TAX AND SUPERANNUATION LAWS AMENDMENT (2014 MEASURES NO.#) BILL 2014: EXPLORATION DEVELOPMENT INCENTIVE

EXPLANATORY MATERIAL

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
Commissioner	Commissioner of Taxation
EDI	exploration development incentive
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
TAA 1953	*Taxation Administration Act 1953*

Chapter 1
Exploration development incentive

Outline of chapter

1.1 This Exposure Draft amends the *Income Tax Assessment Act 1997* (ITAA 1997) and other tax legislation to provide a tax incentive to encourage investment in small mineral exploration companies undertaking greenfields minerals exploration in Australia. Australian resident investors of these companies will receive a tax incentive where the companies choose to give up a portion of their losses relating to their exploration expenditure in an income year.

1.2 The total value of the tax incentives available to taxpayers in respect of expenditure in an income year is restricted to $25 million for 2014-15, $35 million for 2015-16 and $40 million for 2016-17.

1.3 The incentive is not available in respect of exploration expenditure incurred in income years after 2016-17.

Context of amendments

Mineral exploration in Australia

1.4 A significant part of the Australian economy is based on the extraction and sale of its mineral resources. Mineral exploration is a key element that drives mining activity.

1.5 Exploration for minerals often involves significant expenditure and risks. While larger, established mining companies are generally in a position to fund such activities from their own profits, smaller companies focused solely on exploration are dependent on attracting investment to fund their activities.

1.6 Over recent years there has been a noticeable decline in exploration, particularly greenfields exploration.

Policy background

1.7 The Government made a commitment in the 2013 election campaign to provide a tax incentive to Australian resident shareholders of small mineral exploration companies to support the greenfields minerals

exploration undertaken by these companies in Australia. The Government proposed that the incentive would be available in respect of expenditure on greenfields minerals exploration incurred in 2014-15, 2015-16 and 2016-17. This proposal was confirmed in the 2014-15 Budget.

1.8 The Department of Industry will monitor greenfields exploration and the scheme throughout its operation, with a review of the scheme in 2016 and, subject to these review outcomes, the programme may be extended for a further period.

Income tax and mineral exploration expenditure

1.9 Generally, mineral exploration expenditure is likely to be capital in nature and would not be deductible by taxpayers under the general deduction rules in the income tax law. However, specific provisions allow for taxpayers to immediately deduct most expenditure incurred in the course of exploration or prospecting for minerals.

1.10 Section 40-80 of the ITAA 1997 allows an immediate deduction of the full value of any depreciating asset (broadly an asset with a limited useful life) when it is first used for exploration or prospecting for minerals and the taxpayer carries on mining operations, proposes to carry on such operation, or incurred the expenditure in the course of a business of exploration or prospecting for minerals.

1.11 Section 40-730 of the ITAA 1997 allows an immediate deduction for other expenditure (both capital or revenue) incurred in exploration or prospecting for minerals where the taxpayer carries on mining operations, proposes to carry on such an operation, or incurred the expenditure in the course of a business of exploration and prospecting for minerals.

1.12 As a result of these provisions, most expenditure incurred in relation to exploration for mineral resources is likely to be deductible.

1.13 The benefit this provides differs significantly between different types of explorers.

1.14 Large mining companies undertaking minerals exploration obtain an immediate benefit from the deduction, as it can be immediately offset against the assessable income from their ongoing mining activities in the relevant income year.

1.15 On the other hand, smaller companies engaged solely in exploration for minerals may earn less assessable income in a given income year than they outlay on exploration or prospecting. Such companies therefore will generally incur a tax loss for the income year.

This tax loss will not provide any benefit unless a company earns sufficient assessable income in a future income year against which the loss can be deducted.

Summary of new law

1.16 This Exposure Draft would create an exploration development incentive for Australian resident investors in small mineral exploration companies. Investors may be entitled to a refundable tax offset or franking credits where the company in which they have invested issues them an exploration credit (a conversion of a tax loss from exploration or prospecting into an immediately distributable tax benefit).

1.17 Companies may issue exploration credits to their shareholders up to a capped amount. A company's cap is based on its exploration or prospecting expenditure and tax loss for the relevant income year, adjusted by a modulation factor to ensure that the total value of credits provided in respect of an income year does not exceed $25 million for 2014-15, $35 million for 2015-16 and $40 million for 2016-17.

1.18 Companies that issue exploration credits in excess of their maximum entitlement will be subject to excess exploration credits tax on the amount of the excess.

Comparison of key features of new law and current law

New law	*Current law*
Eligible mineral exploration companies can utilise their tax losses: • to reduce their taxable income in later years; or • to the extent the loss results from eligible exploration expenditure, to create exploration credits up to their maximum exploration credit entitlement.	Mineral exploration companies can generally only utilise tax losses to reduce their taxable income in later income years.
Australian resident entities that are not corporate tax entities and receive exploration credits are entitled to a tax offset equal to the amount of the credit. For individuals, superannuation funds and certain trustees, this offset will be	No equivalent provisions.

New law	*Current law*
a refundable tax offset.	
Australian resident trusts and partnerships that receive exploration credits may be able to provide their members with a share of the exploration credit so that their members may obtain the tax offset.	No equivalent provisions.
Australian resident corporate tax entities receiving exploration credits are entitled to a franking credit equal to the amount of the exploration credit.	No equivalent provisions.
Entities that create exploration credits in excess of their maximum exploration credit entitlement will be subject to excess exploration credit tax, and potentially, shortfall penalties in respect of that amount.	No equivalent provisions.

Detailed explanation of new law

1.19 Schedule # to this Bill amends the tax law to establish the exploration development incentive. There are three key components of the incentive.

1.20 First, this Schedule creates an exploration development incentive by way of:

- a tax offset (the exploration development incentive (EDI) tax offset) which is available to certain Australian resident investors that receive exploration credits; and
- additional franking credits for corporate tax entities that receive exploration credits.

1.21 Secondly, it establishes a framework for eligible companies to give up a portion of their tax losses from greenfields exploration to create and issue exploration credits to their shareholders (and other holders of equity interests).

1.22 Finally, it introduces the excess exploration credits tax to apply to companies that issue exploration credits in excess of their maximum entitlements.

1.23 Overall, the incentive will allow eligible exploration companies to convert a portion of their tax loss to exploration credits which can be provided to shareholders to entitle the shareholders to an equivalent tax benefit.

Exploration development incentive tax offset

Exploration development incentive tax offset — general case

1.24 Schedule # amends the ITAA 1997 to introduce a tax offset available to Australian resident taxpayers that receive exploration credits, provided that the taxpayers are not corporate tax entities.

1.25 Consistent with the rules for the tax offset for franking credits, the EDI tax offset is only available to taxpayers that are resident in Australia for the whole of the relevant income year. This addresses integrity concerns around providing offsets to non-residents who may have no other association with the Australian tax system.

1.26 The amount of the offset in an income year for a particular taxpayer is the value of the exploration credits the taxpayer has received in that income year. The offset will generally be available to the taxpayer in the year following the year in which the company undertaking the exploration incurred its exploration or prospecting expenditure.

1.27 The offset is refundable to taxpayers that are individuals, superannuation funds and certain charities and not-for-profit entities that are eligible for refunds of franking credits (referred to in the tax law as exempt entities eligible for a refund see Subdivision 207-E of the ITAA 1997).

1.28 As entitlement to the EDI tax offset is likely to vary significantly between income years, the offset will not be taken into account in determining taxpayers pay-as-you-go instalments.

1.29 This Schedule also amends the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act* 1936 (ITAA 1936) to cover the EDI tax offset. This will ensure that taxpayers who enter into tax avoidance schemes with the predominant purpose of accessing the EDI will not benefit from the incentive.

Exploration development incentive tax offset — life insurers

1.30 Consistent with the imputation system and income tax law more generally, these amendments include special rules for corporate tax entities that are life insurance companies.

1.31 Life insurance companies are eligible to receive the EDI tax offset in relation to some of their exploration credits. Specifically, life insurers hold significant assets wholly on behalf of their policy-holders rather than for the benefit of their shareholders.

1.32 For the purposes of the income tax law and the imputation system, these assets held on behalf of policy holders are taxed and eligible for refundable imputation credits consistent with the treatment these assets would receive if they were held in comparable investment arrangements such as superannuation funds or managed investment trusts.

1.33 These amendments provide that life insurance companies will be eligible to obtain the EDI tax offset in the same circumstances they would be eligible to obtain a refundable tax offset under the imputation system. That is, they can obtain the EDI tax offset respect of that portion of exploration credits they receive in respect of investments they hold on behalf of policy-holders, provided the offset is applied wholly for the benefit of policy-holders.

Exploration development incentive tax offset — trusts and partnerships

General rules for trusts and partnerships

1.34 Schedule # also provides special rules for trusts and partnerships that are neither corporate tax entities nor exempt entities entitled to a refund.

1.35 While trusts and partnerships are entities for income tax purposes, they generally do not have income tax liabilities or entitlements of their own. Instead, trusts and partnerships are generally flow-through entities for income tax purposes, with the tax consequences of their entitlements being passed on to their members.

1.36 Where a trust or partnership is issued with an exploration credit or credits in an income year, they may provide a member of the trust or partnership with a statement entitling that member to a share of the exploration credit or credits the trust has received.

1.37 The member is then entitled to claim the EDI themselves as if they had been issued with that share of the exploration credit or credits directly in that income year. Further, if the member is a trust or partnership they are similarly able to pass on the benefit of the credit they have received to their own members.

1.38 The offset is not available to the trust or partnership to the extent a member has been made entitled to part of the tax offset. This ensures that there can be no double benefit from the tax offset.

Restrictions on providing the benefit of the offset to members

1.39 There are however, a number of restrictions that apply to the transfer of the benefit of an exploration credit to the member. A trust or partnership must have regard to the terms of the trust instrument or partnership agreement when determining shares of exploration credits that can be made available to particular beneficiaries or partners.

1.40 For trusts, this means that a beneficiary's share of the exploration credits received by a trust must the same as the share the beneficiary would be entitled to receive of an equivalent franked distribution from the same source. Similarly, for partnerships, the share of exploration credits provided to a partner must also be the same as the share the partners would be entitled to receive of an equivalent franked distribution from the same source.

1.41 Where a trust or partnership purports to issue a member with a share that would not be consistent with what a member could receive if the exploration credits were instead a franked distribution, the member will not be able to benefit from the share of the exploration credits.

Example 1.1

Rob is an Australian-resident beneficiary of RK Family Trust, a discretionary trust that has made a family trust election under subsection 272-80 in Schedule 2F to the ITAA 1936.

In May 2016, RK Family Trust is issued with exploration credits with a value of $100, by GME Co, a greenfields minerals explorer in which in which the trustee of RK Family Trust, Trustee Co, holds ordinary shares on trust.

In June 2016, under the terms of the trust deed Trustee Co resolves to distribute $50 of the exploration credits to Rob. It makes a determination that Rob should be entitled to this amount and provides Rob with a statement to this effect in the form approved by the Commissioner (see paragraph 1.58). Trustee Co must provide the statement to Rob by the time Trustee Co must lodge the income tax return for RK Family Trust for the 2015-16 income year.

As a result, Rob is now taken to have been issued with $50 of the exploration credits that were issued to the trust in the 2015-16 income year. As an individual resident in Australia for the relevant income year (the 2015-16 income year) he is entitled to a $50 refundable tax offset in respect of these credits, which he may claim in his tax return for that year.

So if Rob's tax payable on his taxable income for the 2015-16 income year is less than the $50 amount of exploration credits he has received, he'll be entitled to a refund of the difference.

To the extent Rob is entitled to this $50 amount of exploration credits, neither the trust nor any other beneficiary of the trust can benefit from these credits.

As a discretionary trust, the deed of the RK Family Trust places no restrictions on what entitlements can be provided to particular beneficiaries, so there is no restriction of the share of the exploration credits issued to the trust that Rob can receive.

However, if the terms of deed for RK Family Trust did restrict the amount that Rob could receive of a comparable franked distribution from the same source, Rob would not be entitled to the benefit of the exploration credit unless his share of the exploration credit was consistent with the share he could receive of a comparable franked distribution.

1.42 Further, beneficiaries and partners will also not be able to benefit from the EDI if they would not be entitled to obtain a tax offset in respect of a franking credit relating to a franked distribution made from the same entity in the same circumstances. This means that, amongst other things, the benefit of the EDI will generally not be available to beneficiaries of discretionary trusts that are not subject to a family trust election as they are not able to satisfy the qualified person rules in relation to a franked distribution (see sections 207-145 and 207-150 of the ITAA 1997).

Example 1.2

Continuing from the Example 1.1, Rob would also not be taken to be entitled to a share of the exploration credit or tax offset if he would not have been entitled to a tax offset in relation to an equivalent franked distribution that flowed indirectly to him through RK Family Trust as a result of the integrity rules in Division 207 of the ITAA 1997.

1.43 Trusts or partnerships that pass on the benefit of exploration credits they receive to their members must report this to the Commissioner of Taxation (Commissioner) in the approved form. This ensures that the Commissioner can ensure compliance with the EDI rules through data matching and can pre-fill individual income tax returns with entitlements to the EDI.

Trusts that are taxed on income in the trust but are not corporate tax entities

1.44 In certain circumstances trusts (or more specifically, the trustee of the trust) may be obliged to pay tax on the income of the trust rather than the income being attributed to beneficiaries. This can include, for example, cases where the beneficiary is under a legal disability.

1.45 To the extent that the exploration credit would be income of this sort were it received as a franked distribution in the same circumstances, the trust may itself receive the EDI tax offset as a refundable tax offset.

1.46 However, as outlined in paragraph 1.40 the offset is not available to the trust to the extent a member has been made entitled to a share of the exploration credit.

1.47 The offset is refundable only in cases where the trustee is taxed on this income as if the trustee were an individual.

Exploration development incentive tax offset – corporate tax entities

1.48 Corporate tax entities are generally not entitled to the EDI tax offset even where they receive exploration credits.

1.49 Unlike trusts or partnerships, corporate tax entities are not flow-through entities and are subject to tax on their own behalf. However, to reduce double taxation of corporate profits, corporate tax entities are entitled to franking credits where they pay tax or receive franking credits from investments in other corporate tax entities, which they can pass on to their members.

1.50 Due to the operation of the imputation system, providing corporate tax entities with a tax offset provides limited benefits to their members.

1.51 Instead of providing corporate tax entities that receive an exploration credit with an EDI tax offset or allowing them to transfer the exploration credit to their members, they instead receive a the same amount as a franking credit in their franking account. Providing the benefit of the EDI in this way allows it to be readily passed on to members of corporate investors without the significant compliance burden that would arise from the creation of a new system to allow for companies to retain and distribute exploration credits.

Example 1.3

Antony is the sole shareholder in AP Ltd, an Australian resident company. AP Ltd holds a number of the ordinary shares in Grieg Explorations, a greenfields minerals explorer.

In May 2016, Grieg Explorations issues $120 in exploration credits to AP Ltd.

As AP Ltd is a corporate tax entity that is not a life insurance company it is not entitled to receive an EDI tax offset. However, as AP Ltd meets all of the other requirements to receive the EDI tax offset, it is entitled instead to receive a franking credit equal to the amount of the exploration credits it has received.

In June 2016, AP Ltd declares a dividend and pays a distribution to Antony. Assuming the other franking requirements are met, it may use the franking credit that arose from its receipt of the exploration credits to frank this distribution, and provide Antony with a tax offset equal to the amount to the franking credit he received.

1.52 Corporate tax entities that are life insurance companies are only entitled to a franking credit in respect of an exploration credit to the extent that they are not entitled to the EDI tax offset in respect of the credit.

1.53 That is, consistent with their treatment for imputation, life insurance companies obtain a franking credit in respect of that proportion of a exploration credit they receive in respect of investments they hold on their own behalf, while being entitled to a refundable tax offset in respect of that proportion of an exploration credit they receive in respect of investments they hold for their policy-holders.

Creating and issuing exploration credits

Eligibility to issue exploration credits

1.54 Broadly, as outlined above, taxpayers may be entitled to the EDI if they receive an exploration credit or credits.

1.55 Schedule # provides that exploration credits can be created and distributed in an income year by an entity that was a greenfields minerals explorer in the prior income year.

1.56 However, an entity cannot create exploration credits in an income year unless they have reported their estimated exploration expenditure and estimated tax loss for the prior income year to the Commissioner in the approved form and the Commissioner has issued a

determination of the modulation factor for the credits created in that income year.

1.57 These requirements ensure that the annual caps on the total financial impact of the EDI can operate. See paragraph 1.79 for a detailed discussion of these caps and this requirement.

Greenfields minerals explorer

1.58 A ***greenfields minerals explorer*** for an income year is an entity that has not carried on any mining operations (within the ordinary meaning of the term, consistent with the existing use of the term in paragraph 40-730(7)(a)) in an income year. Further, no mining operations may have been carried out by another entity that is connected with or an affiliate of the first entity.

1.59 'Connected with' and 'affiliate' are both defined within the existing tax law. Broadly, they apply to entities that control the first entity, are controlled by a third entity that also controls the first entity or which the first entity itself controls (see Subdivision 328-C of the ITAA 1997). In this context control may be direct or indirect.

1.60 These limitations reflect that the concession is intended to benefit small mineral exploration companies with limited revenue. Companies that have established mining operations will not be able to access this incentive. Similarly, entities that may themselves be small but which form part of a larger grouping of entities, some of which engage in mining, will not and are not intended to be able to participate in the EDI. Such entities would receive limited benefits in any case, as they will generally have assessable income from their mining activities which means that the deductions available for the exploration or prospecting expenditure would have already provided an immediate tax benefit, particularly if the group is consolidated for tax purposes.

1.61 A ***greenfields minerals explorer*** must also be a disclosing entity (within the meaning of section 111AC of the *Corporations Act 2001*) and a constitutional corporation.

1.62 The requirement that a greenfields minerals explorer be a disclosing entity is intended to achieve two purposes. First, it targets the concession to entities that are seeking to raise capital from the general public, maximising the potential effect of the incentive (and reducing the scope for manipulation that might apply for closely-held entities). Secondly, it also excludes the need to establish a new reporting regime for greenfields minerals explorers – instead companies will be able to provide the same information for the purposes of the EDI and *Corporations Act 2001*.

1.63 The requirement that the entity be a constitutional corporation ensures that a refund of the EDI tax offset is appropriately supported by the constitutional powers of the Commonwealth.

1.64 Finally, a ***greensfields minerals explorer*** must incur greenfields minerals expenditure in the relevant income year.

Greenfields minerals expenditure

1.65 Expenditure related to exploration and development of mineral resources is already subject to a number of concessions and special rules in the income tax law.

1.66 Amongst other things, entities are generally entitled to immediately deduct all expenditure incurred on exploration and prospecting (section 40-730 of the ITAA 1997). While the purpose of this provision is to ensure that entities are able to immediately deduct capital expenditures which otherwise would not be immediately deductible, it applies to all expenditure for exploration or prospecting, whether capital or revenue, other than that relating to depreciating assets (See paragraphs 7.7 to 7.28 of the explanatory memorandum to the New Business Tax System (Capital Allowances) Bill 2001).

1.67 Entities are also entitled to immediately deduct the full value of any depreciating assets used in these activities (section 40-80 of the ITAA 1997).

1.68 Schedule # provides that an entity's ***greenfields minerals expenditure*** will be the amount it can deduct as a result of these provisions. If an amount would be deductible under one of these provisions but is not deductible because of some other provision, the relevant amount is not greenfields minerals expenditure.

1.69 However, there are a number of qualifications on what exploration expendure will constitute greenfields minerals expenditure to ensure that amounts are sufficiently connected to exploration and prospecting in greenfield areas.

1.70 First, as greenfields minerals expenditure is intended only to cover exploration of mineral resources, amounts deductible under these provisions that relate to expenditure undertaken as part of exploration for quarry materials, oil shale and petroleum are not greenfields minerals expenditure.

1.71 Secondly, amounts deductible under these provisions for activities relating to determining the economic viability of an already identified resource are also not greenfields minerals expenditure.

1.72 Thirdly, deductible expenditure that relates to an area which an assessment under the Joint Ore Reserves Committee Code has identified may contain a mineral resource of ore body with a level of confidence of inferred or greater will not be greenfields minerals expenditure. After an area has been identified as containing at least an inferred resource, the degree of confidence in the existence of the resource means that the expenditure has ceased to relate to finding the resource and instead relates to the quantification and development of the resource.

1.73 It should be noted that area in this context refers to the area identified in the relevant Joint Ore Reserves Committee assessment, not the entirety of the greenfields exploration area in which the resource is located.

1.74 Finally, deductible amounts relating to exploration outside of Australia, or in Australia's marine territory are not included as greenfields minerals expenditure.

1.75 The purpose of this exclusion is twofold. As the EDI is only intended to apply to exploration in Australia, deductible expenditure relating to areas outside of Australian territory is excluded. Additionally, due to the considerable costs and limits on existing extraction and recovery techniques, the only significant offshore exploration is undertaken by large companies engaged in petroleum extraction. As neither these entities nor these activities are intended to benefit from the offset, the amounts of deductions incurred in relation to these areas are also excluded from being greenfields minerals expenditure.

Creating exploration credits — amounts and consequences

1.76 Entities that are greenfields minerals explorers may choose to create exploration credits in an income year. The amount of an entity's tax loss for the previous income year is reduced by the amount of the exploration credits it creates.

1.77 The amount of the credits an entity chooses to create must not exceed its maximum exploration credit amount, which is the smallest of its:

- reported estimated tax loss for the prior income year (see paragraph 1.58);
- reported estimated greenfields minerals expenditure for the prior income year (see paragraph 1.58);
- actual tax loss for the prior income year; and

- actual greenfields minerals expenditure for the prior income year,

multiplied by the corporate tax rate and the modulation factor declared by the Commissioner.

1.78 There are two components to the maximum exploration credit amount. First, entities may only issue credits up to the amount of the lesser of their tax loss or greenfields minerals expenditure in the prior income year. As outlined previously, the purpose of the EDI is to allow small mineral exploration companies to transfer the benefit of that part of their tax loss that arose from exploration to their shareholders. Allowing them to exceed the amount of either their tax loss or their exploration expenditure would provide a greater and unintended benefit not related to greenfields exploration.

1.79 Secondly, the amount of exploration credits an entity may issue must not exceed the estimates of its loss and expenditure in the prior income year that it has provided to the Commissioner (see paragraph 1.58).

1.80 The total financial impact of the EDI is capped in respect of each of the three income years in which it operates. This global cap is implemented by imposing a limit on the value of the on exploration credits entities may issue, based on the total value of exploration credits that could be issued in that year. This Schedule provides that this limit, referred to as the modulation factor, is to be determined by the Commissioner.

1.81 As the modulation factor will affect the amount of exploration credits that can be created, no entity can create exploration credits in an income year before the modulation factor for that year has been declared by the Commissioner.

1.82 Given this modulation factor must be set at a level to ensure the total amount of exploration credits issued does not exceed the cap, it can only be determined once full value of the exploration credits that can be claimed is known. Determining this based on entities' actual loss and expenditure for an income year would require deferring the issue of the modulation until all greenfields minerals explorer have received their income tax assessment for the relevant income year. This would result in a very significant lag in the issuing of credits.

1.83 To reduce this lag, the cap is instead based on entities' estimates of their tax loss and greenfields minerals expenditure for the relevant income year, which must be reported to the Commissioner by 30 September in the following income year. However, for the cap to be

effective when determined using estimated tax losses and expenditure, the amount of exploration credits that can be created must also be no greater than the amount of these estimates.

1.84 The Commissioner's declaration of the modulation factor for an income year is a legislative instrument. The declaration is essentially the result of a mechanical calculation in relation by the Commissioner. More significantly, the modulation factor has immediate consequences for commercial and corporate arrangements. Revising or withdrawing the modulation factor after entities have begun the process of creating or issuing credits would undermine these arrangements and potential expose taxpayers to significant compliance costs and penalties in respect of something that is wholly beyond their control. Therefore it is not appropriate for the legislative instrument to be subject to Parliamentary disallowance.

1.85 To protect taxpayers from similar issues in the event of an error by the Commissioner, the validity of the Commissioner's declaration of the modulation factor for an income year is not affected if the Commissioner errs in complying with the process set out for the calculation of the modulation factor.

1.86 The choice whether or not to create exploration credits for an income year must be made before 30 June of the financial year corresponding with the income year. The choice is final and irrevocable – if a taxpayer chooses to create credits of a particular amount, or does not choose to create credits, it is not possible to subsequently change decision. Greenfields minerals expenditure that is not used to create exploration credits cannot be carried forward and used to create credits in subsequent income years.

1.87 Ensuring the decision to create credits cannot be revised or undone ensures that the entitlements of recipients of exploration credits will be fixed and avoids the complexities and potential abuses that might result from the creation of exploration credits at different time in an income year. It also minimise compliance costs for greenfields minerals explorers, their members and the Commissioner.

Example 1.4

GME Co is a publicly listed mineral exploration company that holds a number of exploration licences covering areas of South Australia.

In 2014-15, GME Co incurs significant expenditure exploring for minerals in the areas covered by its exploration licences.

GME Co decides that it may wish to access the EDI in respect of its exploration expenditure in 2014-15. It identifies that it is a greenfields

minerals explorer for 2014-15 as at no time in this year does GME Co or any of its connected or affiliated entities carry on any mining operations and it meets all other requirements to be a GME.

To ensure it is eligible to access the EDI and issue credits in respect of this expenditure in 2015-16, GME Co must also report its estimated tax loss and greensfields minerals expenditure for 2014-15 to the Commissioner by 30 September 2014. On 28 September 2014, GME Co declares to the Commissioner that its estimated tax loss and greenfields minerals expenditure for 2014-15 are $1.2 million and $1 million respectively.

On 1 November 2015, the Commissioner determines the modulation factor for exploration credits issued in 2015-16 to be 0.5. Following this, on 1 December 2015, GME Co lodges its tax return for 2014-15 and receives its assessment. Consistent with its estimate, GME Co has a tax loss of $1.2 million and has incurred greenfields minerals expenditure of $1 million.

As a result, GME Co's maximum exploration credit amount is $150,000. This amount is the product of the least of its actual and estimated tax loss and greenfields minerals expenditure in 2014-15 ($1,000,000), the corporate tax rate for 2014-15 (0.30) and the modulation factor determined by the Commissioner (0.5).

GME Co chooses to create exploration credits up to its maximum exploration credit amount - $150,000. As a result of creating these credits GME Co foregoes an equivalent amount of its tax loss for 2014-15 - $450,000 (calculated as the amount of exploration credits created ($150,000) multiplied by the corporate tax rate for the relevant income year (0.30)).

Issuing exploration credits

1.88 An entity that has created exploration credits may choose to issue some or all of those exploration credits to the members of the entity (generally its shareholders, but also other holders of equity interests in the entity).

1.89 If the entity does choose to issue exploration credits, the amount issued to each member must be in proportion to the number of equity interests (generally their shares, but see the rules for debt and equity interests in Division 974 f the ITAA 1997) the member holds as a proportion of the total equity interests in the entity.

1.90 Unlike access to franking credits, the issue of exploration credits to members is not linked to a distribution out of profits. As a result, the rules that generally apply around the distribution of profits under the *Corporations Act 2001* do not apply to the issuing of exploration credits.

1.91 In the absence of any link to the rules applying to distributions, Schedule # requires exploration credits be issued strictly in proportion to the number of equity interests each member holds.

1.92 One exception applies to this rule. Before an entity issues any exploration credits, it may elect to restrict the availability of the EDI to equity interests issued on or after 1 July 2014.

1.93 The principal purpose of the EDI is to provide an incentive for investment. This purpose could be achieved by restricting the incentive to new capital issued after the incentive has been announced.

1.94 However, the compliance costs associated with this approach may be significant – at a minimum greenfields minerals explorers would need to arrange for separate trading of pre-EDI and post-EDI interests. Taking into account these compliance costs, exploration credits are generally to be issued to all entities holding equity interests in the greenfields minerals explorer.

1.95 However, some entities may not face these compliance costs or consider them to be worthwhile given the additional incentive. To accommodate these cases, Schedule # provides for greenfields minerals explorers to choose for the incentive to be available only for equity interests issued on or after 1 July 2014. To avoid ongoing complexity, this choice is irrevocable and must be made prior to an entity issuing any exploration credits.

1.96 Entities that issue exploration credits must notify the Commissioner in the approved form. If the entity is an investment body under section 202D of the ITAA 1936 this notification must be provided at the same time as the annual investment income report for the entity. Otherwise, the notification must be lodged at the same time as the entity's income tax return for the relevant income year.

Example 1.5

Continuing from Example 1.4, GME Co chooses to issue the $150,000 of exploration credits it has created to its shareholders on 1 June 2016.

GME Co has only one class of shares, with 6 million shares on issue, held by a number of shareholders including Investor Co, which holds 300,000 shares.

GME Co must issue exploration credits to shareholders in proportion to the fraction of the total shares in GME Co that they hold.

This means that Investor receives $7,500 of exploration credits or 5 per cent of the total of $150,000 of credits as it holds 5 per cent of the issued shares of GME Co (300,000 out of 6 million).

As Investor Co is a corporate tax entity, it is not entitled to claim a tax offset in respect of the credits in its tax return for the 2015-16 income year. Instead, when Investor Co receives the exploration credit (1 June 2016), it receives a credit in its franking account equal to the amount of the exploration credit.

After distributing exploration credits, GME Co must report to the Commissioner in the approved form on or before the date when it must lodge its annual investment income report for 2015-16 – 31 October 2016.

Excess exploration credit tax

1.97 Under the provisions set out in Schedule #, entities may not issue exploration credits in excess of the maximum exploration credit amount.

1.98 However, breaches of the cap can occur for a number of reasons. In some cases the breach may not be identified for a number of years – for example, if the entity made an error in determining its tax loss in the income year that was only identified in a subsequent Australian Taxation Office audit.

1.99 Where such a breach of the cap is found, it would generally be inappropriate to penalise the recipients of these credits for matters that are generally entirely beyond their control (however, different circumstance apply where the general anti-avoidance rules applies). Instead, where it is identified that excess exploration credits have been issued, the entity that issues credits in excess of its cap will be subject to excess exploration credit tax on the amount by which the cap for the relevant year was exceeded.

Example 1.6

In May 2016, SP Ltd determined that, for the 2014-15 income year, it had an actual tax loss of $100,000 and actual minerals exploration expenditure of $125,000. In its report to the Commissioner, it had estimated its tax loss to be $110,000 and its mineral exploration expenditure to be $150,000.

Based on these figures, and the Commissioner's determination of a modulation factor of 0.5 for 2015-16, SP Ltd works out its maximum exploration credits amount for 2015-16 to be $15,000, calculated as the product of:

the least of its actual and estimated tax losses and exploration expenditure for 2014-15) - $100,000
the corporate tax rate for 2014-15 – 0.3
and the modulation factor determined by the Commissioner for 2015-16 – 0.5

In June 2016, SP Ltd issues exploration credits to its members up to its maximum exploration credit cap - $15,000.

Subsequently, in October 2016, SP Ltd is audited by the Commissioner. In the course of this audit, it is identified that SP Ltd, despite taking reasonable care, has made an error in the calculation of its tax loss for the 2014-15 income year, and the amount of its tax loss should only have been $50,000.

The change in SP Ltd's actual tax loss for the 2014-15 income year reduces its maximum exploration credit amount to $7,500 (calculated as $50,000*0.3*0.5). To the extent the amounts of credits SP Ltd has issued exceed this amount, SP Ltd is liable for excess exploration credit tax of an amount equal to the excess - $7,500. This does not affect the validity of the excess exploration credits in the hands of SP Ltd's shareholders.

The Commissioner then provides SP Ltd with an assessment for the amount of the excess exploration credit tax, which SP Ltd must then pay within 21 days of receiving notice of the assessment.

1.100 Rather than introducing a new assessment regime, Schedule # includes excess exploration credits tax in the general tax assessment regime set out in Division 155 in Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953).

1.101 Excess exploration credit tax is due and payable 21 days after the Commissioner assesses the taxpayer as being liable to the tax. Amounts unpaid after this time will be subject to the general interest charge. Overpaid amounts of excess exploration credit tax are treated in the same way as overpayments of income tax under section 172 of the ITAA 1936.

1.102 Taxpayers are required to keep the same records for the purposes of the excess exploration credits tax as they are under section 262A of the ITAA 1936 for income tax.

Additional consequences of issuing excess exploration credits

1.103 A variety of additional consequences may apply in circumstances where a taxpayer incurs a liability for excess exploration credits.

1.104 In particular, the amendments provide that the amount of excess exploration credit tax is also a shortfall amount for the purposes of the administrative penalties provisions of the Division 284 in Schedule 1 to the TAA 1953.

1.105 To the extent an entity has a shortfall amount that has arisen due to a failure to take reasonable care, recklessness or intentional disregard of the tax law, the entity is liable for additional administrative penalties. As a result, where an entity incur excess exploration credit tax they may also be liable for additional administrative penalties.

1.106 Schedule # also provides that the Commissioner may, by written notice, determine that an entity that has incurred a liability for excess exploration credit tax will no longer be a greenfields minerals explorer and may no longer participate in the EDI. This determination has effect for exploration credits issued after the notice of the determination has been received by the taxpayer.

1.107 It is expected in exercising this discretion that the Commissioner will take into account the circumstances in which the excess exploration credits were created and the degree of the entity's culpability (or lack thereof).

1.108 The EDI is a concessional regime provided to a very limited class of entity. Similar to other comparable regimes such as the research and development tax incentive, the Commissioner is provided with a wider power to exclude subsequent access to the scheme by taxpayers who have been identified as seeking to make inappropriate use of the concession.

Example 1.7

> Continuing from Example 1.6, the amounts of SP Ltd's excess exploration credit tax liability would also be a shortfall amount under section 284-80 in Schedule 1 to the TAA 1953.
>
> As SP Ltd took reasonable care to comply with its tax obligations, it will not be subject to any administrative penalty as a result of this shortfall amount.
>
> If SP Ltd had failed to take reasonable care or had not taken a reasonably arguable position where one was required, or if the shortfall amount had arisen because SP Ltd either recklessly or intentionally disregarded a taxation law, the SP Ltd would be subject to an administrative penalty under Division 284 in Schedule 1 to the TAA 1953.

Additionally, as SP Ltd has incurred a liability for excess exploration credit tax, the Commissioner has the power to determine that SP Ltd will not be a greenfields minerals explorer for the purposes of subsequent participation in the EDI.

The exercise of this power is a matter for the Commissioner's discretion. However, given that in this case the liability arose despite SP Ltd taking all reasonable care, absent further considerations it is expected that the Commissioner would not chose to exercise this discretion.

1.109 The Commissioner's determination is subject to merits review in the manner set out in Part IVC of the TAA 1953.

Consequential amendments

1.110 A number of consequential amendments are made to the tax law, especially to guide material, checklists and definitions, to reflect the introduction and operation of the EDI.

Application and transitional provisions

1.111 The measure applies to greenfields minerals expenditure for the 2014-15, 2015-16 and 2016-17 income years, allowing the distribution of credits in the 2015-16, 2016-17 and 2017-18 income years.