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FURTHER SUBMISSION ON THE EXPLORATION DEVELOPMENT INCENTIVE (EDI) DRAFT LEGISLATION

Further to our submission forwarded to you on 24 October 2014, SACOME has now had the opportunity to more fully review the draft legislation from a technical perspective, and provides the following further comments.

Some of these additional comments are absolutely crucial to the operation of the EDI proposal, and require urgent attention for the scheme to be usable by exploration companies. We do not think that the necessary amendments are complex or time-consuming to implement.

I s418-80 – meaning of *greenfields minerals expenditure*

This is a central definition of the EDI provisions, and applies to an "entity" which explores for minerals on a tenement it "holds" in Australia. The word "holds" is not defined in the EDI provisions so is presumably taken to have its ordinary meaning rather than any special tax law meaning. As currently constructed, this provision will exclude almost all exploration done in Australia from the EDI concession.

Typically, exploration groups have their tenements owned in one or more separate 100%-owned subsidiaries, with that tenement-owning subsidiary being required to actually undertake the exploration work and account for it to the State regulator. A group's employees may be employed in a different 100% subsidiary, and equipment may be owned in another. The reason for such structures is that it makes selling a tenement very flexible – a buyer can either buy the subsidiary outright without changing underlying tenement ownership with the State mining authority, or they can transfer tenement ownership from the subsidiary to a new owner with State regulator consents. Often the parent company owns few if any tenements in its own name.

Almost all – if not all – listed junior exploration companies will be the parent company in a consolidated tax group. As such, the parent is the "entity" for tax purposes, and the parent is the taxpayer mentioned in this provision. Any income or expenditure of a 100% subsidiary is held to be the income and expenditure of the parent entity, which completes a

tax return showing all activity of the entire consolidated group and claims the exploration deductions under ss40-25 and 40-730 ITAA97, as mentioned in the EDI provisions.

The problem arises when proposed s418-80(2)(c) links this exploration expenditure of the “entity” – ie the listed parent - to an tenement etc which the entity “holds” . As outlined above, the parent “entity” will rarely hold any tenements. The parent will have no legal interest in the title of a tenement held by its subsidiary.

Accordingly, there will be very few junior explorers which have both incurred exploration expenditure (via a tax consolidated group) and also “hold” the relevant mining tenement themselves in their own name. SACOME assumes this is an unintended outcome. Some solutions are suggested below.

Farm ins

A second problem with this provision related to “farm-ins”. A large amount of exploration expenditure is carried out by joint venture parties who are seeking to “farm in” to a tenement by undertaking exploration that the legal owner of the tenement is unwilling or unable to do itself. In the early phase of a joint venture, a company will contract to undertake a specific amount of exploration in a set time, and once that is completed a portion of the ownership of the tenement will be transferred to the party which did the exploration. This is a “farm in”.

It will be apparent from this description that the “entity” undertaking the exploration will not “hold” an interest in the tenement during the farm in, and is thus unable to meet the EDI requirements in s418-80(2). Again, SACOME assumes this is unintended, as farm ins are very common and make a substantial contribution to minerals exploration in Australia. There is no qualitative difference between farm in exploration and that done by tenement owners – all are deserving of the same treatment. The rest of the tax law makes no distinction between the two, allowing all exploration to be deductible regardless of tenement ownership.

Suggested solutions to the “holds” issue

1. SACOME’s strong recommendation is to ***simply remove*** the provision in s418-80(2)(c) requiring the taxpayer entity to also “hold” the tenement. The existing restrictions on exploration expenditure in s40-730 (*Deductions for expenditure on exploration or prospecting*), which are further restricted by the proposed provisions in the remaining sub-sections of 418-80(2) and (3), are adequate to contain the expenditure to the targeted activities. Simply removing s418-80(2)(c) would, we think, have no adverse consequences and allow the EDI concessions to work as intended.

Any concern that the EDI provisions might otherwise be accessed by mining *contractors* (who have no current or future interest at all in the tenement) is eliminated by the

proposed s418-80(4), as such businesses claim their operating tax deductions under the normal provisions of the tax law rather than the exploration provisions.

If this suggestion is taken up, s428-80(3)(d) should also be removed as a consequential amendment.

2. We note that there *is* a definition of "hold" in the tax law – s 40-40 of ITAA97 – which applies to depreciating assets. Tenements would usually fall within this category. However, there is nothing to cross-reference the EDI provisions to s40-40, and there may be other consequences of using that definition which SACOME has not explored. If it was intended to reference the s40-40 definition, it would be a simple matter to asterisk the word "hold" in s418-80.

Notwithstanding s40-40, the requirement that the explorer also "hold" the tenement (whether ordinary meaning or s40-40) means that ***farm in arrangements would not qualify for EDIs***. (see MT 2012/2). Farm ins do not qualify for s40-40 treatment because of the "immediate" ownership tests in Items 5 and 6 of s40-40.

3. In relation to the problem of subsidiaries holding tenements, a possible ***alternative technical view*** is that the tax consolidation provisions can be interpreted in a way which solves this issue. The "single entity rule" in section 701-1 applies for the "core purposes" of calculating the parent's taxable income and the subsidiary's taxable income. Is the EDI considered to be within the "core purposes" of tax consolidation? If so - perhaps because EDI initially turns on the claiming of a tax deduction - then arguably the parent incurs the exploration deduction of its subsidiary ***and is also*** taken to "hold" the asset (under a combination of the single entity rule and s40-40). If so, this interpretation should be made explicit in the EDI provisions: a short new provision should be inserted confirming that the single entity rule applies for s418-80. The EM should also make the intended link clear.

II – s418-85(3)(b) – COT and SBT tests on losses

S418-85(3)(b) requires the tax loss from the exploration year (ie the previous year) to pass the Continuity of Ownership and Same Business tests in the year in which the credits are issued (ie the current year). Both these tests are "whole of year" tests – it is not possible to determine whether the COT and SBT tests have been met until *after* the end of the current year, and thus after the distribution of EDIs. If a company has distributed EDIs and is then taken over before 30 June that year, the company will have retrospectively failed the COT test. Much less dramatic changes in shareholdings on the ASX could also trigger the COT test, at any time and without any reference to the exploration company itself. Similarly, a new business commenced by any company in the tax consolidated group after EDI distribution date would retrospectively cause the SBT test to be failed.

It is simply not possible for an exploration company to complete the EDI calculation steps set out in s418-85(1) - and in particular Steps 1(b) and (d) - using the modification in subsection (3)(b), given these tests can only be assessed *after* the current year and thus well after the EDI distribution must be made.

Further, it is not clear what "mischief" is being addressed in this provision. If the loss was legitimately incurred in the previous year on eligible exploration etc, and the company met the COT and SBT tests in that previous year, then it should result in an offset for the company's shareholder in the following year. We note that there is no COT or SBT test for the distribution of franking credits earned in one year and distributed in later years. Furthermore, if the explorer had had income last year, the losses would have been used last year without having to meet COT and SBT in later years.

SACOME suggests that s418-85(3)(b) should be deleted.

III s418-115 – Restricting exploration credits to post 1 July 2014 equity interests

SACOME was pleased to see that much of the complexity surrounding restricting EDI credits to particular years has been removed, especially as it relates to separate share issues for each EDI year. The proposed methodology should generally be workable, though we re-iterate our consultation-period comments that the ex-post modulation method adopted is unlikely to be nearly as encouraging to potential exploration investors as an ex-anti model.

Given the lateness of introducing this legislation, many exploration companies have already made both public issues and private placements of their shares since 1 July 2014. These raisings were made with no expectation of receiving EDI credits, and many would have been made in the direst of circumstances to keep the company "alive". The new shareholders have had their shares approved on the basis of those shares ranking equally with other "old" shares on issue, and are listed in the same class. It would be virtually – if not actually – impossible to retrospectively separate those post 1/7/14 issues from the remainder of the company's share capital, re-approve the share issues on different terms, and retrospectively list the shares under a new ASX code. Shares traded in the intervening period would have done so in an uninformed market, and so on.

SACOME also considers that is would be contrary to the spirit of the EDI legislation to try retrospectively separating these "new" shares from the old, as there was no expectation of an EDI credit when they acquired their new shares.

Assuming those "new" shares cannot be separated, under the proposed legislation those companies could not make a s418-115 election to restrict its EDIs only to "new" shareholders, given the retrospective 1 July 2014 cut-off date. This seems unreasonable, since the legislation is now being introduced much later than expected and conditions in the

exploration sector have continued to deteriorate quickly during 2014 so fund-raising has become imperative.

Suggested solution

SACOME suggests that the date of *Royal Assent* be used to distinguish "new" shareholders from "old" ones in the s418-115 election. This will target the EDI at shareholders who actually contribute funding in response to the EDI, and would enable all explorers to have access to the election rather than only those who had not conducted any fund-raisings since 1 July 2014.

We do not think any further restriction on dates is required – eg there should be *no change to the 1 July 2014 start date for eligible exploration expenditure*. The simplified structure of the EDI provisions mean that the "new" shareholders will obtain access to all exploration expenditure of a company, even that done using money contributed in the past by previous shareholders. For them to also get access to EDI credits on money contributed by shareholders who contribute between 1 July 2014 and Royal Assent is inconsequential, and no less equitable.

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SACOME thanks you for the opportunity to make this late submission, and would welcome further discussion on any matter raised in this or our earlier submission.

Additional issues are raised in the attached Schedule.

Yours faithfully,

SIGNED	**SIGNED**
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SCHEDULE OF OTHER TECHNICAL MATTERS REQUIRING FURTHER CONSIDERATION

s418-75 – Meaning of *greenfields mineral explorer*

We are concerned with the mechanism used to ensure that the junior explorer is not related to any company which carries on mining activities – and would thus be excluded from EDI. This test will need to be closely examined by every EDI applicant, so must be clear and unambiguous.

Para (1)(d)(ii) picks up definitions of "connected with" and "affiliate" from the small business concession provisions of ITAA97. Given that all of the taxpayers accessing the EDI will be public companies, these provisions will be wholly unfamiliar to them and thus increase compliance costs.

Of greater technical concern is the vagueness of the definitions in a public company context, where intercompany investments between larger and smaller public companies are common ("big brother relationships" with larger miners, and "institutional shareholder relationships" with the major listed investment entities). It is quite possible that a junior explorer will have shareholders who are mining companies, and/or have institutional investors who in turn invest in many other large mining companies. The junior explorer can be expected to know the identity of its own shareholder base, but not necessarily all the business activities of those shareholders. This is quite different to the small business purpose the provisions are aimed at, where those connected with or affiliated with a small business would be expected to know everything which is happening.

"Connected with"

In relation to the definition of "connected with", we note that a 40% control of shares by an actual miner will exclude the junior explorer from EDI. However, the "triangulation" provisions of s328-125(7) and (8) seem to exclude public companies from that aspect of the test, but not from direct ownership. This seems very odd in the EDI context.

Given the many instances where actual miners hold shares in junior explorers, it would be helpful if several examples could be provided in the EM of how the "connected with" test will be applied to listed exploration companies. The examples should cover both "big brother" miner examples as well as institutional investor examples where that institution also has investments in major mining companies.

There is also a Commissioner's discretion in s328-125(6) for situations where "control" is between 40% and 50%. Again, a public statement about when the Commissioner will exercise this discretion in a public company context would be helpful, given that the timelines in the EDI will not make it easy for a junior explorer to apply for this discretion

between the period when the modulation percentage is announced and the end of the tax year.

A 40% test is made even more difficult in a public company context where ownership changes daily on the stock exchange and even major shareholdings can change rapidly. Must the junior explorer monitor this test constantly, or will the ownership percentages on the record date be the only test time? Both options have inherent problems, as all shareholders could be denied EDIs simply because a large mining company's share of the junior explorer slipped over the 40% threshold from a moment. The junior explorer has no control - or advance knowledge - over its shareholders' actions. Further, if the 40% testing is required to trace back through an institutional investor's other shareholdings, this creates an impossible compliance position for the junior explorer.

Perhaps further consideration should be given to the application of this whole provision in the EDI context? The use of a small business provision might have seemed to be a quick and simple way of testing connectedness, but in practice it will create insurmountable problems for some junior explorers in a way they simply cannot control or even monitor effectively. It certainly will not confidently allow a junior explorer to advise shareholders in advance of a share issue that the EDI is expected to apply to its shares – which is the point of the EDI concession.

"Affiliate"

The definition of "affiliate" is set out in s328-130 of ITAA97, and is also a small business section. It is designed to "mop up" any informal connections between entities which would not be caught by the 40% "connected with" test, and is necessarily vague for that reason. Acting "in accordance with the directions or wishes, or in concert with" another party is generally contrary to the obligations of public company directors, so perhaps only illegal activities by the company are intended to be covered by this provision?

Such a vague test is inappropriate in a public company context, especially given that the tight EDI timeframes mean companies will not necessarily be able to obtain private rulings on their constantly changing circumstances before the last EDI distribution date of 30 June each year.

A series of examples is needed to guide junior explorers in understanding the practical implication of this section, if it is retained. Scenarios which should be covered include companies with one 19.99% actual miner as a shareholder, who has appointed two of four/five directors; companies with two 10% actual miner shareholders each of whom has appointed a board member with great personal influence; companies with well-known directors who also sit on the boards of actual miners; and companies who share a CEO with an actual miner (part-time executive roles are becoming very common in the junior exploration sector).

s418-80(3)(b) – expenditure to identify "viability"

SACOME considers that the word "viability" – even when qualified by the example of "feasibility studies" – is problematic. All exploration work after the initial successful drill hole is seeking to determine viability. The first successful hole proves its "existence", to use the wording of the proposed section. From then on, all expenditure is aiming to show that the size, grade and chemical properties of the discovery are worth continuing with from a financial perspective. This applies to all minerals, from the lowest to highest value.

Even if "financial viability" was used instead of "viability" in the proposed section, that would not necessarily be helpful. Financial viability is central to all mining activities, and that includes drilling the very first hole and all the expenditure after that. Only the most irresponsible of public companies would be unconcerned about financial viability at all stages of an explorer's life cycle.

If this provision is simply intended to exclude feasibility study expenditure, we suggest that be stated without any additional description. Alternatively, the EM should provide for a full listing of the types of other "viability"-related expenditure which the Commissioner considers will not qualify along with feasibility studies.

(In practice, SACOME does not think feasibility studies will be relevant here as it is extremely unlikely that a company with no inferred JORC resource would have also reached the feasibility study phase of their operations. Companies with announced JORC resources are excluded from the EDI provisions.)

Example 1.4, EM (end of para 1.87)

The calculation of the tax losses foregone would appear to be incorrect. S 418-95 requires the amount of EDI credits created to be *divided* by the company tax rate to calculate the losses foregone, whereas this example *multiplies* them by the tax rate. The legislation is conceptually correct, and the tax loss in the example should be reduced by $500,000, not $450,000 as stated in the EM. This should be clarified, though all knowledgeable readers will realise the EM is incorrect.