MINERALS COUNCIL OF AUSTRALIA

SUBMISSION TO TREASURY

Targeting the Immediate Deduction for Mining Rights and Information First Used for Exploration

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EXECUTIVE SUMMARY

Immediate deductibility for exploration expenditure is a long-standing feature of the income tax system to encourage mineral exploration, in recognition of the spill-over benefits to the economy. The Government’s Budget announcement to deny immediate deductibility for the cost of exploration tenements and information to address a specific integrity concern is poorly targeted and will impact on genuine exploration activity. By decreasing incentives to explore, this measure has the potential to harm Australia’s future pipeline of mining projects.

Exploration is the corner stone of future Australian mining investment. Immediate deductibility of exploration expenditure has received close scrutiny over the years. The dominant view has supported immediate deductibility of exploration expenditure on grounds of efficiency, practicality, spill-over benefits and international competitiveness.

The purchase of an exploration tenement and of exploration information is speculative and in most cases a purchase does not lead to a mining project. Such expenses should, therefore, remain immediately deductible in line with other exploration expenditure. Removing legitimate deductions for costs of exploration impact on the attractiveness of Australia as a destination for exploration investment at a time when exploration expenditure and the investment pipeline is declining.

The immediate deductibility of exploration tenements and mining information was legislated as part of a balanced package of measures to simplify capital allowances and remove a number of deductions allowed to the resources sector. It has provided an important measure of certainty and stability to what is, intrinsically, a very high risk economic activity.

The Minerals Council of Australia (MCA) urges the Government not to proceed with limiting the immediate deduction for exploration. The measure is an excessive response to a specific integrity concern, and represents a penalty to exploration activities.

By limiting expenses from immediate deductibility, the proposal imposes complexity and undermines the original policy intent to provide a simple, practical immediate deduction that increases Australia’s competitiveness as a destination for minerals exploration. A stable, consistent and certain tax regime is required to maintain Australia’s competitiveness.

A more targeted approach that does not impact on genuine exploration or impose undue complexity in the tax law will ensure the Government’s policy principle to encourage genuine exploration activity remains intact.

The minerals industry does support the need for legislation to address the complexity, uncertainty and anomalies created by tax rulings MT 2012/1 and MT 2012/2 as a matter of good tax policy.
1. EXPLORATION: TAX POLICY IMPERITIVES

Key points

- The policy objective of immediate deductibility of exploration expenditure is to encourage exploration
- Inclusion of mining tenements and mining information were deliberate design features to reduce complexity
- Measures to target integrity concerns must be balanced with simplicity, certainty and the objective of encouraging exploration in a competitive global capital market

Tax policy and exploration

It has been a long standing feature of Australia’s tax law to provide an immediate deduction for exploration expenditure in recognition of the high costs and risks associated with exploration expenditure and the positive spill over effects exploration has on the economy.

Securing the benefits of Australia’s comparative advantage in mineral resources requires stable and globally competitive tax arrangements that encourage investment and ensuring consistency and certainty in the tax arrangements. The immediate deductibility of exploration expenditure acknowledges that:

- general exploration expenditure cannot be viewed as capital expenditure creating a long-term asset because most exploration expenditure does not result in discovery;
- exploration cannot be deducted over life of mine (LOM) because – by definition – it occurs before there is a mine and in most instances a mine never eventuates; and
- encouraging discovery of new deposits supports the growth of a sector in which Australia has a demonstrable comparative advantage.

Changes introduced in 2001 to include mining information and exploration tenements were legislated as part of the uniform capital allowance regime. A significant aim of the uniform capital allowance provisions was to simplify capital allowance regimes and provide more neutral tax treatment for expenditure on depreciating assets to improve the quality of investment and economic efficiency.

The Ralph Review recommended the retention of immediate deductibility of exploration expenses on practical grounds:

*Expenditure on exploration and prospecting will continue to be immediately deductible under the Review’s proposals. The strict logic of the generalised approach would suggest that expenditure on unsuccessful exploration and prospecting would be immediately deductible, while successful expenditure would be written off over the life of the resulting asset. However, in many cases there may be significant delays before it is known whether the activity has been successful or before a mine is established. It is largely on the grounds of practicality that the current treatment is proposed to be retained.*

Any measure attempting to quarantine exploration expenditure which leads to a mine from the immediate deduction would not only increase complexity, it would also introduce a level of uncertainty into commercial decision making processes around what is a high risk economic activity.

Further, such changes would effectively increase the tax burden on exploration, reducing the competitiveness of Australia as a destination for exploration investment.
The Business Tax Working Group, in considering and ultimately rejecting any changes to the immediate deductibility for exploration, acknowledged that the reduction or removal of exploration deductions "would be expected to increase marginal effective tax rates for explorers, reducing the scale of exploration in Australia and encouraging some investors to transfer activities overseas".

The Budget proposal is targeted specifically at integrity concerns flowing from very limited fact patterns – i.e. large amounts paid for resources which have been evaluated extensively and proceed quickly to an operating mine. The impact of the proposed measures significantly outweigh the reported integrity concerns which should instead be addressed through measured and targeted legislative responses to deliver the policy objective underlying the immediate deduction to encourage exploration and the future pipeline of mining projects in Australia.

**Securing investment in exploration**

Australia’s exploration sector is engaged in a highly competitive, globalised industry. Natural endowment alone is not enough to secure the highly mobile resources of capital and labour required to find and develop mineral resources. Taxation treatment is a crucial influence on exploration expenditure decisions. As 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.”

The investment economics of projects are assessed based on the overall tax burden such that it is the combination of all business tax rates and measures that is used to assess project viability. The stability and predictability of fiscal regimes is also a critical factor influencing commercial decision-making.

Australia’s standing as a destination for exploration expenditure has been falling. The National Mineral Exploration Strategy found a range of factors impacting on exploration in Australia, including:

- perceptions of Australia as a mature exploration destination where there are fewer opportunities for new discoveries;
- challenges in exploring for deposits buried under the overlying sand, soil and sediment that covers much of Australia;
- high cost of exploration in Australia, through factors such as the high Australian dollar and labour costs; and
- increasing global competition with every jurisdiction that permits and promotes exploration.

Recent data shows that exploration expenditure is declining. The Australian Bureau of Statistics has tracked a significant decline in exploration investment over the past 12 months. Greenfield exploration expenditure in the March quarter 2013 declined 29 per cent – and brownfield exploration 21 per cent – over March 2012 levels. The falls were greater in the more significant indicator of exploration activity – namely, the number of metres drilled which fell by 29 per cent for new deposits and 34 per cent for existing deposits over the same period.

While much of this decline may be attributed to moderating commodity prices which peaked in 2011, Australia must act to secure a future pipeline of investment in mining. Attracting exploration capital will become increasingly difficult at the very time the imperative to discover and develop the next generation of minerals projects has increased.

This is all the more urgent given the most recent analysis of major projects by the Bureau of Resource and Energy Economics (BREE) which identified $150 billion of projects that have been delayed, cancelled or had development plans re-assessed in the 12 months to April 2013.
2. SPECIFIC INDUSTRY CONCERNS

Key points

- The measure undermines the policy intent of immediate deductibility to encourage exploration
- It discriminates against some forms of genuine exploration activity
- It would result in outcomes which go significantly beyond the stated integrity concern
- It introduces a significant amount of complexity and definitional difficulties into the law

a. Integrity concerns and “better targeting genuine exploration activity”

The MCA would support action to ensure there is no inappropriate misuse of the immediate deductibility provisions of the law that does not align with the intention to encourage exploration activity. However, care must be taken to not draw artificial delineations.

Removing immediate deductibility for all mining tenements and information on the grounds that it was not the original policy intent conflicts with the purpose of immediate deductibility which is to encourage exploration. Inclusion of such expenses which are fundamental to exploration encourages exploration activity in line with Government policy intent and satisfies the principles of simplicity and certainty.

Further policy grounds for the change provided by Treasury include the concern at the total sum of deductions claimed and the increasing size of individual taxpayer’s claims. However, this would appear to reflect higher prices paid for exploration tenements during a period of very high commodity prices peaking in 2011. With commodity prices and exploration activity currently moderating, the cost to revenue of the deduction may be expected to fall.

b. These acquisitions “are better characterised as the acquisition of a natural resource for development and production and should be treated accordingly”

The proposition that the acquisition of an interest in an exploration tenement is tantamount to the purchase of the “natural resource” is misguided; the application of sections 40-80 and 40-730 of the Income Tax Assessment Act 1997 (the Act) operate to deny an immediate deduction in circumstances where the acquisition of an interest in a tenement is transferred together with information that establishes the feasibility of a mining operation.

The more accurate characterisation of the nature of interests acquired in the vast majority of circumstances is that the taxpayer purchases the right to continue to explore for mineral resources. While there is a possibility that the project will proceed to production at some yet to be determined time in the future, this is never certain. If there is sufficient certainty that a project will proceed to production at the time the tenement is acquired then the tenement would not satisfy the requirements of section 40-80 because the depreciating asset does not satisfy the definition of “exploration and prospecting” in section 40-730.

Likewise if the assertion in the consultation paper that some taxpayers undertake a small amount of exploration activity only in order to obtain access to immediate deductibility is indeed accurate, we would contend that existing powers under the Act should be used to target contrived activities directed towards obtaining an inappropriate tax benefit.

To the extent that significant risk remains in relation to whether the development of an exploration tenement will occur, including economic, political, social, anthropological, environmental, geological, commercial and financial risk, there is no quantifiable enduring benefit identified at the time an exploration tenement is acquired, it is appropriate to allow an immediate deduction for the cost of such a tenement.
There are also circumstances whereby although a vendor of a tenement may have concluded that
development of a project is viable, additional work by an acquirer may identify facts subsequent to
purchasing the tenement that indicate development of the tenement is not economically feasible. We would
proffer that in such an instance the acquirer should not be constrained by decisions made by the vendor so
as to disqualify the tenement from the application of section 40-80. Allowing for the particular risk faced by
such capital-intensive and complex projects in the hope that development and production will proceed is the
exact policy intent of the legislation and continues to be the policy intent of the immediate deduction.

c. The effective life of a mining right or information will be the “life of the mine” or 15 years if the life of
mine “is not known” at the time of acquisition

The overwhelming number of projects which fail to proceed also underlines the inappropriateness of
implementing an arbitrary determination of “effective life” on mining rights and information first used for
exploration. This is particularly the case where the determination of the effective life benchmark is
determined by reference to existing mining projects.

The Proposal Paper asserts that: “The effective life of a mining, quarrying or prospecting right will be the life
of the mine, quarry or petroleum field that it leads to. If that life is not known at the time of acquisition of the
right, a 15-year effective life would initially be used.” Question 1 of the Proposals Paper states: “Views are
sought on whether the methodology used to determine the life of the mine; quarry or petroleum field for the
purpose of this measure could be made clearer or simpler.”

The simplest methodology is that proposed by the Ralph Review – immediate deductibility. This recognises
the inappropriateness of attributing a “life of mine” determination to exploration expenditure when only a very
small proportion proceed to development and production. The Colorado School of Mines has concluded that
it takes 500 to 1,000 grassroots exploration projects to identify 100 targets for advanced exploration which
lead in turn to 10 development projects, one of which becomes a profitable mine. It is therefore
fundamentally inappropriate to impose a capped effective life which is necessarily arbitrary and unconnected
to the vast majority of claims to which it would be applied.

d. If exploration is unsuccessful, the remaining value of the right or information “will be written off
when this is established”

Determining the point of time that exploration is “unsuccessful” would be highly contentious, if not impossible
to objectively determine. Furthermore, a determination could become obsolete almost immediately with a
change to any one of the multiple economic or social variables that go to evaluating exploration results and
the potential for their development. At one extreme, it could be argued that exploration is “unsuccessful” until
the first profitable sale of the extracted resource. At the other extreme, exploration could be claimed to be
“unsuccessful” only if no trace of minerals was found.

The MCA contends that the “unsuccessful” concept is neither a meaningful nor practical indicator of the
threshold test to trigger a deduction for the adjustable value of the tenement. The more relevant determinant
would involve an inquiry directed toward determining economic obsolescence; whereas the exploration
program may successfully identify and quantify the existence of an ore body/coal deposit, the feasibility
study may in turn lead to the conclusion that the deposit is uneconomic in the current economic
environment. In that instance, although the holder of the tenement may subsequently decide not to proceed
with development of the project immediately on the basis that the net present value (NPV) of the project was
either not positive or that the project did not meet the holder’s hurdle rate of return, a holder is typically
motivated to hold such tenements in the hope of future improvements in commodity prices or extraction
technologies or simply retain access to the tenure as a potential future competitive advantage.
In determining if exploration is “unsuccessful”, a taxpayer should not have to dispose of an exploration tenement to receive an immediate deduction. A tenement should be written off immediately pursuant to a provision comparable to section 40-295(1)(c) but which does not require the taxpayer to stop holding or using the asset. A holder of an exploration tenement may elect to continue to hold a tenement which has been determined to not be economically viable. Requiring a tenement to be relinquished to receive an immediate deduction fails to recognise the highly cyclical nature of exploration and resource development. Even more impractical would be the requirement that a taxpayer demonstrate it is not “holding” information. That which is learnt cannot be unlearnt, particularly when it remains on the public record under the explorer’s name at the Australian Stock Exchange, for example.

It is for reasons of simplicity and efficiency like these that multiple reviews have recommended retention of the immediate deductibility of exploration expenditure.

e. **The inappropriateness of using “the longest lasting venture” for the effective life of information associated with more than one project when the information is relevant to a mining region**

The MCA submits that this proposal is also impractical. The reality is that information obtained from individual projects within a region is used to extrapolate data across that region and therefore may have an “effective life” of many generations.

f. **“The costs of depreciating assets clearly involved in genuine exploration activity continue to be immediately deductible.”**

The Proposal Paper states this will be achieved by continuing to allow an immediate deduction for “farm-in, farm out” arrangements; the costs of acquiring a mining right or information from a “relevant government authority” and costs incurred by a taxpayer in “generating new information or improving existing information”. While the MCA supports the carve-out for these transactions, the exemption demonstrates the arbitrary nature of the Budget proposal.

The MCA supports the continuation of the current system by which deductibility is determined on the facts and circumstances of the taxpayer, not an arbitrary prohibition on longstanding, well-defined and well understood limits that have been and can continue to be effectively administered.

The Proposal Paper’s Appendix purports to provide an “illustrative example” of the alleged mischief the proposed measure purports to address. The examples involve a small number of very fact specific circumstances. These examples are not indicative of the vast majority of circumstances involving the acquisitions of exploration tenements.

The MCA is concerned that the phrase “resources with considerable potential for commercial exploitation” seeks to establish a new limitation of the scope of exploration limited to the discovery of a deposit.

The MCA is concerned that the phrase “minor ‘confirmatory’ exploration work” seeks to limit the importance of genuine classes of exploration activity which may have significant flow on effects to the activities which qualify as “exploration or prospecting” under section 40-370 of the ITAA 1997.
AUSTRALIAN TAXATION RULINGS MT 2012/1 AND 2012/2

The MCA supports the intention to codify the tax outcomes sought to be delivered by the Australian Taxation Office in tax rulings MT 2012/1 and MT 2012/2. However, it is the minerals industry’s view that the approach taken in the rulings to deliver these outcomes are unnecessarily complex and gives rise to a number of unintended anomalies. Whilst the MCA acknowledges that the ATO have sought in the rulings to achieve the appropriate outcomes, the rulings approach this in a way which is so complex that many taxpayers would have significant difficulty seeking to apply those rulings without extensive and costly professional fees. The rulings also arguably do not provide certainty and can result in inequitable and inappropriate outcomes which have the potential to distort commercial decisions.

The MCA would welcome a legislative approach to deliver appropriate tax outcomes relevant to farm-out arrangements. Any legislative approach should be significantly simpler than the approach taken by the rulings and be targeted towards certainty and consistency.

MINING RIGHTS THAT DO NOT SATISFY THE REQUIREMENTS OF S40-80 ITAA 1997

The MCA welcomes the clear statement in the Proposal Paper that the Budget announcement will not change the effective life of mining rights that do not satisfy the requirements of section 40-80 ITAA 1997 and that in these circumstances, the effective life will continue to be the life of the mine, quarry or petroleum field to which the right relates (subsection 40-95(10) ITAA 1997).

It is critical that this clear statement of the Government’s policy intent is made equally unambiguous in any further discussion or legislation enacting the Budget announcement. Any lack of clarity on this point will only add further to the uncertainty concerning the tax treatment of exploration expenditure generated by the Budget announcement and further discourage investment in Australian exploration.

RECOMMENDATIONS

To avoid the unintended outcomes associated with the Government’s measure, and appropriate targeting of tax practices resulting in base erosion, the MCA recommends that the Government:

1. Not proceed with removing mining, quarrying and prospecting rights and information from the immediate deductibility provisions;
2. Undertake targeted consultation on measures to address the specific integrity concerns involving large amounts paid for well evaluated projects which move quickly to a mine and where the exploration activity undertaken post acquisition is minor; and
3. Codifying the tax outcomes sought to be delivered by Australian Taxation Office tax rulings MT 2012/1 and MT 2012/2.