2014-15 but that the government only commit to a single year's operation at this stage, for the full \$100m. We suggest that a 'best-guess' EDI percentage is announced before the beginning of the next tax year. That may be 100%, but **a clear announcement of a lesser EDI percentage** would still send a clear and unequivocal message to investors that this incentive is real, can be relied upon, and will result in a benefit to them. In this case, certainty is more desirable than extracting every cent from the proposal.
85. By the time of the Budget process next year there will be data on how much exploration has been done already in the 2014-5 year and information on the remainder of the year could be requested from explorers. Using that experience further Budget decisions can be made. If that decision is that all \$100m has been used, then the industry could not complain that it had been

short-changed by two years of the program. If the funding has not been fully used, a decision as to its future could then be made.

86. Alternatively, SACOME favours commencing the ex-post method as soon as possible so that exploration in the 2014-15 year can receive EDIs, with the ex-ante method to commence as soon as possible after that. The first ex-ante estimates would be submitted to the ATO in March – April 2015 for expenditure in the 2015-16 tax year. For the first year of operation, two modulation methods would thus exist simultaneously, but the processes would relate to different exploration years.

Converting tax losses to Exploration Credits

Question 6.1 - Subchapter 6.2 illustrates one way of ensuring the scheme converts tax losses into exploration credits and does not provide a greater benefit. Is there a simpler or better way to achieve this?

87. SACOME understands the theoretical reasons for making the adjustments outlined in ¶64 and ¶65. However, we do not believe they are the only possible way of achieving the benchmark neutrality outlined in ¶57 and ¶67.
88. The debit entry in the exploration company's imputation account outlined in ¶63 is a simple and elegant solution for the company's side of the "transaction". For most explorers, this will be their first entry in their franking credit account. SACOME supports this adjustment.
89. However, the treatment proposed for shareholders will approximately halve the value of their EDI credit for most individual shareholders, who are likely to be on the highest marginal tax rate. The analogy with franking credits in this instance is not a good one, as dividends provide both cash from the company (which is understandably assessable), and a tax credit. EDIs will not provide any cash from the company – shareholders will struggle to understand why they are required to pay tax on an amount that is a legislative fiction, and can never be received in cash from the company – and is paid two years after the company incurred the exploration expense anyway.
90. The value of the EDI to shareholders as an incentive is whittled away significantly by this proposal.
91. Furthermore, the dividend mentioned in the illustrative example as being paid the following year will, in real life, be several years away for the shareholder. Companies can only pay dividends out of profits, and for most explorers profits will only arise once a mine has been discovered, permitted, constructed and commissioned – many years hence, is shareholders are lucky. Any connection between the EDI they received during exploration, and the unfranked dividend paid down the track will be lost.
92. Effectively, from a shareholders perspective the EDI will be an incentive which is only worth 55% of what is claimed - the inverse of the top marginal tax rate. Shareholders will quickly "catch on" to the sting in the tail of this incentive, and discount its value by 45% when considering an exploration investment. When combined with the many problems of modulation and the lengthy delay in receiving any EDIs, it is hard to see it motivating investors very much.
93. SACOME makes two suggestions which we believe would provide more incentive for no greater net cost to government:
 - The Budgeted amount for the EDI proposal could be approximately doubled to \$181m, so that the assessable effect of the EDI's inclusion in taxable income is factored into the caps. The net cost, after all tax adjustments in both companies' and shareholder' hands, would remain \$100m. This would be simple, would make the headline EDI percentage much higher (and potentially in excess of 100%), and show the government's support for mining exploration. it could even encourage more investors into exploration.
 - Alternatively, shareholders could include the EDI credit as a cost base adjustment for future CGT purposes. This would reduce their CGT cost base, so more CGT would be payable when the shares were sold. Shareholders are very familiar with this type of mechanism as many listed "non-taxable" unit trust distributions are handled this way – see CGT Event E4, s104-70 of ITAA 1997. This seems a very fair way to deal with a non-cash legislative

fiction such as EDI credits. For shareholders holding their exploration shares on trading account the same solution as used for trading in unit trusts could apply.

Other matters

94. SACOME would like to draw Treasury's attention to the need for the EDI rules to correctly interact with the R&D rules, to ensure that the EDI continues to work as an incentive. If the EDI measures are drafted in a way that the transfer of EDI credits to shareholders simply removes the income tax deduction for exploration expenditure, then the expenditure may not be eligible for the R&D concession. There are a number of ways the proper interaction could be achieved – we would be pleased to provide our ideas upon request.
95. If this linkage is not correctly drafted, then there is a risk that accessing the EDI concession will automatically preclude access to the R&D concession. Given that the refundable R&D offset is a critical source of funding for junior explorers, it would be counter-productive if the EDI measures (directed at increasing funding to the sector) came at the cost of another funding source. If companies are required to make a choice, the uncertainties associated with the modulation process, compared with the relative certainty of the R&D concession, may mean that many companies simply would not be able to afford to adopt the EDI concession. This would make it a policy failure.
96. We are aware that allowing companies to access both the EDI and R&D concessions may be seen as "double-dipping" in respect of exploration expenditure. However, viewed as forms of government support to the industry, it is clear that R&D on its own has not been sufficient to achieve the economic goals sought by the Government. Therefore, the EDI should be allowed to apply in addition to the R&D concession.
97. If it is intended that the EDI be an alternative to the R&D concession, this needs to be made explicit immediately, before further policy work is done on the EDI. We suspect there would be limited industry support for the EDI if it is to come at the expense of the R&D concession.