Institute of Chartered Accountants Australia

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

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Dear Madam,

Exploration Development Incentive

Thank you for providing the Institute of Chartered Accountants Australia (the Institute) with the opportunity to comment upon the discussion paper *Exploration Development Incentive: Policy Design*.

The Institute, like the Government, recognises improving Australia's productivity is key to sustaining our high standard of living. Levers that can be used to improve Australia's productivity include reducing unnecessary red tape and reducing the complexity of our tax system.

The Institute has concerns whether the exploration development incentive, as currently proposed, will be effective in meeting its policy intent in providing an incentive for exploration by junior explorers.

Specifically the Institute is concerned that a rationing of the tax concession appears to create challenges. If the flow through is designed to attract investors, then the rationing process should ideally be resolved before the investor monies are raised, rather than having large uncertainties about deduction amounts arising after the investors have invested their funds and are expecting a tax benefit.

To reduce the substantial red tape and compliance costs associated with this measure, consideration should be given to taking the exploration development incentive outside of the tax act and into the grants system. Alternatively, if that is not a viable option, then the number of taxpayers subjected to compliance costs associated with the proposed exploration development incentive could be substantially reduced by redesigning the incentive as a refundable tax offset.

Notwithstanding those reservations, the Institute has outlined below its response to the specific issues raised in the discussion paper.

Should you have any queries please contact my colleague, Susan Franks on 0401 997 342 or by email to susan.franks@charteredaccountants.com.au.

Yours sincerely

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Appendix A – Response to issues raised in the discussion paper

Should the Government decide to proceed with the exploration development incentive, based on the approach set out in the discussion paper, the Institute has outlined below its response to the specific issues raised in the discussion paper.

Junior mineral explorers

The discussion paper proposes that there be a 'no taxable income test' and a 'no mining activities test' so that only junior explorers can have access to the exploration development incentive. In addition, a company would need to be an Australian resident that is widely held.

If this proposal proceeds, then consideration will need to given as to how this definition will apply in a joint venture (JV) context. The incentive could be made available to eligible companies funding eligible exploration activities, provided this funding can be traced through wholly owned subsidiaries, JVs or unincorporated JVs. This would require integrity measures to prevent major mineral explorers from structuring into the incentive.

No taxable income test

Companies that earn significant income from mining operations can claim an immediate deduction for expenditure on exploration or prospecting. This deduction provides an instant tax benefit for the exploration costs.

Exploration companies which do not have income from mining operations can claim an immediate deduction for expenditure on exploration costs, but as they do not have income against which it can be offset, they cannot gain an instant tax benefit. Rather, such companies have to wait until they have earned income against which the exploration loss can be offset. This can take a significant amount of time, and given the time value of money, diminishes the tax effectiveness of the exploration costs.

The proposal that there be a no taxable income test appears to be broadly appropriate to ensure that the policy is targeted at junior explorers, Restricting the incentive to loss making companies should have the effect of levelling the playing field with regard to the immediate deduction for exploration expenditure.

No mining activities

A no mining activities test may harshly exclude some junior miners from the exploration development incentive. For example, junior miners may lease/hire some of their equipment or sell one of their multiple exploration licences in order to raise funds for exploration. If such activities are considered to be mining activities, then a junior miner would be excluded from the exploration development incentive. It is suggested that a de minimus rule be included to allow junior miners to undertake some activities to help the continuation of their business.

The term "mining activities" is not currently used in the tax law. The term "mining and quarrying operations" is defined in subsection 40-730(7) of the Income Tax Assessment Act 1997 (ITAA 1997). Perhaps the exclusion could be limited to 'ordinary income from conducting a business of "mining operations"' as defined in subsection 40-730(7).

The discussion paper also proposes that any assessable income from mining activities could be used to reduce the amount of exploration expenditure that is eligible for the exploration development incentive. At first glance, this would appear to be a practical solution to the definitional problem. However, when consideration is given to how the modulation process is to work, this would appear to add another level of complexity to an already complex framework.

New share issue needed?

The exploration development incentive is meant to encourage new investment. As such, a question arises as to whether the exploration development incentive should be distributed to all shareholders or confined to the holders of new shares.

Under either scenario, complicated anti-arbitrage provisions similar to those in either or both the franking credit provisions and the loss provisions will be required. The anti-arbitrage provisions for the exploration development incentive would need to be stronger than the already complicated provision for franking credits as exploration companies would have a choice as to when losses would be converted to an exploration credit. Companies do not have a choice as to when they recognise franking credits. These additional provisions regarding the exploration development incentive will add a further layer of complexity to an area that is already extremely complex.

In addition to any anti-arbitrage rules, there would need to be rules to prevent the 'churning' of capital through share swaps, capital returns and fresh share issues, and other similar scenarios.

The anti-arbitrage and anti-avoidance measures from a tax perspective are likely to substantially add to the tax and accounting costs that the exploration company will incur.

This proposal will also add to the costs of a wide range of taxpayers who would not normally expect to have to bother with exploration cost provisions due to the flow through nature of the exploration development credit. For example, a managed investment trust would need to alter its recording and reporting requirements should it inadvertently have in its wide investment programme an investment in a junior exploration company.

The 'new shares' idea is clearly in line with the policy intent – i.e. to encourage new investment. However, it would likely require a separate class of ASX listed shares which is a costly process. It is noted that a new class of shares would be needed every time there is a new issue of shares as each new issue would have different entitlements which would further increase administrative costs. There would also be a share price difference for each class, and extremely complex tracking procedures for use of funds from each issue.

An alternative approach might be to cap the credits to expenditure spent from new capital raised, but distribute the credit proportionately to all shareholders. However, this raises further issues such as which shareholders would be eligible: only holders at a particular date or pro rata based on period of holding during a year,

Eligible expenditure

The discussion paper proposes to use the existing section 40-730(4)(a)(i) of the ITAA 1997, which states that exploration or prospecting includes:

> *"geological mapping, geophysical surveys, systemic 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 discussion paper intends to exclude exploration for petroleum[1] and geothermal energy resources[2]. As the policy announcement refers to minerals, it is considered that quarrying should also be excluded from this definition.

[1] As defined by 40-730(6) – any naturally occurring hydrocarbon or naturally occurring mixture of hydrocarbons whether in a gaseous, liquid or solid. It also includes hydrogen, sulphide, nitrogen, helium or carbon dioxide.
[2] As defined by 40-730(7A) – matter occurring naturally within the Earth and containing energy as heat.

The discussion paper also intends to exclude other aspects of exploration that are defined in other parts of 40-730(4). These include:

- Search for ore within, or near, an ore-body;
- Search for quarry materials by drivers, shafts, cross cuts, winzes, rises and drilling
- Feasibility studies to evaluate the economic feasibility of mining minerals once they have been discovered
- Obtaining mining or prospecting information associated with the search for and evaluation of areas containing minerals.

The proposed definition appears appropriate with the policy intent of finding new greenfields. It excludes brown field exploration, quarry materials, and existing information about greenfields. Excluding feasibility studies to evaluate the economic feasibility of mining minerals may prove to be controversial with industry but it is consistent with the policy intent.

Greenfields

It is important to ensure that the exploration development incentive is used to promote exploration in Australia. The Institute supports the discussion paper's proposal to include a reference to Australia in the definition of greenfields.

The Institute also supports the discussion paper's proposal to ensure that brownfield expenditure is excluded by denying expenses related to existing mines or a mineralisation that is an inferred mineral resource or higher under the JORC code. Using JORC will provide a tension between Australian stock exchange obligations for continuous disclosure and the ability to use the tax incentive. As such, it will be a natural anti avoidance provision that takes advantage of existing industry understandings without complicating the tax law.

Modulation process

Beneficiaries of government assistance often prefer for the assistance to be provided through the tax system rather than the grants system. But, as the above analysis demonstrates, incorporating what might otherwise be a grant into the tax system greatly adds to the complexity and red tape associated with the tax system. The modulation process associated with the exploration development incentive highlights the difficulties.

Neither of the suggested modulation approaches really provide 'certainty' of any material flow-through benefit, either at the point of investment or at the time compliance costs are incurred.