Submission to The Treasury:

Treasury Laws Amendment (R&D Incentive) Bill 2018

ASSOCIATION OF MINING AND EXPLORATION COMPANIES

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Contents

Prepared by

Association of Mining and Exploration Companies Inc (AMEC)
The Association of Mining and Exploration Companies (AMEC) is the peak national industry body for hundreds of mining and mineral exploration companies throughout Australia.

Head Office
6 Ord Street, West Perth WA 6005 (Offices located in Perth, Brisbane and Sydney)
Please address all correspondence to PO Box 948 West Perth WA 6872
P: 08 9320 5150 E: info@amec.org.au www.amec.org.au

1. EXECUTIVE SUMMARY

Thank you for the opportunity to comment on the draft *Treasury Laws Amendment (Research and Development Incentive) Bill 2018* and Explanatory Materials.

The Association of Mining and Exploration Companies (AMEC) is the peak national industry body representing hundreds of mining and mineral exploration companies and service providers throughout Australia.

On behalf of our members, AMEC has a continuing direct interest in the Research and Development (R&D) Tax Incentive and strongly supports the provision of the Incentive as a mechanism by which the Government can promote business investment in innovation and R&D activities.

This is critically important in the context of an extremely competitive international investment market, and the natural resource growth potential and competitive advantage that Australia has in emerging mining sectors such as rare earths, lithium and battery related minerals.

When it was introduced in 2011, the Research and Development Tax Incentive (R&D Incentive) was particularly intended to support small and medium sized enterprises (SMEs) at a time when refundable R&D tax offsets have most impact.

The business operations of SMEs in the mining and mineral exploration sector are generally linked to R&D activities that might not otherwise be conducted without the Incentive because of the investment risk due to an unknown outcome and uncertain return from the activities.

In addition to promoting the continuation of this critically important initiative, AMEC has previously emphasised during the 2016 Review of the R&D Tax Incentive of the need to ensure that the administration and compliance burden on industry is minimised, whilst also meeting the Government`s Science and Innovation agenda. AMEC still maintains that view. However, many of these administrative related recommendations have largely been ignored, with the exception of the release of mining specific Guidance material in late 2016.

It is noted that these recommendations will also contribute to addressing some of the integrity concerns being expressed by Government.

In addition to a low administrative and compliance burden the industry needs clarity and certainty in public policy settings for long term financing and business decision making purposes. This includes the R&D Tax Incentive programme.

Unfortunately, in the case of the draft Amendment Bill under consideration:

- Industry will continue to be faced with extreme uncertainty in relation to critical eligibility provisions, and reduced cash refunds in light of a falling corporate tax rate,
- The Government`s public commitment to driving cutting edge research and development will not be met,
- There will be lost national economic and social opportunities,

- Australia`s international competitiveness will be detrimentally affected, which will push mobile R&D investment offshore where the concessions and incentives may be more attractive,
- The capacity of SMEs to development innovative, efficient and cost effective solutions to complex and capital intensive mining operations, flowsheets, mineral exploration programmes, and pilot mining will be significantly diminished, and
- The compliance and administrative burden will be significantly increased.

In summary, AMEC does not support the Amendment Bill in its current form.

Recommendation 1
The Amendment Bill should not be passed in its current form.

In the absence of any data, there is a clear need for further stakeholder consultation, and consideration of the national unintended consequences through release of a publicly available Regulatory Impact Statement.

Recommendation 2
A Regulatory Impact Statement should be prepared and made publicly available.

This submission addresses specific initiatives contained in the draft Amendment Bill, and other issues requiring attention.

2. RECOMMENDATIONS

Primary Recommendation 1
The Amendment Bill should not be passed in its current form.

In the event that the Bill is further debated in Parliament, the following secondary recommendations are made:

Recommendation 2
A Regulatory Impact Statement should be prepared and made publicly available.

Recommendation 3
That the R&D Intensity model be removed.

Recommendation 4
That the use of the 'expenditure' definition be aligned between accounting standards and tax rules.

Recommendation 5
That the mining and mineral exploration sector be excluded from the proposed $4 million cap.

Recommendation 6
Subject to the outcome of Recommendation 5,
That rare earths, lithium, strategic and battery related minerals be excluded from the proposed $4 million cap.

Recommendation 7
Confirm that mineral exploration companies are excluded from the 'annual aggregated turnover' test as they have no sales turnover.

Recommendation 8
The R&D offset rate should be maintained at the current rate of 43.5%.

Recommendation 9
The annual turnover threshold should be increased to, at least $25 million and indexed to inflation.

Recommendation 10
That a retrospective commencement date is not implemented.

Recommendation 11
The clawback and feedstock provisions should be made clearer.

Recommendation 12
Guidance material be released on the proposed anti-tax avoidance provisions.

The following administrative related recommendations are made regardless of the outcome of the Amendment Bill:

Recommendation 13
AusIndustry should publish sanitised versions of all Findings (ie Rulings) that are issued.

Recommendation 14
The sector specific guidance material should provide case studies on anonymised real-life examples.

Recommendation 15
There should be a more conciliatory approach to resolve issues, rather than what appears to be a legalistic regulatory role.

Recommendation 16
There should be improved direct and early engagement between AusIndustry and industry.

Recommendation 17
Regular training sessions / workshops should be held in key locations around Australia.

Recommendation 18
Retrospective application of findings should be limited to an agreed timeframe with peak industry bodies.

3. SPECIFIC COMMENTS ON THE SCHEDULES TO THE DRAFT AMENDMENT BILL

Schedule 1 – Main Amendments

R&D Intensity adds additional complexity

Considerable uncertainty will be created as a result of the R&D intensity calculation. Predicting with any accuracy a claimant`s total accounting expenditure, as well as R&D expenditure for an income year could result in some companies, prior to the end of the financial year, being unable to forecast what proportion of their expenditure may be eligible for incentivised treatment, and at what rate.

This uncertainty is further exacerbated by economic conditions, mineral commodity prices, exchange rates and global events.

The major proportion of AMEC members in production are likely to be severely impacted by the proposed Intensity test and find themselves in the lowest tier of R&D intensity due to their comparatively high operating costs. This would reduce the R&D benefit obtained from the current level of 8.5%, to 4%. These are the same companies which require assistance in their R&D activities in view of their lower margins and access to technical expertise.

Recommendation 3
That the R&D Intensity model be removed.

Alignment on the 'Expenditure' definition

As the proposed model is based on 'expenditure' it is fundamentally important that there is a clear and unambiguous definition. In this regard, the legislation appears to place significant reliance on 'accounting expenditure'. However, the Consultation Paper states "*the total expenditure will be based on that of the claimant, which would have to be retrieved from the claimant`s own tax return".*

As there is a mismatch between income tax law and accounting standards there may be a risk and uncertainty created by using a hybrid of rules. It should be noted that accounting standards are significantly less precise than taxation law.

The determination of a claimant`s 'R&D expenditure' using tax principles, whilst using accounting principles for the determination of 'total expenditure' will create further confusion, complexity, integrity issues, and potential for increased non-compliance.

The use of tax rules is also likely to unnecessarily result in the ATO taking a greater interest in the makeup of these amounts, thereby creating increased compliance costs for Government and claimants.

Recommendation 4
That the use of the 'expenditure' definition be aligned between accounting standards and tax rules.

Exclusion from the cap for mining and mineral exploration companies

The introduction of a $4 million cap on cash refunds for R&D claimants with aggregated annual turnover less than $20 million will have severe ramifications for the mining sector.

AMEC considers that the introduction of such a cap to be short sighted and extreme as it will become a major disincentive to innovative and capital intensive R&D mining activities, and has the potential to drive mobile R&D innovation offshore. It also has the potential to prevent mining projects from progressing.

It is noted that clinical trials in the medical and pharmaceutical industry will be excluded from the cap. However, there is no rationale in the Explanatory Material on the reason for such an exclusion.

AMEC considers that there is a clear case to introduce such a similar exclusion for the critically important mining and mineral exploration sector, particularly in view of the significant payback and national economic and social dividends that will be achieved.

This is even more significant and timely in view of a number of emerging trends in the mining and mineral exploration sector, such as:

- Existing mines are not being replenished at a sustainable rate,
- Existing mines will come to their natural end over the decade or two,
- Lower discovery rates, poor grades and deeper deposits, and
- High cost operating environment.

These trends all require an increased investment in critical innovation and technology. This is of great importance for the emerging rare earths, lithium, battery minerals, base and precious metals mining and exploration sectors.

The national economic and social importance of these sectors should be acknowledged by them being similarly excluded from the $4 million cap.

The critical importance of the current R&D Tax Incentive programme is highlighted in a recent media release[1] in relation to the Northern Minerals Limited Browns Range heavy rare earth pilot plant, which stated "*it would not have gone ahead if the R&D rebates had not been available at the level they were at the time. It is testament to the benefits of positive government policy."*

In the same media release, the internationally uncompetitive nature of the proposed changes were emphasized by the fact that the magnitude of R&D rebates in Germany would exceed four times that available in Australia.

It also emphasized that pilot mining is a fundamentally important component of the whole mine cycle, noting that some commodity markets are still being developed, such as rare earths, lithium and battery minerals. For these to develop, financing of new projects requires confirmation that the proposed technological, quality and economic outputs are achievable at acceptable and viable levels. This requires an extensive financial investment in R&D, including the development of mining

[1] https://lithium-au.com/media-archive - 18 July 2018 – Federal Government cuts to R&D rebates threaten Lithium Valley concept

flowsheets, mine design and pilot plants where the proposed type of mining, or orebody has never been done before.

Companies needing to undertake pilot mining to develop new technology, particularly in base, precious, rare earth and battery minerals are faced with a conundrum as they need critical funding to build and commission the pilot plant stage of the project. However, they are generally unable to raise those investment funds until they can test and prove that the plant can produce quality product at levels acceptable to future offtake partners. They also need to satisfy investors that they can produce the commodity at commercially acceptable rates, whilst also meeting financial forecasts.

This is further exacerbated by the fact that the pilot testing could take at least 3 years for this to occur, and can involve hundreds of millions of dollars. It is a stepping stone in the whole mine cycle which can take 10 years from the time of the original discovery.

Access to cash flow from the R&D Tax Incentive is therefore vital for start-up emerging miners who have limited access to capital. The proposed implementation of a $4 million annual cap for these companies will be disastrous and will have a direct impact on Australia`s capacity to maximize its resource potential. It will reduce future Government taxation revenue streams.

This change will create an immediate and major new barrier to value-adding opportunities and the development of a battery minerals processing industry in Australia, which is in conflict with the efforts of the Federal Government to promote the opportunity of value adding and downstream processing for battery minerals.

In addition, it will be contrary to the Government`s stated public policy intention to increase mineral exploration in greenfield areas to make new discoveries to replenish those mines that are coming to the end of their natural lives. The Government has committed funding of $100 million over 4 years towards the Junior Minerals Exploration Incentive for this to occur.

Recommendation 5
That the mining and mineral exploration sector be excluded from the proposed $4 million cap.

In the event that Recommendation 5 is not adopted, it is strongly recommended that rare earths, lithium, strategic and battery related minerals should be ‘carved out’ and specifically excluded from the proposed $4 million cap.

Independent research has shown that the exponential rise in demand in the global market for lithium rechargeable batteries presents a unique opportunity for Australia, and that a once-in-a-generation confluence of local advantages exists to achieve further downstream adding in Australia. This research also shows that there is a short window of opportunity to maximise these advantages.

In order for this to occur, critical innovative R&D will need to be undertaken, particularly as most mining and technological methodologies in these emerging strategic minerals are untested. Relevant companies will need access to an uncapped R&D Tax Incentive programme. The proposed $4 million cap will be inadequate for the special needs of this sector. If the cap is not

removed, it is highly probable that some of these projects will not be able to attract investment, and not go ahead. This will not be in the national interest.

Recommendation 6
That rare earths, lithium, strategic and battery related minerals be excluded from the proposed $4 million cap.

Aggregated annual turnover definition
There is an additional argument to exclude mineral exploration companies from the proposed $4 million cap based on the definition of 'aggregated annual turnover'.

In accounting terms, 'revenue' is defined as the income that a business has from its normal business activities. This is usually from the sale of goods and services to customers, and is referred to as 'sales or turnover'.

Mineral exploration companies have no sales 'turnover' as they do not generate any revenue from mining operations. They raise equity funding from shareholders, and a minor proportion of income from interest earned on term deposits, or from the sale of an asset (eg exploration project, mining information, goodwill).

As they do not appear to be caught by the $20 million 'annual turnover test', confirmation should be provided that mineral exploration companies are excluded from the proposed $4 million annual cap as they have no sales turnover.

Recommendation 7
Confirm that mineral exploration companies are excluded from the 'annual aggregated turnover' test as they have no sales turnover.

R&D tax offset rate
The proposed amendment to the refundable tax offset will tie the offset rate to 13.5% above the relevant corporate tax rate. This will have the effect of a significant reduction in the effective tax rate.

When the incentive was introduced in 2011, the R&D offset rate of 45% was specifically decoupled from the corporate tax rate so that claimants had certainty around the benefit they could receive.

Proposed progressive reductions (subject to passage of the Enterprise Tax Plan through Parliament) in the corporate tax rate from the current level of 30% to 27.5%, and then to 25%, will result in the R&D offset being ultimately lowered to 38.5%. This will represent an overall reduction of 6.5% over the longer term. This significant reduction will make Australia uncompetitive against such countries as Germany. The United Kingdom, United States, Canada and Singapore are understood to be making their R&D initiatives more competitive, and not reducing them.

AMEC is of the view that the R&D offset rate should be maintained at the current rate as the economic and social multipliers from doing so would far exceed any perceived annual budget savings.

Recommendation 8
The R&D offset rate should be maintained at the current rate of 43.5%.

Annual turnover threshold

The Amendment Bill proposes an increase in the $100 million R&D expenditure threshold to $150 million, allowing larger companies to continue to be rewarded for their additional R&D activity. However, there is no change in the $20 million annual aggregated turnover threshold. It is noted that this threshold has not changed since the R&D Tax Incentive was introduced in 2011.

Yet in the 2019 financial year the threshold for companies being able to access the base rate for the 27.5% corporate tax rate will be $25 million. This is a clear inequity and should be rectified.

Recommendation 9
The annual turnover threshold should be increased to, at least $25 million and indexed to inflation.

Retrospective commencement date

AMEC understands that there is an intention to have a retrospective commencement date of 1 July 2018.

In that event, it is likely that a large number of applicants would have already planned their activities for the 2018/19 financial year based on the existing R&D incentive framework, and their forecast financial rebates.

The subsequent implementation of retrospective legislation which has the potential to change claimant eligibility, and reduce their allowable claim, will create extreme uncertainty, non-compliance and potential financial stress.

Recommendation 10
That a retrospective commencement date is not implemented.

Schedule 2 – Integrity measures

Clawback of grants and feedstock

The proposed amendment in Part 2 introduces a new complicated formula which compares the offset claimed with the amount that would have been received if notional deductions were reduced by the clawback amounts calculated for the income year. These should be made clearer.

Recommendation 11
The clawback and feedstock provisions should be made clearer.

Anti-tax avoidance provisions

It is understood that increased anti-tax avoidance provisions will be introduced to prevent companies from restructuring themselves to exploit the Incentive. This could be further complicated in circumstances where Joint Venture arrangements may exist, or R&D entities have been formed within or between large corporate groups to achieve a high R&D intensity.

Safe harbour guidance material should be released on the proposed ant-tax avoidance provisions for when companies are considering restructuring themselves.

Recommendation 12
Guidance material be released on the proposed anti-tax avoidance provisions.

Schedule 3 – Administrative matters

Public Reporting
The Amendment Bill proposes that the Commissioner is required to publish information about the R&D entity`s notional deductions claimed taking into account any feedstock adjustments for the year.

AMEC considers that this is commercially sensitive information and should not be publicly disclosed, as it could result in the company losing any competitive advantage it may hold.

Board Delegation
Part 3 provides for the Board of Innovation and Science Australia to delegate some or all of its powers to a member of the Australian Public Service staff. As this expands the existing delegation power, great care should be taken to prevent any unintended consequences in implementing such an initiative to 'high volume, low risk functions' to improve efficiency and timeframes.

Issues such as the making of 'Reviewable Decisions' should be confined to Senior Executive Service staff. This will also recognise the importance of such decisions, and the considerable expenses incurred by claimants associated with any such decisions.

Extension of times
AMEC notes the proposed amendment to limit the period allowed for providing information to 3 months.

Care should be taken to ensure that there are no unintended consequences in limiting such action to 3 months, particularly where 'special circumstances' may be applied, and which could cause a longer delay in providing relevant information.

4. OTHER ISSUES REQUIRING ADDRESSING

AMEC has previously emphasised, during the 2016 Review of the R&D Tax Incentive programme, the need to ensure that the administration and compliance burden on industry is minimised, whilst also meeting the Government`s Science and Innovation agenda. AMEC still maintains that view although mining specific guidance material was released in late 2016.
It is noted that these recommendations will contribute to addressing some of the integrity concerns being expressed by Government.

In order to achieve that, there continues to be a clear need for programme administration improvements such as:

1. Improved transparency, and early effective engagement / direct liaison between AusIndustry and industry,

2. Regular training, and
3. Limiting retrospective application of findings.

Improved transparency, and early effective engagement / direct liaison between AusIndustry and industry

In order to improve transparency and accountability, AusIndustry should publish sanitised versions of all Findings (ie Rulings) that are issued. This is a similar concept to the ATO Private Binding Rulings (PBR) Register, which is available on their website and can be searched. This will help with consistency of interpretation and accountability.

This will most effectively address uncertainty about AusIndustry's interpretation of the legislation in relation to activities conducted by this sector. Sectoral guidance should build on the Guide to Interpretation. A case study approach to exemplify the application of the legislation should provide more examples illustrating the R&D activity tests. A case study approach drawing on anonymised real-life examples should also build on the hypothetical case studies previously prepared for other sectors.

Recommendation 13
AusIndustry should publish sanitised versions of all Findings (ie Rulings) that are issued.

Interpretative guidance that is developed with regard to real-life issues and with cooperative stakeholder engagement will support non-adversarial integrity assurance in the longer term.

AMEC is advised that it has been challenging to understand some of AusIndustry's interpretation of the legislation and issues as they have given limited dialog and feedback to industry. This approach has led to statutory examination of registered activities for a number of minerals sector companies.

Industry advises that AusIndustry may be evolving its guidance led approach to integrity assurance for the minerals sector by turning its attention to additional scrutiny of R&D registrations by SMEs in the minerals sector, especially those benefiting most from a refundable tax offset.

Recommendation 14
The sector specific guidance material should provide case studies on anonymised real-life examples.

There is a clear need for improved transparency and early engagement between AusIndustry and industry in order to remove uncertainty.

AMEC members advise that legislative interpretation issues have been compounded by a lack of engagement and transparency in reasoning; the outcome of which has led to an unnecessary number of companies being subject to a statutory examination of registered activities.

Recommendation 15
There should be a more conciliatory approach to resolve issues, rather than what appears to be a legalistic regulatory role.

AMEC is advised that AusIndustry has apparently stated that any differences in opinion or interpretation can be settled at the Australian Administrative Tribunal (AAT), rather than adopting the approach of the Australian Taxation Office of early engagement and working through the issues in a constructive and enabling manner. Many of the companies being impacted cannot afford the associated legal costs, and have limited avenue for an independent judgement or review.

Industry has suggested that improved engagement during AusIndustry's compliance continuum should involve further dialogue between AusIndustry reviewers and the company's representatives. This can also be addressed by Advance Rulings.

Recommendation 16
There should be improved direct and early engagement between AusIndustry and industry.

A common understanding would be supported by AusIndustry adopting a more proactive and cooperative approach.

For example, by asking targeted and specific questions about the company's R&D activities with genuine intent to seek understanding. This should happen as early as possible, ideally within the initial request for information (desk review stage of the compliance continuum). If the review progresses to a meeting (activity review stage) then specific issues and questions should be clearly articulated and multiple opportunities for discussion with the company's representatives should better inform AusIndustry's review. In fact, there would appear to be justification to provide an option for a meeting early in the process to understand AusIndustry`s issues.

All issues that are expected to contribute to a high risk rating should be clearly articulated and discussed. The specific reason and justification for the high risk rating should be given in sufficient detail, with a legislative basis, relating specifically to the R&D activities conducted. General statements that activities are, for example, "*not core activities because they do not contain an experiment*" are insufficient, especially when a detailed description of what the company considers to be an experiment has already been provided.

If a high risk rating letter is issued, an option to provide additional information should be accompanied by an invitation to discuss that information with AusIndustry reviewers including at least one reviewer in a Senior Executive Service level position. A decision to maintain a high risk rating and issue a notice of assessment should only then be made.

Consideration could also be given to form a traffic light system for applicants at the outset of the R&D submission process whereby initial submissions, even at a high level, could be promptly assessed by AusIndustry personnel, independent of any R&D consultants or tax agents, and a risk ranking notified.

AusIndustry could invest more of its resources at the start of the process rather than only at the end through compliance reviews and audits. This would save business, the Australian Taxation Office and AusIndustry time and money where a project is deemed ineligible, or at least flag to a

claimant at the outset that the key components of a particular claim description raise potential compliance risks.

Regular training

AMEC considers that regular Information Sessions / Workshops for the minerals sector would be most useful for all stakeholders, including AusIndustry.

As AMEC is a national body it would be pleased to host such sessions / workshops in key locations around Australia.

Such Information Sessions / Workshops would assist in clarifying:

- inconsistencies in assessments between Australian jurisdictions,
- interpretation by industry and AusIndustry, and
- understanding of the mining and minerals exploration sector.

Recommendation 17
Regular training sessions / workshops should be held in key locations around Australia.

Assessment and decision making

AMEC has been advised that AusIndustry may now be considering the vast majority of registered activities which are conducted whilst prospecting, exploring or drilling to be excluded as core R&D activities. This view ignores the fact that the purpose test must be satisfied before the exclusion applies. AusIndustry seems to be ignoring the application of the purpose test and assuming that all prospecting, exploring or drilling activities are excluded. In addition, this has resulted in AusIndustry expecting claims to evidence the fact that R&D activities were undertaken in a "known" area so as not to be caught under the exploration exclusion.

The R&D Tax Incentive is a broad based market driven program for incentivising Australian businesses to undertake R&D activities that otherwise would not have been conducted. However, it appears AusIndustry may not appreciate that 'business reasons' (such as minimising costs, considering the cost in project decisions, raising finance, completing projects within a deadline, etc.) drive the private sector, and that to achieve these business outcomes requires technical outcomes which themselves require R&D activities.

Interpretative principles

Clarity is required around AusIndustry's interpretative principles derived from the Mt Owen case[2] which appear to represent a departure from a common understanding of eligible R&D activities for tax incentives that has existed in Australia for decades.

Interpretative principles were established by relevant case law and sector specific guidance existed prior to the introduction of the R&D Tax Incentive.

[2] It should be noted that the Mt Owen case related to the interpretation of the previous R&D Tax Concession not the current R&D Tax Incentive. Whilst some aspects may be relevant to the current incentive it provides no more of a precedence value than other earlier Tribunal cases.

Limiting retrospective application of findings

AMEC is concerned that AusIndustry and the ATO are able to retrospectively apply findings, and claw back previously paid claims for an unlimited timeframe.

There have been examples where this potential clawback of funds from claims paid several years prior, would place the relevant company`s in a severe financial predicament and possibly result in administration and closure.

This clawback should be limited to an agreed timeframe with peak industry bodies, such as AMEC.

Recommendation 18
Retrospective application of findings should be limited to an agreed timeframe with peak industry bodies.