

*Taxation Issues for the Mining Industry:
2004 Update*

A Report by the Intergovernmental Working Group on the Mineral Industry

Mines Ministers' Conference 2004
Iqaluit, Nunavut

EXECUTIVE SUMMARY

Background

At the 2003 Mines Ministers' Conference, Ministers mandated the IGWG Working Group on Taxation Issues (the working group) to continue its deliberations for another year, to conclude its evaluation of the effectiveness of the Investment Tax Credit for Exploration (ITCE) and related provincial programs, to review and clarify expenses that are eligible for "Canadian Exploration Expenses" treatment, and to analyze the impact on the mining industry of recent changes to the federal *Income Tax Act*.

The working group held a number of meetings during the review period, including a meeting with national and regional industry associations in March 2004, at which industry views were expressed on tax issues under review. The working group also included observers from Finance Canada and the Canada Revenue Agency (CRA).

This report presents a summary of the government and industry discussions and the resulting analysis of the working group. The report is divided into three sections corresponding to the three main subject areas. Apart from the specific subsections presenting the views and recommendations of individual provinces and industry associations, the report does not contain specific recommendations, but it represents the consensus views and analysis of the working group as a whole.

Flow-Through Shares for Mineral Exploration – Status Report

The ITCE was introduced in 2000 as a temporary measure to stimulate "grass-roots" mineral exploration, which was being affected by a global downturn. The program was extended a first time in 2003 to allow time for the tax credit to have a greater impact on exploration levels. Since 2000, the availability of the ITCE, stronger metal prices and provincial tax measures to stimulate mining investment have all contributed to a significant increase in exploration and deposit appraisal expenditures.

The March 23, 2004, budget extended the ITCE for an additional year, until December 31, 2005, and provided that issuing corporations could make expenditures related to these flow-through-share arrangements up to the end of 2006. According to the budget plan, a one-year extension was allowed to provide companies with ample time to plan their transition to a situation where the federal tax credit will no longer be available. Nevertheless, industry associations have requested a further extension of the ITCE. The working group is generally of the opinion that the proposal for a further extension of the federal program would benefit from a clear demonstration that the original conditions leading to the introduction of the program still prevail or that the consideration of new factors requires such an extension.

In 2004, Ontario, Manitoba, Saskatchewan and British Columbia adjusted their own tax credit programs in order to remain harmonized with the federal tax credit.

Quebec has increased the deduction linked to flow-through shares and has made flow-through shares a permanent feature of Quebec taxation.

Clarifying or Enhancing the Income Tax Treatment of Exploration-Related Expenses

With respect to the income tax treatment of exploration-related expenses, more detailed knowledge of the size and range of the costs for which industry has requested a more advantageous tax treatment is required to assist in the analysis of the issue. The working group is of the opinion that consideration should be given to other options in addition to just inclusion in Canadian Exploration Expenses. A meeting among industry, Finance Canada, NRCan and the CRA will take place in the fall to discuss ways to address these issues.

Federal Income Tax Restructuring for the Resource Industries

With regard to the federal income tax restructuring for the resource industries, Bill C-48 received Royal Assent on November 7, 2003. This bill contained the following changes to corporate income tax imposed on mining and oil and gas companies' income, to be fully phased in by January 1, 2007:

- A phased reduction in the income tax rate from 28% to 21%;
- A deduction for actual provincial mining taxes and other Crown royalties paid;
- An elimination of the 25% Resource Allowance; and
- A new 10% tax credit for qualifying mineral exploration expenditures.

As noted in the 2003 Taxation Issues report, these structural changes may result in incidental increases in provincial taxes paid by the mining industry in several provincial jurisdictions due to the commonality of, and interaction between, federal and provincial corporate income tax bases. In response to this issue, Alberta and Quebec have proposed to keep the current resource provisions unchanged until December 31, 2006, at which time these provinces will eliminate the resource allowance provisions (subject, in the case of Quebec, to possible consequential adjustments). Ontario has proposed to maintain the current resource allowance rules indefinitely for the purposes of Ontario corporate income tax calculations.

Federal reform of resource taxation is now in its second year of the five-year transition period. The main outstanding issues relate to:

- the effect of federal changes on provincial/territorial income tax payments in provinces that have not yet proposed adjustment measures; and
- uncertainty about the deductibility of certain types of mining taxes and Crown royalties under the provisions of Regulation 3900 of the federal *Income Tax Act*.

The Department of Finance is consulting with industry on the latter issue.

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FLOW-THROUGH SHARES FOR MINERAL EXPLORATION – STATUS REPORT

Introduction

The federal Investment Tax Credit for Exploration (ITCE), related provincial tax credits and increased tax deductions were introduced to respond to the depressed mineral exploration levels of the late 1990s. The ITCE was introduced in October 2000 as a temporary measure to encourage “grass-roots” mineral exploration and thus to moderate the impact on mining communities of sharply declining mineral exploration expenditures. Indications are that these goals have been achieved. Also, with the help of stronger metal prices, exploration and deposit appraisal expenditures have now reached higher levels and the short-term outlook remains positive.

Since October 2003, a number of tax policy developments have occurred concerning tax incentives for grass-roots exploration. Although market conditions for mineral exploration have improved, the 2004 federal budget proposes to extend the ITCE for a further year, establishing in legislation an expiry date for raising money of December 31, 2005. The further extension is intended to provide companies with ample time to plan their transition to a situation where the federal tax credit will no longer be available to flow-through-share investors.

The provinces of Manitoba, Saskatchewan and British Columbia have since proposed to extend their tax incentive programs to correspond with the extension of the federal ITCE program (until the end of 2005). The Ontario tax credit is of indefinite duration and, in its 2004 budget, Quebec announced a proposal for an indefinite extension of its flow-through-share provisions and related additional deductions.

The Quebec 2004 budget also included proposed changes to its tax incentive program for exploration financed by flow-through shares. The additional deduction available for surface exploration expenses incurred in Quebec was increased to 50% from 31.25%. For underground mineral exploration, the additional deduction was increased from 10.42% to 25%.

While they remain, the above-mentioned incentives, as well as continued strength in metal prices, interesting discoveries, positive results at known projects, and a sustained effort for discovering diamonds, will be the most important factors influencing exploration levels in this country over the coming years.

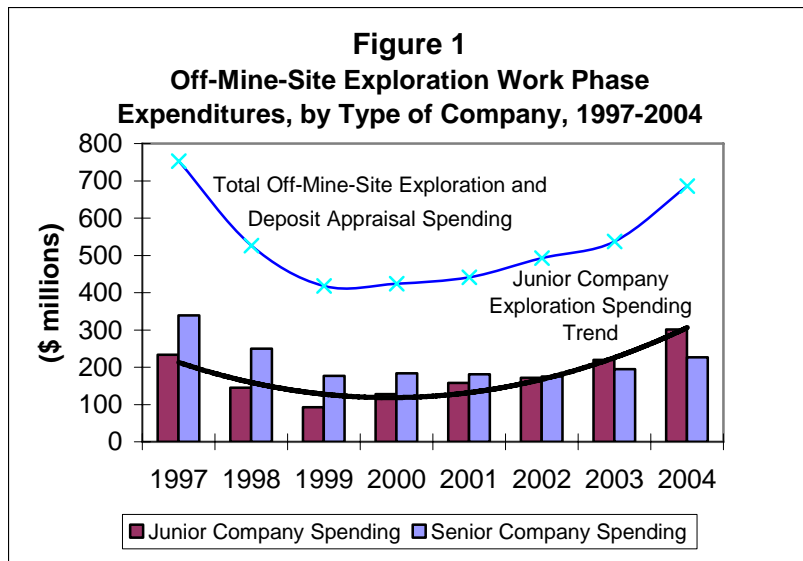
Exploration and Deposit Appraisal Spending

Prior to the introduction of the ITCE in October 2000, exploration and deposit appraisal expenditure levels had decreased dramatically from a cyclical peak of \$921 million (current dollars) in 1997 to \$504 million in 1999. The 2000 level of \$497 million (an historic low) further confirmed the severity of this downward trend. From then on, spending improved, slowly at first, but more rapidly afterwards to

reach \$641 million in 2003. Company spending intentions for 2004, which were expressed in late 2003, point to an even stronger increase with expenditures expected to reach \$795 million. This amount could even be surpassed as indications from incoming “revised intentions” survey data are that a number of companies will invest more than originally planned and appear to have gathered the financing necessary to conduct these expanded projects.

The recovery in exploration and deposit appraisal spending is happening across the country as all 12 mining jurisdictions (all provinces and territories except Prince Edward Island) are expected to experience higher spending levels in 2004. In terms of spending by work phase, exploration will likely account for almost 75% of the \$795 million expenditure total with deposit appraisal representing the remaining 25%.

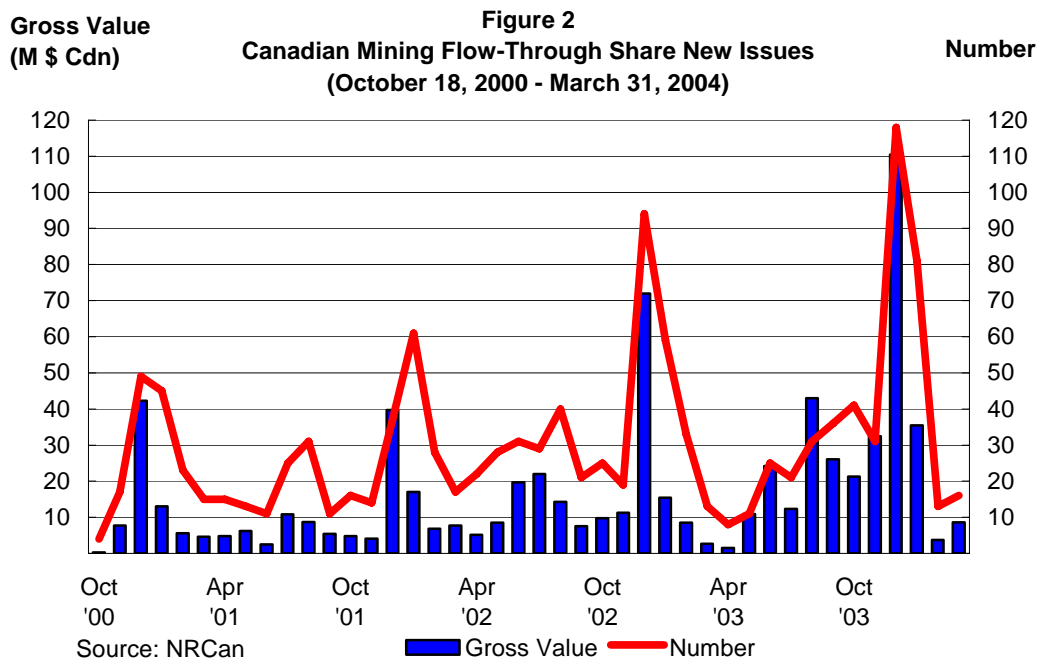
Within the exploration work phase, off-mine-site expenditures are expected to reach \$528 million, almost doubling the \$270 million recorded in 1999 (**Figure 1**). This resurgence in off-mine-site exploration spending, as well as dramatically improved junior company off-mine-site spending, which is expected to reach \$301 million in 2004 (from a low of \$93 million in 1999), gives some indication that the ITCE, related provincial tax credits and improvements to existing deductions have contributed to the revitalization of exploration activity in Canada. While rising metals prices are a major factor behind this recovery, the strong growth in off-mine-site and junior spending, both of which fall directly within the types of activities that these incentives were meant to foster, is indicative of the success of these measures. In fact, the ITCE was specifically geared towards off-mine-site surface exploration and its connection to flow-through shares ensured that junior companies would use it.



Exploration Financed by Flow-Through Shares

NRCan has established a database of flow-through-share financings to track the success of the ITCE as this tax credit can only be used in conjunction with flow-through shares. This database consists of various public documents released by issuing companies to their investors and to regulators of the securities industry.

An analysis of the compiled data, from the inception of the ITCE in October 2000 to April 2004, reveals that over \$718 million has been raised from 1278 separate flow-through-share issues (**Figure 2**). On a yearly basis, total flow-through-share financings for mineral exploration grew from \$50 million in 2000 to \$110 million in 2001 and \$202 million in 2002. This positive trend continued in 2003 when \$309 million was raised for mineral exploration via the flow-through-share mechanism. Interestingly, the number of share issues in 2003 (427) was only slightly higher than the number of issues recorded in 2002 (415). The resulting larger average size of flow-through-share financings points to stronger industry fundamentals and increased investor interest in this type of share because of the additional tax benefits they provide relative to an ordinary share. For the first quarter of 2004, 110 flow-through-share issues resulted in \$47.7 million in funding for mineral exploration projects in Canada.



Exploration Financed by Tax Credit-Bearing Flow-Through Shares

A Letter of Understanding with the Canada Revenue Agency (CRA) provides NRCan with access to certain types of aggregated data on flow-through shares and the ITCE. This information is compiled by the CRA based on the various forms and documents that must be filed by companies issuing flow-through shares. A

preliminary analysis of the data obtained in June 2004 further confirms the trends that were highlighted in previous submissions to Mines Ministers.

For instance, in 2003, the number of companies planning flow-through-share offerings to fund mineral exploration projects and the total number of planned offerings continued on the upward trend that was initiated after the introduction of the ITCE in October 2000. The typical size of planned offerings also increased substantially to the point where, in 2003, the number of offerings valued at between \$500 000 and \$5 million had almost doubled the number of such offerings in 2002, and more than doubled those of 2001 and 2000. While planned offerings of less than \$250 000 continued to be frequent, their overall importance in terms of funding for exploration projects was diluted by the move to larger financings. Nevertheless, there were enough of these smaller offerings to warrant noting that, under current securities regulations and practices, companies conducting these small equity financings continue to bear a share of issuance costs that is larger, in proportion to actual proceeds, than is normally the case for companies proceeding with large issues of common or flow-through shares.

As far as flow-through-share sales are concerned, the data also show significant improvements in the post-October 2000 period for the number of sales, the amounts of financing raised, and the typical proceeds of individual financings. The rise in the value of both offerings and sales indicates that junior mining companies have better access to financing, that they can finance larger projects, and that the investment community is more receptive to mining investment opportunities and to the benefits of investing in this type of shares.

Since 2000, Canada has witnessed a resurgence of its junior mining sector and an increased use of the flow-through-share financing mechanism for funding mineral exploration activity. While it is not possible to isolate the contribution that the ITCE has made to this trend, the availability of the ITCE, along with an improved metals price outlook and the introduction of several provincial measures to enhance Canada's exploration investment climate, are contributing factors.

Provincial Views

British Columbia

British Columbia has two complementary programs to support grass-roots mineral exploration. The British Columbia Mining Exploration Tax Credit (METC) program was introduced in 1998 and provides a 20% provincial tax credit for non-flow-through-share-funded grass-roots mineral exploration. Unlike the federal ITCE, underground exploration and exploration for coal and certain industrial minerals are eligible activities. The 2003 provincial budget extended the period for eligible expenditures from July 31, 2003, to July 31, 2006. The province is examining a further extension to December 31, 2006, and perhaps beyond.

The B.C. Mining Flow-Through-Share (BC MFTS) tax credit program is completely harmonized with the ITCE. Where the 2003 BC MFTS extension was conditional

on the federal ITCE extension, the 2004 BC MFTS extension was automatic with the federal ITCE extension.

A preliminary analysis of available data suggests that the tax credit programs have made a significant contribution to the recovery in B.C. mineral exploration expenditures. The following tables illustrate the recent increases in B.C. mineral exploration expenditures and B.C. tax credit claims (millions \$)¹:

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u> <u>(estimated)</u>	<u>2004</u> <u>(intentions)</u>
Juniors				18.3	28.1	39.6	40.3
Seniors				10.8	11.1	10.2	13.9
Total	54.5	41.3	35.9	29.1	39.2	49.8	54.2

	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
METC	1.4	3.7	3.9	2.9	2.2	N/A	N/A
BC MFTS				2.2	5.4	N/A	N/A
Total	1.4	3.7	3.9	5.1	5.3		
Implied Mineral Exploration (Total * 5)	7.2	18.6	19.5	25.5	26.7		
% of Mineral Exploration \$	13%	45%	54%	87.6%	68.1%	Not Calc	Not Calc

In March 2004, the B.C. Minister of Finance, the Honourable Gary Collins, wrote to the Honourable Ralph Goodale in support of a one-year extension to the federal ITCE. While B.C. appreciates concerns that further ITCE extensions could contribute to the program becoming “embedded,” the Ministry of Energy and Mines will support further extensions to the programs:

- if B.C. mineral exploration expenditure levels do not achieve those consistent with a sustainable industry (i.e., at least \$125 million per year) in an environment of “rational and restrained capital markets” – that is, markets that are not “irrationally exuberant”; and
- until a major Canadian discovery (e.g., another Eskay Creek, Lac de Gras or Voisey’s Bay) is made to rekindle widespread investor awareness of the opportunities offered by the Canadian mineral exploration sector.

Manitoba

The Manitoba Mineral Exploration Tax Credit (METC) was announced in the provincial 2002 budget. The METC is a 10% non-refundable personal income tax

¹ The mineral exploration expenditure data are from NRCan and the tax credit data are from the Canada Revenue Agency (CRA) and B.C. Revenue. The analysis is approximate as the METC figures are based on estimates of the expenditures allowed (based on audit results) and reflect when the claims were processed and paid out by the CRA as opposed to when the work was done. Furthermore, it is probable that not all of the 2002 METC claims have been processed. Ministry regional geologists estimate 2003 expenditures at \$55 million.

credit that is earned on eligible flow-through-share investments. Eligibility for the tax credit is harmonized with the federal ITCE. The incurred mineral exploration must be for a mineral resource located in Manitoba and the tax credit only applies against Manitoba tax payable.

Since introduction of the METC, Manitoba has seen a dramatic increase in off-site mineral exploration financed by flow-through shares. Although it is difficult to segregate the impact of the METC as a factor in increased grass-roots exploration levels in the province, Manitoba feels that, along with strengthening commodity prices and increased investor interest in the junior sector, the METC has been a contributing factor.

NRCan estimates that over \$25 million will be spent on exploration in Manitoba in 2003. Manitoba has attempted to catalogue flow-through-share financings and expenditures in the province, but all numbers generated are either anecdotal or garnered from the review of company press releases. Manitoba is aware of \$9.1 million, or approximately 36% of total exploration expenditure estimates for 2003, that has been raised via flow-through-share financing for mineral exploration activity in the province. In 2002, Manitoba estimates that slightly more than \$4 million was raised via flow-through shares for exploration in the province.

It is difficult to determine what proportion of the 2003 flow-through-share financings will be eligible for the METC. In 2002, preliminary estimates indicate that approximately \$60 000 was credited to Manitoba investors via the METC. This figure indicates that \$600 000 was invested by Manitobans in Manitoba exploration financed by flow-through shares. From discussions with Manitoba explorers, it appears that one influence of the METC was to increase the ability of Manitoba-based junior exploration companies to raise exploration funds locally.

Saskatchewan

The Saskatchewan Mineral Exploration Tax Credit was introduced in 2001 as a complement to the federal ITCE. The provincial program parallels the federal program requirements and offers a 10% non-refundable tax credit for investors paying Saskatchewan income tax. The Saskatchewan Mineral Exploration Tax Credit is part of the Mineral Exploration Incentive Program, aimed at increasing exploration expenditure levels and ultimately identifying new mineral deposits. This program included enhanced geoscience, reduced royalty rates, competitive regulations and related fee structures, and corporation and prospector incentive grant programs.

Mineral exploration expenditures in the province increased from \$27.8 million in 2002 to \$31 million in 2003, and indications are that they will continue to increase in 2004. Industry has indicated that the Mineral Exploration Incentive Program has contributed to its decision to carry out exploration programs in the province and that a number of these programs have led to the discovery of new showings.

Incentives that target junior mining companies are particularly effective in increasing exploration in Saskatchewan as junior mineral exploration companies are significant investors in the province's mineral potential. In 2003, junior companies contributed approximately \$12.6 million (41%) of the \$31 million in total exploration expenditures. Of this, Saskatchewan Industry and Resources is aware of \$8.4 million that was raised by junior companies that applied for the provincial or federal mineral exploration tax credit in 2003. These companies targeted a diverse range of commodities, including uranium, diamonds, gold and platinum group metals, over a wide geographic area of the province.

Improving commodity prices and investor confidence have also contributed to increased exploration expenditures. Vehicles, such as partnerships, that raise financing for junior companies have also evolved and have become very effective in attracting investors into the mineral exploration sector. While the availability of provincial and federal tax credits increases the attractiveness of investing in flow-through shares, there remains the challenge of ensuring that companies and related financing vehicles file the required documentation so that investors actually receive the Saskatchewan Mineral Exploration Tax Credit for eligible expenses.

Industry Proposals

Three provincial exploration associations (the British Columbia and Yukon Chamber of Mines, the Ontario Prospectors Association and the Quebec Mineral Exploration Association) are recommending a further extension of the ITCE program to the end of 2007, beyond its planned termination date at the end of 2005. Provincial associations believe that conditions that led to the introduction of the ITCE (lack of liquidity in the venture capital markets) are still prevalent and that industry needs extended assistance "while it awaits the return of a steady investor confidence."

They also recommend that the closing date for flow-through-share (FTS) financing be extended from December 31 to February 28 so that it coincides with the closing date of the Registered Retirement Savings Plan subscription period. This is a reiteration of the same recommendation made in 2002 by the Prospectors and Developers Association of Canada (PDAC).

IGWG Comments on Industry Proposals

In examining proposals relating to the ITCE as part of its mandate to analyze the effectiveness of the program, the working group is generally of the opinion that the rationale presented by the three provincial associations for further program extension would benefit from a demonstration, using concrete examples, that the original conditions leading to the introduction of the ITCE in 2000 still prevail or that the consideration of new factors requires such an extension. The working group is also of the opinion that the proposed limit for the program extension – the return of a steady investor confidence – is rather vague and not conducive to developing criteria for program effectiveness.

With respect to the request for an extension to February 28 of the closing date for FTS financing, IGWG members already expressed the opinion, in their 2002 report,

that this measure would not likely be particularly effective in raising additional FTS investment. This opinion is based on statistical evidence provided by monthly and quarterly data concerning FTS financing activities. These data show that December is the busiest FTS financing month, which indicates that investors do not appear to be distracted by the holiday season or concerned about a lack of precise knowledge of their tax position. Also, it can be seen that the months of January and February are among the next busiest FTS financing months, thus indicating that the December closing date is not a significant hindrance to this type of exploration financing, even at the beginning of the fiscal year. Finally, from a public policy point of view, the pertinence of matching the investment season of a speculative investment vehicle such as FTS with that of income-security-oriented RRSP funds could be questionable.

CLARIFYING OR ENHANCING THE INCOME TAX TREATMENT OF EXPLORATION-RELATED EXPENSES

Background and Introduction

Background

The House of Commons Standing Committee on Industry in its April 2000 Report, *Productivity and Innovation: A Competitive and Prosperous Canada*, on the basis of industry recommendations, recommended that the government consult industry about two separate (but related) issues:

1. Clarify the definition of Canadian Exploration Expenses (CEE); and
2. Make the flow-through-share investments more attractive.

The temporary ITCE was introduced in October 2000 in response to the second issue and was widely acclaimed by industry as a significant enhancement in the value of flow-through shares for investors, as well as an effective means to stimulate mineral exploration. (See first section, *Flow-Through Shares for Mineral Exploration – Status Report*.)

Although discussions were held on the first issue, the outcome of those discussions did not meet industry's expectations. The CEE clarification issue has subsequently been broadened by industry to include other exploration and mining-related expenses. Further discussion of this issue had been sporadic until the implementation of corporate income tax restructuring for the resource industries in Budget 2003. Since then, discussions have resumed, but they have not led to a resolution of the issues to date.

Originally, industry wanted to clarify whether certain expenses would fall under the definition of eligible CEE for income tax purposes. This clarification was intended to allow companies to plan, finance and execute their exploration work with a high degree of certainty concerning the tax treatment of incurred expenses. If industry's proposals were restricted to an issue of clarification, this request could likely be dealt with through the normal administrative routes of having the Canada Revenue Agency (CRA) explain its administrative practices and perhaps, if necessary, issue additional interpretation bulletins.

However, in addition to clarification of the current tax treatment, it appears that industry is also proposing an expansion of the scope of CEE to cover categories of expenses that are related to exploration, but that are not actually treated as CEE under current tax laws. Some of the proposals may involve significant policy changes and changes to the tax legislation.

The 2003 IGWG Report on *Taxation Issues Relating to Exploration and the Restructuring of Resource Taxation* attempted to shed some light on the issues at stake by allowing a frank exchange of views and arguments. Hence, the report provided a snapshot of the CRA's administrative practices regarding the types of exploration expenses under scrutiny, along with industry rationale and arguments in support of each of their requests. Provinces also provided their initial reaction. The report led to no recommendation other than the need to pursue the discussions. The provinces and territories understood the complexity of the issues involved and wanted a fuller review of arguments, factors and considerations before qualifying their support of any specific industry proposal.

The Department of Finance and the CRA are considering these issues in consultation with NRCan.

Introduction

Over time, the separation between the need to clarify the current CEE definition and the industry's desire to obtain a more favourable tax treatment for certain exploration-related expenses has become blurred with the consequence that the discussions have effectively been subsumed under one broad agenda labelled the need to "modernize" the definition of CEE. The best illustration of this new categorization can be found in the introductory paragraph of the section of The Mining Association of Canada (MAC) brief entitled *Rationale for Modernizing the CEE Definition* (see Annex 1), where MAC makes the following statement:

"A significant opportunity exists to supplement the flow-through share investment tax credit, by modernizing the current definition of Canadian Exploration Expenses (CEE)."

The statement is followed by a list of recommendations, the sum of which, if adopted in their entirety, would radically change the nature of CEE. The industry argument suggests that all recommended changes are necessary. It further suggests that, over time, the current CEE definition of eligible expenses may have become obsolete to the point that it no longer reflects the reality of modern exploration.

Although the current tax treatment of mineral exploration costs appears relatively progressive and generous by international standards, a case may exist for reviewing the tax treatment of certain types of expenses that are related to exploration or new mine development but that are currently excluded from CEE. However, there may be options other than inclusion in CEE for those expenses.

The discussions held in 2004 raised a concern that the CEE modernization approach adopted by industry might make it more difficult to achieve significant progress in terms of incremental adjustments to the tax system. While industry seems to have focussed on the CEE issue, members of the IGWG working group are concerned that other avenues may not have been fully explored.

Certain costs associated with exploration have never been included in CEE. For example, the fact that certain types of costs associated with exploration are also associated with other non-exploration activities may preclude their treatment as CEE. In addition, other costs may relate to activities that are necessary components of an exploration program without themselves directly contributing to the determination of the existence, location, extent and quality of a mineral resource. Finally, in the case of other costs, options other than inclusion in CEE may adequately address the needs without conflicting with tax policy principles or objectives.

With a view to advancing these issues, the working group suggests a five-step process:

1. Identify and define the issues (in terms of whether they are in the nature of a request to clarify the CEE definition, as opposed to a request for additional incentives);
2. Assess the importance of each issue (in quantitative terms if possible);
3. Examine the relationships between issues (Are issues interdependent? Would addressing one issue make addressing others less critical?);
4. Accordingly, rank issues according to their importance; and
5. For each issue and tackling them in their order of importance, critically examine various potential options.

The last step, a detailed discussion of potential tax options, is obviously beyond the purview of this report as it is the responsibility of the Department of Finance and the CRA, which are considering these issues and which are not party to the report.

Accordingly, the following subsections will attempt to recast the discussion into a framework that clarifies the industry issues, opens up options for response, and does not force a pre-conceived solution. All propositions made by industry in the previous reports (IGWG reports of 2002 and 2003) are spelled out in the annexes to this report and will not be repeated here. Similarly, government views that are known to industry will be left out of the discussion. Instead, the discussion will focus strictly on new information and the propositions provided by industry, and will seek to provide considerations related to the five-step process suggested above.

Although all the issues identified by industry will be briefly examined, a more elaborate discussion will be made of environmental costs and Aboriginal and community consultation costs. This is because these two issues were the subject of the most extensive discussions in the IGWG forum during the past year. Also, these are issues on which there seems to be consensus about their importance among all the national and provincial industry associations involved in the discussions.

Issues Identified by Industry

Background

Industry associations made three separate written submissions to the IGWG working group on the issue of clarifying or enhancing the income tax treatment of exploration-related expenses:

- MAC provided a summary of previously submitted arguments in a brief entitled *Mining Association of Canada Summary*, which is attached to this report as Annex 1;
- The Prospectors and Developers Association of Canada (PDAC) submitted a joint MAC-PDAC letter that was sent to the federal Minister of Finance on January 26, 2004. This letter is attached to this report as *Annex 2 – Prospectors and Developers Association of Canada Submission*; and
- The British Columbia and Yukon Chamber of Mines, the Ontario Prospectors Association and the Quebec Mineral Exploration Association made a joint submission that is attached to this report as *Annex 3 – Combined Submission by Three Provincial Mineral Exploration Associations*.

Update on Issues

There is consensus among national and provincial industry associations (representing both the exploration and production segments of mining) concerning a request to address issues relating to the tax treatment of:

- Exploration costs incurred to extend ore reserves on existing mine properties;
- Costs incurred to perform feasibility studies;
- Aboriginal and community consultation costs;
- Environmental baseline study costs.

In addition, both MAC and the PDAC expressed concerns about the tax treatment of certain capital assets used in the course of an exploration program.

Finally, the three provincial associations reiterated a request to have flow-through-share issuing costs considered as CEE, a proposal that was studied by the IGWG working group in its 2002 report to Mines Ministers.

The following paragraphs will provide a restatement of the issues in the context of the framework presented in the introduction. The restatement will aim at assembling and organizing considerations and supporting information that would be pertinent to better define and clarify the industry issues and give some insight on how best to address them. When appropriate, incomplete or missing information will be identified and remaining areas of misunderstanding will be highlighted to help focus future discussions.

Extension of Ore Reserves on Existing Mine Property

This item was the subject of an industry proposal included in the 2003 IGWG report and is included again this year.

Industry is requesting a modification of the CEE definition to extend CEE status to “qualified” exploration expenditures:

- related to the extension of ore reserves at an existing mine; or
- undertaken in new zones of a mine that has not been in production for a minimum of 24 months for reasons other than a strike or labour unrest.

Industry is proposing specific wording changes to the *Income Tax Act* (ITA) to give effect to this request. Industry believes that the current wording is overly restrictive and that the proposed amendment would provide greater certainty in the application of the law. Industry argues that greater certainty would facilitate exploration to target discrete new zones of potential mineralization in and around existing operations or previously operated mines that, based on new geological information, merit additional exploration. It would also encourage exploration to extend mine life, maintain jobs, and secure the economic independence and infrastructure of local communities.

Considerations relevant to this issue include:

1. The current wording of the ITA establishes a difference between exploration related to a mine or related to a potential or actual extension thereof, and exploration that is not.
2. While all exploration activities are intrinsically risky enterprises with uncertain outcome, there is inference, or at least common perception, that exploration conducted in areas where there are no mineral reserves, no mine and a lack of basic infrastructure (so-called “grass-roots” exploration) is commensurably riskier than exploration conducted in areas where some or all of these favourable factors exist. Also, there is a natural incentive for mining companies to first consider exploration investment in the vicinity of existing mines so as to derive, to the extent possible, a maximum return on existing installations. As a result, tax considerations set aside, exploration projects in the vicinity of existing mines tend to get far more attention (and easier access to financing) from companies and from outside investors than projects in grass-roots areas.
3. Many mines were originally found in previously under-explored territories and there remains a formidable potential for new discoveries in these areas in Canada. The more favourable tax treatment provided for riskier grass-roots mineral exploration activities potentially increases the fraction of available venture risk capital that could flow to areas where risk (or perceived risk) is higher and immediate industry opportunity is lower, thus promoting “frontier” exploration.

4. The proposed changes to the wording of the ITA would eliminate the intended tax incentive differential in situations where exploration work meeting the proposed criteria was eventually found to be related to an existing mine.
5. The current wording of the ITA does not preclude a CEE tax treatment for “grass-roots” exploration conducted in the vicinity of an existing (either operating or non-operating) mine. A CEE status is actually available for on-property exploration activities that are not related to a mine or not related to an actual or potential extension thereof.
6. There are well-defined steps for companies to manage uncertainty relating to the tax treatment of proposed exploration expenditures conducted in the vicinity of existing mines. A first step is to request an advance ruling from the CRA to clarify that expenses undertaken in specific and well-defined circumstances are indeed CEE. A second step could be to manage the exploration program and, eventually, the resulting mine development program in such a way that the terms of the advance ruling are respected.
7. The changes proposed by industry involve introducing a series of detailed technical rules (e.g., depth and distance from the shaft) that may be more difficult to administer than current rules.

Feasibility Studies

Industry is requesting clarification that feasibility study costs incurred for the purpose of, and in the course of, determining the existence, location, extent and quality of a mineral resource be considered as CEE by the CRA. Industry argues that the cost of feasibility studies undertaken to assess the opportunity of pursuing an exploration program, or to evaluate the potential to bring a deposit into production, should be considered as CEE on the basis that “quality” is more than a physical concept.

At issue is a determination as to whether or not feasibility study costs are related to an activity that adds to a taxpayer’s knowledge about the extent and quality of a mineral resource or is needed to reach a decision to bring a mine into production, in which cases it would presumably fall into the definition of CEE under the current wording of the ITA.

Technical considerations relevant to this issue include:

1. Feasibility studies are an essential part of the mineral property evaluation process.
2. A feasibility study of a mineral property represents an engineering and economic appraisal of the commercial viability of that mineral property.

3. A feasibility study may be conducted to help make informed investment decisions concerning further exploration activity or to help make informed investment decisions concerning the development of a mineral deposit.
4. Exploration and evaluation of a mineral prospect is an iterative procedure with initial, preliminary, intermediate, and comprehensive feasibility studies being essential components in the exploration and development process that goes from initial concept and prospecting, through discovery of a mineral deposit, to the decision to develop a deposit and place it into production.
5. Feasibility studies at each stage of the exploration process constitute a critical assessment of the economic and technical data that have been collected to date. Thus, at the end of a feasibility study, the knowledge and understanding of the existence, location, extent and quality of the mineral resource and its potential for development is greater than it was at the beginning of the feasibility study.
6. As a mineral prospect progresses from initial exploration through to the time when a management decision is made to develop and mine the property, a number of evaluations and feasibility studies may be conducted on the property. These feasibility studies will differ in several respects. Each will be based on increasing amounts of data pertaining to geologic information, preliminary engineering designs and plans for mining and processing facilities, and initial estimates of project revenues and costs; each will require increasing amounts of time (and therefore expense) to prepare and each will have increasing degrees of accuracy. At more advanced stages, there may be a change in the purpose of evaluation or feasibility studies from one of helping to make informed decisions about moving to the next exploration stage to helping to make informed decisions regarding bringing a mine into production.
7. For example, as exploration occurs on a mineral prospect, the intersection of mineralization by a few drillholes typically triggers the need for an initial analysis to assist with necessary decision making. This initial analysis is designed to answer questions pertaining to (a) the magnitude of deposit that might exist rather than what is known to exist, (b) whether further expenditures should be incurred to look for what might exist or whether the project should be abandoned, or (c) what additional expense or effort is required and how such an expense might be best incurred.
8. If the project continues to appear favourable through the preliminary and intermediate feasibility studies, the project must be assessed by means of a comprehensive (or “bankable”) feasibility study that assesses the technical and economic viability of the project and helps the organization to make the “go or no go” decision regarding project development.

Aboriginal and Community Consultation Costs

Issues related to the tax treatment of these costs are discussed in the subsection below entitled *Analysis of Aboriginal and Community Consultation Costs and Environmental Study Costs*.

Environmental Baseline Study Costs

Issues related to the tax treatment of these costs are discussed in the subsection below entitled *Analysis of Aboriginal and Community Consultation Costs and Environmental Study Costs*.

Depreciable Properties Used in Exploration

MAC and PDAC recommend that:

1. charges relating to depreciable property employed in exploration activities should be classified as CEE; and
2. the CRA interpretation of depreciable property employed in exploration activities – costs related to tangible capital assets that are permanently embedded in a mine working that would eventually have to be removed from underground – should be officially rendered public through an interpretation bulletin or other relevant public document.

At issue is a concern that subparagraph (l) of the definition of CEE could lead to an unduly restrictive interpretation by the CRA. This subparagraph, introduced in 1997, clarifies that depreciable property of any prescribed class would *generally* (emphasis added) not be eligible for CEE. To reflect the substance of the CRA interpretation communicated to industry in the course of past discussions, the working group interprets the second industry recommendation as meaning the following:

The CRA *administrative practice relating to the tax treatment of costs* of depreciable property *consumed* in exploration activities – costs related to tangible capital assets that are permanently embedded in a mine working *and that could not eventually be recuperated from underground for a salvage value greater than the cost of removing them* – should be officially rendered public through an interpretation bulletin or other relevant public document.

The economic and financial impact of uncertain tax treatment on industry has not been quantified, but it appears to be relatively modest. Discussion of the issue included in the 2003 report is still relevant and there are no supplemental considerations to add to this point by the working group.

Financing Costs

Three provincial associations are requesting that overhead and administrative costs associated with public financing operations via the issuance of flow-through shares be considered as CEE for income tax purposes.

This request was discussed in the 2002 IGWG report entitled *Tax Credits for Mineral Exploration Flow-Through Shares* in the chapter covering options for improvements or replacement of the tax credit mechanism.

Considerations expressed then are still valid, to which could be added the following:

1. Issuance costs for flow-through shares are of the same nature as issuance costs for ordinary shares, which are not eligible for CEE treatment.
2. Costs associated with the financing are not directly related to the exploration activity per se; dollars spent on financing do not add to the taxpayer's knowledge about the existence, extent and quality of a mineral resource.
3. Although they represent a significant (and perhaps, increasing) financial burden for exploration companies, issuance costs are also a reality for all start-up businesses in all other spheres of economic activity. None of these other businesses are allowed to transfer these charges to investors so that they can deduct them from their own taxable income.

Analysis of Aboriginal and Community Consultation Costs and Environmental Study Costs

Industry Request

All industry associations recommend that both baseline environmental costs and Aboriginal and community consultation costs incurred in the course of mineral exploration and new mine development be considered as CEE. It is further recommended that these costs be eligible for the ITCE when they are incurred specifically in relation to grass-roots exploration for minerals that qualify for the program.

Current Tax Treatment and Administrative Practices

The CRA considers that consultation costs and costs related to environmental studies are classified as Canadian Development Expenses (CDE) when they are required to be undertaken in order to obtain or maintain a permit or other right to a mineral deposit. Such costs may qualify as CEE where they were incurred for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada or for the purpose of bringing a new mine into production. CEE treatment would not generally be available where such costs are incurred before a decision has been made to proceed with the exploration project or to develop the mine. However, costs incurred to fulfil an obligation, either regulatory or informal, which are related to the exploration activities being carried out or to the development of a new mine, may qualify. For example, expenses incurred to determine where to locate tailings ponds or to determine the impact that blasting would have on the environment would generally relate to the development of a mine; however, expenses incurred to determine which port should be used to transport

production or how the property will be reclaimed when the minerals have been exhausted would not normally relate to bringing a mine into commercial production.

Industry Rationale for More Favourable Tax Treatment

Nature of the Cost

Industry suggests that costs associated with environmental baseline studies and Aboriginal and community consultations meet the definition of CEE since they are incurred as part of the exploration activity or in the course of developing a new mine.

Examples of the types of environmental baseline studies include sampling and analysis of water, soils, vegetation and resident wildlife, particularly fish, and preparation of expert reports. The costs associated with community consultations include the distribution of public notices, community visits and on-site tours, employee travel, the rental of meeting rooms, translation and legal advice, not to mention expenditures related to wages and benefits, overhead and other expenses essential to a smoothly run consultation process.

Industry is of the opinion that these costs are more closely related to prospecting, exploration and mine development activities on properties covered by issued subsurface rights than to the acquisition of such mining rights or exploration rights in a given province or territory.

Technical considerations pertinent to this issue include:

1. There is evidence that environmental baseline studies and community consultation costs are closely associated with all stages of exploration and new mine development, and are becoming a required component of those activities.
2. This evidence notwithstanding, community consultation and environmental assessment costs will not be eligible for inclusion in CEE (under the current wording of the Act and administrative guidelines) unless they are incurred for the purpose of determining the existence, location, extent and quality of a mineral resource or for the purpose of bringing a new mine into production. In addition, they will not be included in CEE if they represent part of the cost of acquiring or maintaining a mineral right.
3. These costs are not related to activities that, per se, add to a taxpayer's knowledge about the existence, location, extent and quality of a mineral resource. Nor are they related, per se, to a physical stage of mine development. In that sense, they are akin to financing and overhead costs that are also required, but ancillary, components of the exploration and mine development process.

4. These costs may or may not be required as a pre-condition for acquiring or maintaining a mineral right. However, they will generally be required to give effect to the mineral right, being a condition that must be satisfied in order for actual exploration or mine development work to be performed.

Significant and Growing Cost

As observed in the 2003 report, the costs of environmental studies are generally relatively low and community consultation costs are not usually an issue until a mineral resource has been defined and work begins on specific mine development plans.

No statistics are collected on Aboriginal and community consultation costs per se. These costs are normally reported as overhead costs by industry. From that fact and on the basis of limited sample surveys conducted by British Columbia and Manitoba (the results of which are reported under the provincial views subsection), it can be inferred that these costs, on average, still represent a small proportion of total exploration costs. As suggested by the results of the provincial surveys, it also appears that some exploration projects, under specific circumstances, may be subject to a consultation process that is significantly more onerous and time-consuming than is normally the case. But there is not enough documented evidence for the working group to conclude that this situation occurs in a significant number of cases.

However, the NRCan-Statistics Canada Survey of Mineral Exploration, Deposit Appraisal and Mine Complex Development Expenditures does provide information on environmental costs incurred at the different stages of exploration and mine development. The following table represents the share of total exploration costs accounted for by environmental assessment activities, as reported by mining companies for the period 1998-2002.

Environment Costs, as % of Total Exploration Expenditures¹

	1998	1999	2000	2001	2002
Exploration Stage	2.5	0.9	1.1	0.8	1.1
Deposit Appraisal Stage	9.2	7.1	4.3	3.8	7.7
Exploration and Deposit Appraisal Stages	4.7	3.5	2.2	1.6	3.2

The following observations can be made:

1. Environmental assessment costs tend to be relatively more onerous at the deposit appraisal stage, which involves more extensive delineation drilling.

¹ Source: Natural Resources Canada, based on the Survey of Mineral Exploration, Deposit Appraisal and Mine Complex Development Expenditures. Data for 2001 and 2002 are not final.

2. Environmental assessment costs vary considerably from year to year in proportion to total costs. This possibly reflects the fact that expenses are incurred in different regions for which environmental assessment requirements vary.
3. The total burden of environmental assessment costs represents, on average, roughly 3% of total exploration costs.
4. Since all types of environmental assessment studies are reported under one generic entry, the survey does not give any indication of the relative and absolute importance of the costs specifically incurred for the purpose of conducting environmental baseline studies. It would be important that industry provide detailed evidence of these costs to give the working group a full appreciation of their economic significance and of the effect of their tax treatment.

There are indications that costs related to environmental assessment and community consultation costs may be a significant, and perhaps growing, component of exploration and mine development costs, particularly from the latter stages of the exploration process. However, national statistics about industry expenditures lack the specificity required to provide conclusive evidence on the significance of environmental assessment costs. With respect to community consultation costs, no national statistics are collected and the regional evidence provided by British Columbia and Manitoba, while helpful, remains inconclusive because it is drawn from limited sample surveys.

Government-Mandated

All provincial and territorial governments have a formal process for the environmental assessment of large projects, including new mine developments. A description of the environmental assessment regime in place in Nova Scotia is provided as an illustration of Canada's statutory requirements in Annex 4.

While there are structural differences among the different regimes, there are general similarities in steps that project proponents are subject to or required to undertake:

1. Determination of whether a given project is subject to environmental review.
2. Determination of the extent of the environmental assessment review, depending on the scale of the project and the potential for environmental damages.
3. Completion and submission of an environmental assessment plan to government.
4. Review of the environmental assessment report by government officials (analysis and recommendations are referred to minister(s) for approval).

5. Communication of ministerial decision on the project (approval may be conditional on meeting specific requirements for ongoing environmental monitoring and community consultation).

Public consultations may be required for a project proposal at one or several stages of the environmental review process. Typically, requirements are significantly more onerous and time consuming at the development stage than they are at the exploration stage.

While it is legally required for firms to conduct environmental assessments and related community consultation prior to the development of new mining projects, there appears to be no legal requirement for those activities to be conducted by exploration companies prior to undertaking "grass-roots" exploration work. However, provincial environmental assessment processes may require baseline data to be supplied prior to approval of a project for development. For example, in Nova Scotia, the published guide to environmental registration of mining projects requires baseline data for all "Valued Environmental Components" that may be affected by the project, including, but not limited to, flora and fauna, fish and fish habitat, groundwater, surface water, well water and archeology. In this situation, collection of baseline data during the exploration phase would be a prudent and necessary precursor to entering the formal environmental assessment process, and it is reasonable to assume that these data must have been collected during the exploration phase.

Statutory or more informal administrative policy requirements for environmental assessment and related community consultations appear to vary not only with the size of the project, but also with sensitivity of the ecological system and sensitivity of the local communities that would be affected by a project. Thus, exploration projects, particularly at the advanced stage of the exploration process, may be subject to requirements that vary in terms of time and resources consumed. An important implication is that some projects could be subject to significantly more onerous environmental assessment requirements than is generally the case.

In addition, industry claims generally that community consultations that are conducted independently from the environmental assessment process may have become a significant obligation for "many" prospectors and mine developers. The working group found indications of a trend in Canada towards more formal and more demanding requirements for community consultation at all stages of the exploration and mine development process. This appears to be particularly the case in respect of Aboriginal groups. Most notably in British Columbia, but likely elsewhere, First Nations consultation must occur when a Crown-permitted activity may lead to the infringement of Aboriginal rights or title.

A principal difficulty for the working group is the fact that, at this time, there is no clear documented evidence of the relationship between actual expenditures and provincial requirements for environmental assessment and Aboriginal and community consultation. Provincial regulations tend to provide general guidelines with considerable flexibility in application and no reference to the financial

obligations they entail. The working group would benefit from receiving from industry documented, quantified evidence of environmental assessment and community consultation costs incurred as a result of statutory requirements.

Environmental Benefit

Even if not legally required at this time, it is in the public interest, and good business practice, for project proponents to conduct environmental baseline studies at the earliest stages of exploration work to gather the basic data that will establish the standard for measuring the environmental impact of planned future activities. Baseline study data would facilitate the ongoing monitoring of changes to environmental conditions during the present and succeeding stages of project development.

Good baseline data are fundamental to undertaking more detailed studies and to evaluating the efficacy of measures and practices that may be implemented to minimize any adverse effects of mineral development on the environment. In one form or another, environmental baseline studies are becoming an integral part of the environmental assessment process that is now applied to mineral development proposals virtually around the world.

Barriers to Entry for Small Firms

Statistical evidence suggests that, on average, environmental assessment costs represent a relatively small (around 3%) proportion of total exploration costs, particularly at the early exploration stages. The share of total costs that community consultation costs represent cannot be evaluated precisely, but it is also likely to be low, on average, particularly at the early exploration stage.

However, there are indications that the share of environmental assessment and community consultation costs may vary considerably from project to project as a proportion of total exploration costs. Since mineral exploration is often carried out in remote regions where requirements to consult with Aboriginal groups tend to be more extensive, consultation-related expenses could potentially represent a significant cost for junior mining companies engaged in otherwise relatively inexpensive preliminary exploration work in those areas.

A heavy financial burden of community consultation costs might be beyond the capacity of some junior mineral exploration companies that rely on the conventional venture capital markets to finance their operations. If these costs cannot be financed by way of flow-through shares, there is a risk that some junior exploration companies might not be able to participate in exploration projects located in the most promising northern discovery areas.

Industry Proposal and Options

Industry is proposing that the needs they expressed be specifically addressed by including Aboriginal and community consultation costs and environmental baseline study costs in CEE. It is further proposing that these cost items be transferable to

flow-through share investors and that such costs be considered as qualifying expenses for the purposes of the ITCE.

It should be noted that there may be other options for addressing these issues that might also be pursued.

Provincial/Territorial Views

British Columbia

The following is further to the analysis and discussion appearing on pages 35 to 37 of the report *Taxation Issues Relating to Exploration and the Restructuring of Resource Taxation* that was prepared by British Columbia for the 2003 Mines Ministers' Conference.

Environmental study and community and Aboriginal consultation practices, requirements and costs are evolving in response to community expectations, industry and government initiatives, and court decisions. Examples include the E3 program developed by the Prospectors and Developers Association of Canada and the framework contained in the *Seven Questions to Sustainability* published by the Mining, Minerals and Sustainable Development Network North America. Similarly, the British Columbia and Yukon Chamber of Mines is hosting "First Nations Cultural Awareness" workshops in various centres around British Columbia. The results of the Haida appeal to the Supreme Court of Canada could provide important direction for future Aboriginal consultation requirements in B.C. and the rest of Canada.

Changes to how the province's mining industry recognizes consultation expenditures for tax purposes could have implications for the province's other resource industries (e.g., forestry, oil and gas, tourism). These and related matters are the subject of ongoing industry and Aboriginal consultations and discussions by government officials. However, as a result of the need for a consistent set of policies, the Province has not determined if those costs should be CEE when incurred during mineral exploration.

The B.C. government has been working with the British Columbia and Yukon Chamber of Mines to survey some of the Chamber's members regarding their costs and experiences related to environmental studies and community and Aboriginal consultations. Preliminary results are that the direct costs can be a relatively small portion of an exploration program (e.g., 2-3% of a \$1 million program, or less). However, the activities provide important opportunities to build relationships, with training and employment opportunities, and can lay the groundwork for successful development if a discovery is made. Furthermore, the range of costs is quite wide and they could escalate significantly as a result of evolving expectations, court decisions, etc.

Focusing the issue of CEE eligibility on field expenditures, rather than those incurred at the head office or by head office personnel, would simplify the issue. This approach would be analogous to the criteria for other CEE-eligible activities

and would remove a potential ambiguity or problem for field personnel (and related expenditures), whose activities are otherwise CEE-eligible, doing consultations. However, this approach would make the work of head-office consultation specialists ineligible for CEE and be contrary to the intent of providing appropriate tax treatment for such activities.

In summary, in the interests of developing tax policies that are consistent with a sustainable mining industry, the B.C. Ministry of Energy & Mines continues to support the further review and analysis of the implications of policies that:

- classify expenditures for consultations and environmental expenditures undertaken until the completion of pre-production development as CEE;
- allow for the renunciation of those expenditures under FTS agreements; and
- allow for those consultation and environmental expenditures that are FTS financed to also be eligible for the federal ITCE.

Manitoba

During 2003-2004, Manitoba conducted a survey among companies that carried out mineral exploration in the province in an attempt to assess the extent of costs that were incurred during their exploration to facilitate community consultation.

Data were collected from six exploration projects. Total exploration expenditures for the three projects that reported consultation expenses were just over \$900 000, of which a total of \$50 000 was deemed a consultation expense. The percentage of consultation expense for the three individual projects ranged from 3.75% to 8.7%.

Saskatchewan

The issues identified by The Mining Association of Canada and the Prospectors and Developers Association of Canada have not been identified as major concerns by the Saskatchewan mining industry. Nevertheless, Saskatchewan Industry and Resources supports the clarification of the definition of CEE. However, a comprehensive study to evaluate the financial implications for the province has not been initiated at this time.

FEDERAL INCOME TAX RESTRUCTURING FOR THE RESOURCE INDUSTRIES

Background

Bill C-48 received Royal Assent on November 7, 2003. This bill contained the following changes to corporate income tax imposed on mining and oil and gas companies' income, to be fully phased in by January 1, 2007:

- A phased reduction in the income tax rate from 28% to 21%;
- A deduction for actual provincial and other Crown royalties and mining taxes paid;
- An elimination of the 25% Resource Allowance; and
- A new 10% tax credit for qualifying mineral exploration expenditures.

As noted in the 2003 Taxation Issues report, these structural changes may result in incidental increases in provincial taxes paid by the mining industry in several provincial jurisdictions due to the commonality of, and interaction between, federal and provincial corporate income tax bases. Unless provinces where provincial tax calculations would be affected by the federal restructuring of resource income tax provisions make appropriate adjustments, resulting increases in provincial income taxes could hurt the industry's international competitiveness.

Status on Provincial/Territorial Actions

As part of their 2004 budgets, three provinces have proposed measures that neutralize the effects of federal tax restructuring on the amount of income tax to be paid to these provinces by mining companies. Alberta and Quebec propose to keep their current resource provisions unchanged until the end of the transition period (December 31, 2006), at which time they will both eliminate the resource allowance (subject, in the case of Quebec, to possible consequential adjustments). The Ontario budget proposes to maintain the current resource allowance rules indefinitely for the purposes of Ontario corporate income tax calculations.

Federal tax changes do not affect the provincial tax calculations of taxpayers subject to the British Columbia corporate income tax because provincial tax rules already disallow the resource allowance and provide a deduction for actual mining tax payments instead.

All other provinces and territories have not yet proposed any measures for adjustment and, therefore, mining companies subject to the income tax of these provinces will be affected in various degrees depending on their particular circumstances. The effect is directly proportional to the difference between the calculated resource allowance and the actual amount of mining taxes paid. This effect will increase over the transition period and will be stabilized afterwards.

Other Provincial Issues Relating to Federal Income Tax Restructuring

Access to the New Exploration Tax Credit for the Coal Industry

British Columbia is of the view that coal mine developments should be eligible for the Investment Tax Credit that has been developed for diamonds, base or precious metals, and industrial minerals that become base or precious metals through refining. Coal and copper are generally the top two mineral products in B.C. and recent statistics clearly indicate their importance to the province.

Net B.C. Mining Industry Revenues, By Product¹ (millions of \$)

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
Coal (Thermal and Metallurgical)	752	962	964	964
as a % of Total	29%	37%	38%	36%
Copper Concentrates	485	512	425	463
as a % of Total	19%	20%	17%	17%
All Other Products	1 320	1 140	1 134	1 271
as a % of Total	52%	43%	45%	47%
Total Mining Revenues	2 557	2 614	2 523	2 698

B.C. coal mines employed 50% of the people working at the province's major mines in 2003.

Statistics in 2003 also indicate that the scale, operations and logistics of B.C. coal mines are similar to those of B.C. metal mines.

<u>Mine</u>	<u>Mine Method</u>	<u>Products</u>	<u>Scale</u>	<u>Average Employment</u>	<u>Markets</u>
Highland Valley Copper	Open Pit	Copper and Molybdenum	49 million tonnes milled	986	SE Asia
Fording Coal	Open Pit	Metallurgical Coal	8.9 million tonnes produced	768	SE Asia, South America, Europe

¹ Net B.C. mining industry revenues are gross industry sales revenues less treatment and refining charges, marketing expenses, and freight and transportation charges.

<u>Mine</u>	<u>Mine Method</u>	<u>Products</u>	<u>Scale</u>	<u>Employment</u>	<u>Markets</u>
Eskay Creek	Underground	Gold and Silver	115 000 tpy milled	258	SE Asia and Quebec
Quinsam	Underground	Thermal Coal	442 000 tonnes produced	48	BC and Washington

Conversely, the scale of existing and potential B.C. coal mine developments is significantly different from the huge, multi-billion-dollar tar sand developments that are under way or being contemplated in Alberta.

B.C. recognizes the important role of coal in a modern, diversified energy supply system; the province also understands the growing reliance of North America on natural gas and appreciates the environmental issues associated with hydro-electric developments. Where alternative energy sources, such as wind and solar power, are environmentally attractive, the energy requirements of a competitive and growing economy must be recognized.

Coal and uranium production is both consumed domestically and exported. In addition to equity concerns, a policy under which uranium is eligible for the tax credit, while coal is not, does not seem consistent with the objective of simplifying the taxation of Canada's resource industries.

Extension of the credit to the coal sector could make welcome contributions to the successful development of several advanced B.C. coal properties.

<u>Property</u>	<u>Investment</u>	<u>Employment</u>	<u>Production Rate</u>
Willow Creek	\$20 million	103	0.9 million tpy
Wolverine	\$116 million	200	1.6 million tpy
Klappan	\$400 - \$450 million	750	1.5 million tpy

Successful development of those properties would employ dormant rail and port infrastructure, provide welcome economic opportunities in northern B.C., and reduce the province's reliance on the mines and transportation systems in southeastern B.C.

In summary, B.C. supports the federal tax reform measures and strongly recommends that the Investment Tax Credit be extended to include coal mine developments. The recommended measure will remove an inequity, support investment and employment, and make welcome contributions to energy diversity and the realization of Canada's resource potentials.

Saskatchewan Comments on Federal Income Tax Reform

Saskatchewan Industry and Resources supports federal initiatives that would assist producing mining companies in expanding their ore reserve base. This includes increasing the federal corporate mineral exploration tax credit from 10% to 20%.

The Saskatchewan mining industry will generally not experience an overall higher tax burden as a result of the implementation of the 2003 federal budget. Unlike many other provincial and territorial jurisdictions in Canada, the elimination of the resource allowance will not create a significant gain in Saskatchewan provincial revenues. The province will, however, continue to review and revise its royalty and taxation systems to ensure they are competitive with other mineral-producing jurisdictions.

Regulation 3900 Issue

Background

Regulation 3900 defines the nature and amounts of income-based mining taxes that companies are allowed to deduct for federal income tax purposes. The regulation has been in abeyance with respect to its application to mineral resources since 1974, when a policy decision was made to replace the deductibility of Crown royalties and mining taxes by tax abatement and, subsequently, the resource allowance.

Industry Concerns

MAC has expressed concerns about the potential effects of reintroducing Regulation 3900. Legal counsel (including the co-chair of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants) to industry have advised MAC that Regulation 3900 may no longer fully reflect the various forms that mining taxes can take and, as a result, some payments to the Crown may not be allowed as a federal income tax deduction.

“There can be little doubt that legislators are currently under the impression that there will be a full deduction for all mining taxes. As demonstrated in this article, that impression is not well-founded as Bill C-48 and the draft amendments to Regulation 3900 currently stand.”²

MAC attributes this situation to the fact that, in Regulation 3900, there is no definition of “royalties” and “taxes on income from mining operations,” and no criteria to distinguish one from the other. A possible result is that some provincial charges intended as a royalty but that take the form of a tax on income or on capital imposed only on mining operations could be disallowed as a federal deduction. This could be the case, for example, for the Saskatchewan “resource surcharge,” which is levied at 3.6% of “resource sales” but which is enacted under the *Capital Tax Act*. Another example is the N.W.T. mining “royalty” imposed under the *Territorial Lands Act*, which takes the form of a tax on income from mining operations. Finally, some provinces have royalties combined with taxes on income (Nova Scotia, New Brunswick and British Columbia). Without a clear definition, industry fears that some provinces’ mining levies may be deductible in full whereas others may be non-deductible (Newfoundland and Labrador) and yet others may only be partially deductible (Ontario and Quebec).

² Carr, Milot, Casgrain, *Mining Taxes: An Old Problem Revisited*, Federated Press, March 30, 2004.

The Canadian Fertilizer Institute (CFI) notes that Bill C-48 will eventually restore tax fairness for Canada's potash industry as long as the outstanding issue of Regulation 3900 is resolved. The CFI also contends that the draft regulation, formulated as proposed by the Department of Finance, would deprive the potash industry and other mining sectors of the full tax relief intended by Parliament. This view is based on the same commentary noted above.

Provincial Comments

Saskatchewan provided the following comments.

Some industry participants have raised the re-introduction of Regulation 3900 as a concern with the Saskatchewan government. Initial analysis and consultation with the federal government have provided reasonable assurances that Saskatchewan's provincial taxes and levies currently not deductible will become fully deductible with the elimination of the resource allowance. Despite this, the province fully supports clarification of the definition of "taxes on income from mining operations" to clarify that all mining taxes are deductible.

Status

The Department of Finance is consulting with industry on this matter.

ANNEX 1 – MINING ASSOCIATION OF CANADA SUMMARY

Introduction

According to year-end data for 2002, copper, lead, zinc, and silver reserves were at their lowest levels since 1977, with gold reserves being at their lowest level since 1983 and nickel at 1999 levels. Without appropriate levels of exploration, Canada's mineral and metal reserves are approaching dangerously low levels.

Over the past 25 years, copper reserves have dropped by 61%, nickel reserves are down 37%, lead reserves have declined by 90%, molybdenum reserves are down 78%, zinc reserves have dropped down 67%, and silver reserves have declined 64%. Gold remains the only metal that has witnessed an increase in reserve levels, rising by 103% over the 25-year period 1977-2002, although it has been in decline since 1995.

Without the support of the federal and provincial governments, and action by industry to immediately address the decline in mineral reserves, the gap between existing projects and new developments will continue to increase. At risk is the future of the mining industry and resultant repercussions of closing mine, mill and smelting and refining

facilities, lost jobs and communities, and the significant contribution of mining to the Canadian economy and dependent industrial sectors.

Mining Industry's Economic Contribution

- **In 2003, the minerals and metals industry contributed about \$40 billion, or 4% of GDP;**
- **Mining accounts for one of every eight Canadian export dollars, or 13.2% of total exports valued at \$47 billion;**
- **80% of Canadian mineral production is exported, generating a \$1.2 billion trade surplus;**
- **Canada is among the top 5 global producers of 13 major minerals;**
- **Mining employs 389 000 people, representing 1.2% of the Canadian population, or 1 in every 10 jobs in the goods-producing sector;**
- **70% of the world's mining companies are listed on Canadian stock exchanges;**
- **Canadian financial markets generated C\$15.1 billion in global equity mine financing in 2003, representing 44% of total world financing;**
- **The minerals and metals industry generates 73% of the total volume handled at Canadian ports and 61% of domestic rail freight revenue;**
- **Mining and oil and gas extraction undertook more than \$28.5 billion of capital investment, or about 13% of total Canadian investment.**

Comparison of Select Major Canadian Mineral and Metal Reserves

Metal	Reserve Levels		Percentage Change in Reserves 1977 to 2001
	1977	2001	
Copper (000 t)	16 914	6 666	-61
Nickel (000 t)	7 749	4 920	-37
Lead (000 t)	8 954	872	-90
Zinc (000 t)	26 953	8 898	-67
Molybdenum (000 t)	369	82	-78
Silver (t)	30	11	-64

Source: Natural Resources Canada

Corporate Income Tax Restructuring for Resource Industries

Since Budget 2000, MAC has continuously expressed its deep concern that the general corporate rate reductions announced at that time excluded the resource sector. The government responded to these concerns in Budget 2003 by:

- reducing the corporate tax rate of the sector to 21% over the period 2003-2007;
- phasing out the resource allowance over a five-year period, with full elimination in 2007;
- phasing in deductibility of provincial and other Crown royalties and mining taxes over a five-year period, with full deductibility in 2007; and
- introducing a new 10% corporate mineral exploration tax credit for base and precious metals.

While we support the need to lower corporate income taxes, a number of factors must be considered:

- the targeted corporate income tax rate of 21% for the general economy was reached on January 1, 2004, whereas the corporate income tax rate phase-in schedule for resource income will reach 21% in 2007;

- throughout the period 2003-2005, the corporate income tax rate gap between the general economy and resource income will be greater than before the proposed changes in Budget 2003;
- the graduated phase-out of the resource allowance and phase-in of deductibility of provincial mining taxes and royalties will create different resource allowance and deductibility rates for each and every year during the period 2003-2007; the varying rates create an extended period of confusion for investors and administrative complexity for both industry and government; and
- the immediate phased transition period (90% resource allowance rate, 10% deductibility of mining tax in 2003) provided the provinces and territories with no time to adjust to the impacts of the tax changes on their jurisdiction; in the interim period, industry has been left to bear the burden of higher taxes with no commitment that the provinces/territories will adjust their tax system.

Elimination of the resource allowance has increased taxable income for many provinces, creating a windfall revenue gain. Several provinces rely on the calculation of the federal taxable income in the computation of their own corporate income tax. With the exception of British Columbia and those jurisdictions (Alberta and Quebec) that will not proceed with the gradual phase-out schedule for resource allowance, the federal changes will affect the base of most provinces. The impact is immediate as the phase-in period was initiated in 2003. This was clearly recognized in the report prepared by the Intergovernmental Working Group (IGWG) on the Mineral Industry (September 2003) which stated:

“As a result of the new federal tax structure and in the absence of any offsetting adjustment, existing provincial rates will apply on a larger taxable income where mining taxes are less than the existing resource allowance, and provincial income tax revenues from mining will increase.”

Further analysis prepared for MAC by AnalysisWorks concluded that, pending action by the provinces, the net provincial income tax rates on new mines will rise and the increase will be larger for the existing mature mines throughout the phase-in period. The combined federal/provincial net income tax change on existing mature mines will result in higher taxes paid.

While all mining companies will benefit from a lower rate of federal corporate income tax, individual companies will be affected differently by the removal of the resource allowance and provision for deductibility of mining taxes and Crown royalties. The net impact of the new structure will depend on the mix of projects undertaken by individual corporations, the size of accumulated tax pools carried forward from previous years, the level of exploration expenditures, the provincial mining tax rate and profitability of the operation.

MAC recommends that the federal government:

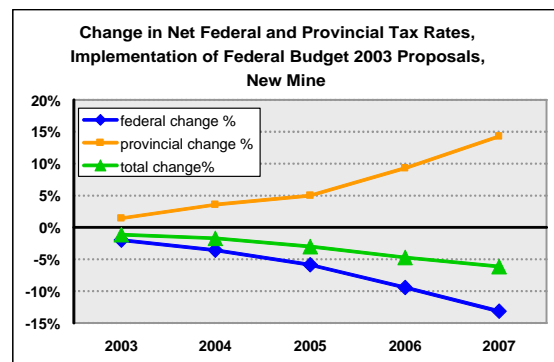
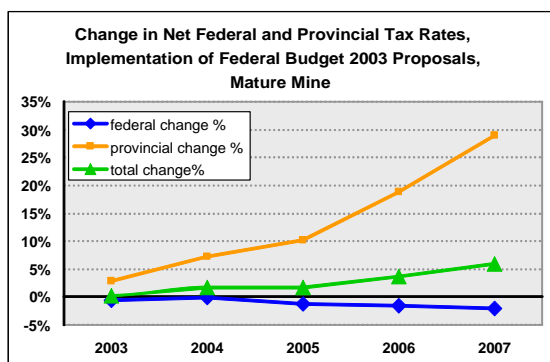
- support the mining industry in addressing the urgency of providing provincial/territorial offsetting adjustments to neutralize any increase in mining revenues resulting from the implementation of Budget 2003;
- increase the new federal exploration tax credit from 10% to 20%;
- modernize the Canadian Exploration Expense (CEE) definition; and
- provide full deductibility of provincial mining taxes and royalties, which may be compromised by the re-introduction of Regulation 3900.

MAC recommends that the provincial governments:

- provide offsetting adjustments to neutralize any increase in mining revenues resulting from the implementation of Budget 2003.

Rationale for Provincial Action Regarding Federal Corporate Income Tax Restructuring

Federal income tax changes in 2003 increased the tax burden on mature base-metal and gold mines. The higher taxable income was offset at the federal level by a reduction in the corporate tax rate, but has not been similarly offset by provinces, therefore creating a windfall income tax revenue increase at the provincial level. Analysis prepared by AnalysisWorks (March 2004 – based on a provincial average of major mining jurisdictions) concluded that the windfall revenue gain will result in 15% higher provincial taxes for new mines and up to 30% higher provincial taxes for mature mines.



Source: AnalysisWorks (March 2004)

With the introduction of legislation resulting from the passage of Bill C-48, *An Act to amend the Income Tax Act (natural resources)*, the transition from pre-2003 rules to the phased-in new regime will have a negative impact on mines across Canada, new mines in general, and mature base-metal mines in particular. Mature mines have substantial invested capital and are effectively captive to the changes in the tax rules.

Neutralizing the impacts of Budget 2003 is paramount, as was duly noted by IGWG (September 2003), which concluded:

“Unless these provinces and territories [exception British Columbia and Saskatchewan] adjust their own corporate income tax regimes, the federal corporate income tax reduction for mining companies will be cancelled out and, in some cases, will result in even higher tax burdens. Finance departments and ministries at the provincial/territorial level need to urgently address this issue since the federal measures will soon be embedded in legislation.”

Given the competitive tax implications and investment link to declining reserves, MAC recommends that the federal government assist industry in urging a rapid provincial and territorial response to evaluate the extent of the problem resulting from the implementation of Budget 2003. Industry is prepared to work with each jurisdiction to identify an appropriate measure to offset and neutralize the impact of the federal budget, recognizing that different circumstances and solutions will apply across jurisdictions.

Rationale for an Improved Exploration Investment Tax Credit

A significant component of the 2003 income tax changes was the introduction of the 10% investment tax credit on basic exploration and initial mine development to offset what the Department of Finance recognized would be an increase in taxes for mature metal mines. Unfortunately, the 10% rate does not fully achieve this objective (as presented to IGWG on March 9, 2004) – mature mines face an increased tax burden.

The benefit of the exploration investment tax credit is largely limited to the encouragement of new mines, which will be able to effectively accumulate and claim qualifying expenses. Operating mature mines, with substantial invested capital previously deducted, are unable to take advantage of the investment tax credit.

As base-metal ore reserves decline across Canada, we are approaching a critical stage whereby some smelters and refineries risk permanent closure, while others operate at reduced capacity due to a lack of domestic ore feed. Most smelters and refineries are maintaining production by importing concentrates, while imported feedstock remains uncertain. The only solution is to renew the ore reserve base through increased exploration to support expanded mine production and maintain Canada’s position as a global mining leader.

An increase in the investment tax credit from 10% to 20% would both neutralize the income tax burden disadvantage remaining from Budget 2003 and encourage incremental exploration by senior mining companies targeted at extending and increasing domestic mineral production.

The projected cost of a 10% increase in the investment tax credit rate is estimated at \$23 million annually post-2006, which is within the tax expenditure forecast by

Finance of \$39 million for 2005, when the tax credit reaches its 10% limit. Based on updated exploration spending figures provided by NRCan, MAC projects that the current cost forecast of the 10% tax credit is substantially less than the \$39 million estimated by the Department of Finance. From our perspective, this provides considerable room to absorb the incremental cost of increasing the rate to 20% while remaining within the projected cost estimates.

Rationale for Tax Amendments to Address Deductibility Concerns With Regulation 3900

Bill C-48 re-introduced Regulation 3900, thus permitting a deduction for “taxes on income from mining operations” that is computed by a complex formula. The intent of the policy change was to provide for full deductibility of provincial and territorial mining taxes and royalties as a replacement for the phasing out of the resource allowance.

From a technical perspective, the definition of “minerals” in Regulation 3900 was broadened in the new legislation and will now apply to minerals extracted from a mineral resource to permit taxpayers to deduct taxes paid on income derived from the extraction of minerals from a mineral resource. While amending the definition is a positive measure, the key issue is the formula.

Regulation 3900 and retention of its complex formula will create a variety of jurisdictional problems whereby some provinces will incur full deductibility while others will only be allowed partial or non-deductibility.

For example, there is no definition that distinguishes “royalties” from “taxes on income from mining operations.” This is best exemplified by the Saskatchewan “resource surcharge,” which is levied at 3.6% of “resource sales” but which is enacted under the *Corporation Capital Tax Act*. Another good example is the N.W.T. mining “royalty” imposed under the *Territorial Lands Act*, which really is a tax on income from mining operations. Finally, some provinces have royalties combined with taxes on income (Nova Scotia, New Brunswick and British Columbia). Without a clear definition, some provinces’ mining levies may be deductible in full whereas others may be non-deductible (Newfoundland and Labrador) and yet others may only be partially deductible (Ontario and Quebec).

From industry’s perspective, the repeal of paragraph 18(1)(m) is insufficient if the formula remains in place. This is contrary to the policy intent of Budget 2003 and raises questions as to why the formula was maintained.

MAC believes that a more appropriate solution would be to amend the *Income Tax Act* so as to make it clear that all mining taxes are deductible. For example, deductibility of mining taxes could be addressed by repealing paragraph 18(1)(m) and amending subsection 20(1) to provide that notwithstanding paragraph 18(1)(a), mining taxes paid to a province or a municipality are deductible by a taxpayer in computing income.

Rationale for Modernizing the Canadian Exploration Expenses (CEE) Definition

A significant opportunity exists to supplement the flow-through-share investment tax credit by modernizing the definition of Canadian Exploration Expenses (CEE). It is in this context that MAC and the Prospectors and Developers Association of Canada have teamed together to recommend the following:

Extension of Ore Reserves: The current interpretation of CEE by the Canada Revenue Agency (CRA) is not consistent with the intention of encouraging renewal of mines through exploration to extend ore reserves, and eventually mine operating life. Exploration to better define a known reserve for mine planning is properly considered a Canadian Development Expense (CDE). However, the exploration effort to extend the reserve base of an operating or recently closed mine involves searching for the “unknown.” Although such exploration may be undertaken from within the area of a current mine, it incurs costs that may never be recouped from future production if a reserve extension is not discovered. From industry’s point of view, at some point between additional quantification of a known reserve and searching for a reserve extension, the cost treatment for tax purposes should shift from CDE to CEE, reflecting the risk profile of the expense. If the exclusion of a reserve extension remains in place, the eligibility of mineral resources that have not yet been developed will eliminate the possibility of finding additional ore near an existing orebody, possibly leading to premature closure of a mine.

Depreciable Property: Industry recommends that charges relating to depreciable property employed in exploration activities should be classified as CEE and that the CRA interpretation of depreciable property employed in exploration activities – costs related to tangible capital assets that are permanently embedded in a mine working that would eventually have to be removed from underground – should be officially rendered public through an interpretation bulletin or other relevant public document.

Feasibility Studies: The current interpretation by the CRA of feasibility studies states that they simply ascertain whether to bring a mineral resource into production and, as such, do not qualify for CEE since they do not determine the existence, location, extent or quality of a mineral resource required to bring a new mine into production. The mining industry has strong reservations regarding this interpretation since a feasibility study should be defined as a summary of knowledge obtained on a specific mineral resource. Ensuring that feasibility study costs are treated as CEE should be addressed by amending the *Income Tax Act* or confirming revisions to the present interpretation.

Community and Aboriginal Consultation Costs: Costs associated with community consultation include expenditures for public notices, community visits, site tours, employee travel, rental costs for meeting facilities, translation services, and legal advice, as well as salaries, benefits, administrative overhead and other internal

expenses necessary to carry out the consultation process. The CRA has considered these costs as CDE since they are incurred for the purpose of acquiring a right, licence or privilege to prospect, explore, drill or mine for minerals. Industry, however, considers these costs to be CEE since they are more closely connected with consent to prospecting activity of existing subsurface rights rather than obtaining or acquiring mining or exploration rights. With the growing magnitude of Aboriginal consultation expenditures, industry recommends that these costs be properly categorized as CEE.

Environmental Baseline Studies: The exploration industry is strongly encouraged to commence environmental baseline studies at the earliest stages of exploration work to establish baseline conditions before the possibility of any significant environmental effects taking place. Examples of the types of studies include sampling and analysis of water, soils, vegetation and resident wildlife, particularly fish, and preparation of expert reports. Proper studies are integral to the completion of the environmental assessment process and should be classified as CEE.

At risk is the competitiveness and sustainability of the Canadian mining industry. It is no longer enough to reiterate past interpretations of the CRA based on the existing legislation. Industry strongly recommends that legislative and/or interpretive change be quickly and formally put in place to ensure that an appropriate level of exploration is consistently under way in Canada to replace its reserve base.

Conclusion

These recommended actions would help to reverse the decline in mineral and metal reserves and ensure that mining continues to provide employment and opportunities across the country. Failure to address this issue will result in lost investment, lost opportunities, and risk the contribution that mining and reliant businesses currently provide to the Canadian economy.

ANNEX 2 – PROSPECTORS AND DEVELOPERS ASSOCIATION OF CANADA (PDAC) SUBMISSION

(Excerpt of a letter sent to the federal Minister of Finance on January 26, 2004,
under joint MAC and PDAC heading)

...This is not a new issue for the mining and exploration industry. In April 2000, the House of Commons Standing Committee on Industry recommended in its report, “Productivity and Innovation: A Competitive and Prosperous Canada:”

“That the government consult with MAC, the PDAC and the Canadian mining industry to clarify the definition of CEE and make flow-through share investments more attractive.” (Recommendation #26)

On numerous occasions over the past three years, we have met with officials from the Canada Customs and Revenue Agency (CCRA), Natural Resources Canada (NRCan) and the Business Income Tax Division of Finance Canada. During the course of these meetings, industry has provided a detailed explanation of our concerns, but with limited progress to date.

During several meetings last year, both MAC and the PDAC were encouraged by discussions initiated under the auspices of a new Federal-Provincial/Territorial Industry Government Working Group on Resource Taxation to address issues related to the CEE definition. While we remain committed to this process, we strongly believe that legislative change is required to modernize the policy intent currently underlying the definition of Canadian Exploration Expenses. The dramatic decline in Canada’s base and precious metal reserves puts Canadian jobs and communities at risk. The ongoing administration of the current law does not address the seriousness of our concerns related to declining mineral and metal reserves.

Modernizing the current definition will provide greater clarity, easier compliance with tax policy principles, encourage exploration, and address problems identified by the CCRA, while providing certainty for flow-through share investors. While no progress has been made over the past six months, we would welcome further dialogue with officials from your Department, CCRA and NRCan and Federal-Provincial/Territorial Mines Ministers, and we would encourage you to consider the following recommendations.

1. Extension of Ore Reserves

The current interpretation of CEE by CCRA is not consistent with the intention of encouraging renewal of mines through exploration to extend ore reserves, and eventually mine operating life. Exploration to better define a known reserve for mine planning is, properly, considered a development expense (CDE). However, the

exploration effort to extend the reserve base involves searching for the currently "unknown". Although such exploration may be undertaken from within the area of a current mine, it incurs costs that may never be recouped from future production if a reserve extension is not found. In our view, at some point between additional quantification of a known reserve and searching for a reserve extension, the cost treatment for tax purposes should shift from CDE to CEE, reflecting the risk profile of the expense. A possible approach to make this differentiation would be as follows:

(a) Operating Mine

Industry believes that a technical modification of paragraph 66.1(6)(f) of the *Income Tax Act* is required since the current definition states that CEE status does not apply to an expenditure otherwise qualified, if it relates to a potential or actual extension of a mine already in operation. In our view, amending 66.1(6)(f) would maintain the policy intent of the current definition but extend CEE status for specific prescribed exploration expenses related to the extension of ore reserves at an existing mine.

(b) Non-Operating Mine

As is the case for operating mines above, an extension of exploration costs prescribed for the application of paragraph 66.1(6)(f) should also be applied to qualified exploration expenditures realized in new zones of a mine that has not been in production for a minimum of 24 months, for reasons other than a strike or labour unrest. The proposed amendment would only apply in circumstances where the mine in question has not officially closed, as defined by provincial legislation, but has remained under care and maintenance for a minimum period of 24 months from the last date of operation.

We propose that the definition of CEE in both the operating and non-operating mine can be achieved by modifying paragraph 66.1(6)(f) as follows:

“but not including

(vi) any expense that may reasonably be considered to be related to a mine that has come into production in reasonable commercial quantities or to be related to a potential or actual extension thereof, except if it is a prescribed expenditure”,

New regulations should be drafted (applicable to both operating and non-operating mines) to specify that, for the purpose of paragraph 66.1(6)(f), the following expenditures, to the extent they are otherwise qualified as CEE would be prescribed:

- *Surface exploration costs incurred outside the boundaries of the extraction rights under which a nearby mine is (has) operated;*
- *Surface or underground exploration costs incurred inside the boundaries of the extraction rights under which a mine is (has) operated. The drilling or*

development must be targeted at a discrete new zone, lithology or structure for mineralization and the intent and result of the exploration program must achieve the following conditions:

- o The drilling or development is at least “x” metres in any direction from existing workings;*
- o The drilling or development is at least “x” metres in any direction from known inferred resources; and,*
- o The drilling or development is for the purpose of adding inferred resources*

The proposed amendment would provide greater certainty on the application of paragraph 66.1(6)(f) and facilitate exploration to target discrete new zones of potential mineralization in and around existing operations or previously operated mines which, based on new geological information, merit additional exploration.

Industry believes that the proposed amendment to paragraph 66.1(6)(f) and related regulations would provide greater certainty in the application of the law and encourage exploration to extend mine life, maintain jobs, and secure the economic independence and infrastructure of local communities.

2. Depreciable Property

MAC and the PDAC continue to believe that the recent introduction of paragraph 66.1(6)(l) raises concerns with the proper classification of tangible items incorporated in underground workings. In a draft document prepared following a February 2001 meeting of the MAC Taxation Committee, CCRA summarized the following:

“CCRA’s position is that depreciable property does not qualify as CEE/CDE. CEE includes expenses incurred with respect to sinking a mineshaft, or constructing an adit or other underground entry. If these expenses were incurred after a mine comes into production, they should be treated as CDE. On the other hand, costs incurred in respect of machinery and equipment and any tangible property acquired solely for servicing, supporting, or providing access to the machinery and equipment are included in a prescribed class. CCRA cannot agree to classify the cost of a cage or a skip as CEE, since those costs are in respect of depreciable property. If such equipment were put in an exploration shaft, it would normally be removed once exploration is over. If that equipment were acquired for a production shaft, the expenditures would also be in respect of depreciable property. On the other hand, CCRA is prepared to work on an assessing policy that would accept that certain electrical wire, ventilation and water pipe expenditures might be considered as pre-production CEE, if incorporated into construction of an underground facility. This could be the case if the costs are incurred in the course of a development program and if the pipes or wires lose their separate existence as tangible capital assets (permanently embedded to a working).

CCRA will not dispute the classification of certain underground costs as CEE, if the costs are in respect of tangible capital assets that are permanently embedded to a mining working and if they would eventually have to be removed

from underground, they would be sold at a value not in excess of their salvage value.”

Industry appreciates CCRA’s interpretation, but recommends that changes relating to depreciable property employed in exploration activities should be classified as CEE and that the interpretation be officially rendered public through an Interpretation Bulletin or other relevant public document.

3. Feasibility Studies

Industry continues to have fundamental concerns with the CCRA claim that the principal purpose of feasibility studies is simply to ascertain whether to bring a mineral resource into production. Based on this logic, feasibility study costs would not qualify for CEE since the study neither determines the existence, location, extent or quality of a mineral resource nor is it required to bring a new mine into production.

The mining industry has strong reservations regarding this interpretation since a feasibility study can also be defined as a summary of knowledge obtained on a specific mineral resource and, as such, is an integral information collection component related to the mineral resource in question.

If feasibility study costs were not considered CEE, they would be deemed an operating cost. This creates a potentially unfair outcome since many projects take longer than seven years (maximum period to carry forward losses) between the time feasibility study costs are incurred and the start of commercial production (not to mention the frequent incidents where the start of commercial production does not proceed). Such an interpretation suggests that exploration expenditures may never be permitted as a deduction. Ensuring that feasibility study costs are treated as CEE should be secured by amending the *Income Tax Act* or confirming revisions to the present interpretation.

4. Community and Aboriginal Consultation Costs

Under many of the provincial mineral tenure statutes, it is a requirement to seek the consent of the surface rights owner, lessee, or any other person having an equitable interest in the relevant land before any searching, prospecting or exploration for minerals can occur, even though the taxpayer has been granted an exploration permit, licence or lease for the mineral rights. In circumstances where such holder of the surface rights is unable to be found or refuses to consent, the Minister may, by order, dispense with the need for the consent and allow the taxpayer to enter the land and proceed with exploration. Certain statutes provide that the owner will be deemed to have consented if the owner refuses to respond to the consent request within 30 days or refuses to grant access for a prescribed reason. If the property is damaged in the course of the exploration activity, the taxpayer is required to compensate the owner accordingly.

In recent times, community consultation, particularly with Aboriginal groups, has become a significant obligation for many prospectors and developers. At worst, the surface rights holder can request an injunction to defer any exploration activity until the matter is settled before the courts. Costs which the PDAC considers associated with community consultation include expenditures for public notices, community visits, site tours, employee travel, rental costs for meeting facilities, translation services, and legal advice, as well as salaries, benefits, administrative overhead and other internal expenses necessary to carry out the consultation process. These discussions are often ongoing and frequently subject to further negotiation as the exploration activity progresses. No additional licence is granted after reaching consent. If a project evolves from the grass-roots stage, a memorandum of understanding may be the end product of such consultations for advanced exploration, but it is an ongoing process that is required to move a project into pre-production.

We understand that the CCRA has in the past considered such costs as CDE on the basis that such expenditures arise from acquiring a right, licence or privilege to prospect, explore, drill or mine for minerals in a mineral resource in Canada. With due respect, the PDAC considers these costs to be CEE since they are more closely connected with a consent to prospecting activity of existing subsurface rights rather than obtaining or acquiring mining or exploration rights.

The magnitude of Aboriginal consultation expenditures may be considerable, even for junior companies operating at the initial exploration stage. Given the perennial challenges that junior companies face in raising sufficient funds for exploration, as well as the critical importance of sustaining high-risk “grass-roots” exploration in support of the overall mineral development cycle, we respectfully request that the CCRA review its position and confirm that these costs should be properly categorized as CEE.

5. Environmental Baseline Studies

The PDAC and the Canadian mineral industry concur in the need to implement exemplary environmental practices wherever the industry explores for minerals throughout the world. Consistent with these values, the PDAC has established its Internet-based Environmental Excellence in Exploration (“E3” Program), which is an unparalleled online resource designed to promote and ensure the highest levels of environmental care in mineral exploration throughout the world. Managed by the PDAC with the contributions of industry leaders, E3 offers field-proven information on environmental management practices for minerals exploration globally.

Through this and other initiatives, explorers are strongly encouraged to commence environmental baseline studies at the earliest stages of exploration work to establish baseline conditions before any significant environmental effects take place. Examples of the types of studies include sampling and analysis of water, soils, vegetation and resident wildlife, particularly fish, and preparation of expert reports.

Good baseline data are fundamental to undertaking more detailed studies and to evaluating the efficacy of mitigative measures and other practices that may be implemented in order to minimize any adverse effects of mineral development on the environment. As a result, proper studies are integral to the proper completion of the environmental assessment process that is now applied to mineral development proposals virtually throughout the world.

We believe costs associated with baseline studies also meet the definition of CEE since they are incurred as part of the exploration activity. We would appreciate the CCRA's concurrence with our views. If the CCRA wishes to proceed along these lines, the PDAC looks forward to assisting in the preparation of an Interpretation Bulletin.

ANNEX 3 – COMBINED SUBMISSION BY THREE PROVINCIAL MINERAL EXPLORATION ASSOCIATIONS

About Industry Associations

The British Columbia and Yukon Chamber of Mines, the Ontario Prospectors Association and the Quebec Mineral Exploration Association are regional forums for Canada's mineral exploration stakeholders. They serve to enhance exploration efforts and foster mineral development throughout the country. These forums comprise roughly 2400, 850 and 600 members, respectively. Their members are prospectors, geologists, geophysicists, contractors and promoters, not to mention corporate members such as junior and major mining companies.

Among other activities, each of these forums organizes an annual convention to focus on issues such as land use, tenure security, Aboriginal participation, exploration technology, geoscience, and access to risk capital. These events are always well attended. For example, 4000 participants were at the Vancouver Roundup, 1100 were at Quebec Exploration 2003, and 700 participated at three geoscience symposiums in Ontario.

Canada's Mining and Minerals Industry

Canada's mining and minerals industry is a major component of this country's economy. In 2003, it directly employed 389 000 Canadians. These jobs were shared across a number of sectors: 47 000 in mining, 59 000 in smelting and refining, and 283 000 in the manufacture of mineral and metal products. Furthermore, workers in the mining, quarries and oil wells industry earned, on average, over \$1000 weekly, one of the highest levels of any industry in Canada. In 2003, the mining and minerals industry contributed a respectable \$41.1 billion to the Canadian economy. This is equal to 4.1% of the national gross domestic product.

Specifically by region, British Columbia's mining and minerals industry employs over 7000 and, including coal exploitation activities, contributes roughly \$2.8 billion annually to the Canadian economy. For its part, the mining and quarries industry in Ontario employs over 14 000 workers. Among these, some 9000 are employed in the mining of metals such as nickel, copper and gold. The Ontario sector contributes around \$5.7 billion every year to the Canadian economy. The mining and minerals industry is also important in Quebec. Employing 11 000 directly in mining, the provincial industry annually contributes \$3.7 billion to the economy. In 2003, 61% of exploration and deposit appraisal expenditures in Canada was spent in these three provinces alone.

It also needs to be noted that the activities of the mining and minerals industry are largely concentrated in the rural and northern regions of the country, often in the vicinity of Aboriginal communities. As a result, the industry's economic impact carries even greater weight on local and regional scales.

Falling Commodity Reserves

Canada's mining and minerals industry is passing through the worst low cycle to have been experienced in several decades. Investments in exploration began to decrease dramatically in 1997. This trend can be attributed to a number of factors, including plummeting metal prices. In response to the negative trend, the Investment Tax Credit for Exploration (ITCE) was implemented in October 2000. The program proved effective and resulted in increased investment in mineral exploration as shown below:

EXPLORATION AND DEPOSIT APPRAISAL EXPENDITURES			
Jurisdiction	2001 (\$ millions)	2003 (\$ millions)	Increase 2003/2001
Quebec	102.9	150.0	46%
Ontario	113.6	190.8	68%
British Columbia	29.1	49.9	71%
Canada	512.9	641.3	25%

Source: Natural Resources Canada, Minerals and Mining-Statistics On-Line
http://mmsd1.mms.nrcan.gc.ca/mmsd/exploration/byprov2004_e.htm

Despite these improvements, however, investments did not climb to the levels observed in the mid-1990s. By way of illustration, in British Columbia in the 1980s, two mines opened for each closure; in the 1990s the opposite was observed. It is these low levels of mineral exploration that directly account for the drop in Canada's commodity reserves. Mineral exploration is a long-term process; time is necessary to identify and bring into production the new mineral deposits that will replace extracted commodities.

Investment Tax Credit for Exploration

Extension for Three Years, Until 2007

To ensure the levels of mineral exploration necessary to renew exploited reserves, **the ITCE must be extended for another three years, until 2007.**

Over the last few years, a period marked by extremely difficult market conditions, including a meltdown of the high-tech sector, lacklustre commodity prices and major

corporate scandals, the ITCE has proved effective. It has not, however, been in place long enough to allow necessary levels of investment to be attained.

The monies raised through the ITCE stay in Canada. The program has encouraged some companies to return to Canada (e.g., Candente in Newfoundland and Labrador), others to drill deeper (e.g., Miramar beneath its Hope Bay, Boston and Suluk deposits in Nunavut) and still others to assume more grass-roots projects (e.g., Stornoway and others exploring the Melville Peninsula for nickel and platinum group metal potential, and finding diamonds instead).

The program is a model for innovative and “smart” regulation. It requires no extra administration for disbursement of what in effect are transfer payments, nor is there any need for government officials to pick “winners.”

This economic activity is concentrated in rural and northern Canada, including Aboriginal communities, and it maintains or creates employment in areas with limited job opportunities. Operation and service sector jobs are filled locally.

Mineral exploration requires protracted, highly technical work, even after an initial discovery has been made. Planning programs, consultations, plan revision and coordination with contractors frequently in remote locations require long-term commitments. Such commitments are difficult even when the economy is strong. One-year extensions of flow-through-share funding create uncertainty and have a negative impact on planning. A three-year renewal of the ITCE would offer more continuity and better reflect the nature of remote exploration projects where year-round access is rarely possible.

The ITCE was introduced to help the mineral exploration sector to raise funding while investor confidence and interest were low. Liquidity, which is a reflection of investor interest, remains a serious problem. While the industry awaits the return of a steady investor confidence, a significant exploration effort can still be sustained by the continuation of the ITCE. On the other hand, failure to extend the program will immediately reduce exploration activity with a concomitant drop in mineral discoveries and their associated economic activity across the country.

In Quebec, the provincial government announced in its spring budget that its flow-through-share program would become permanent. The Quebec government has made a clear statement by making its program a key element of future mining industry development.

February 28 Deadline

The cut-off date for raising funds eligible for the ITCE should be moved to February 28.

Under current rules, companies that have to raise public funds are faced with a major schedule obstacle. The December 31 deadline is a problem for many exploration

companies because it forces them to campaign for financing in November and December. These months of the year are not in line with other tax shelter programs and it is difficult for investors to make informed decisions. A February 28 deadline would bring exploration companies and investors in line with the other tax shelter programs available at that time of the year.

Canadian Exploration Expenses

Over the last two decades, legislative requirements (financial and environmental) and communications with Aboriginal communities have evolved tremendously. During this same period, eligible Canadian Exploration Expenses (CEE) have not been updated significantly to take into consideration the industry's modern operational framework.

Five changes are necessary to improve the CEE so that Canada remains a high-priority destination for exploration companies. These changes could also contribute to the recuperation of the over \$2 billion in Canadian exploration dollars spent abroad in 2003.

1. Financing Costs Via the Super Flow-Through-Share Program

With the increase in legislative and control measures, exploration companies have to invest considerable amounts of money in preparing public financing campaigns. The amounts thus required draw heavily on working capital normally allocated to administration and management. Consequently, share-issuing costs related to financing through the super flow-through-share program should qualify as CEE.

2. Community and Aboriginal Consultation Costs

For a few years, community consultations have represented a heavy financial burden for many mineral exploration companies. The costs associated with these consultations include the distribution of public notices, community visits and on-site tours, employee travel, the rental of meeting rooms, translation and legal advice, not to mention expenditures related to wages and benefits, overhead and other expenses essential to a smoothly run consultation process.

Since mineral exploration is often carried out in remote regions, consultation-related expenses can be inordinately high for junior mining companies engaged in relatively inexpensive preliminary work. Conscious of the necessity to support high-risk local exploration projects in order to stimulate the economic development of the mining industry as a whole and the regions concerned, these consultations have become an integral part of exploration work. They need to be included as CEE. In fact, they are more

closely related to prospecting activities on properties covered by subsurface rights than to the acquisition of mining rights or exploration rights in a given province or territory.

3. Environmental Baseline Studies

Environmental baseline studies are a normal part of exploration activities and are often compulsory under federal or provincial regulations. As tax treatment should encourage exemplary environmental practices, these studies should qualify as CEE.

4. Exploration Close to an Existing Mine

Exploration investment should qualify as CEE provided it targets new zones or geological structures separate from existing resources that have been or are being mined. Exploration investments should fit into the CEE definition of “determining the existence, location, extent or quality of a mineral resource in Canada.”

5. Feasibility Studies

Feasibility studies are essential to determine the quality of a mineral resource, whether it is a reserve or a resource. If these studies do not qualify as CEE, they must be operating costs and hence they represent potential lost deductibility if the project doesn't proceed on time.

Recommendations

Changes to the Investment Tax Credit for Exploration (ITCE)

- Extend for three years, until 2007
- Move cut-off date to February 28

Changes to Canadian Exploration Expenses (CEE)

- Financing costs via the super flow-through-share program
- Community and Aboriginal consultation costs
- Environmental baseline studies
- Exploration close to an existing mine
- Feasibility studies

ANNEX 4 – DESCRIPTION OF NOVA SCOTIA'S ENVIRONMENTAL ASSESSMENT PROCESS

Environmental assessment in Nova Scotia is led by the Environmental Assessment Branch of the Department of Environment and Labour. It is legislated by Part IV of the *Environment Act (1995)* and the environmental assessment process is set out in the *Environmental Assessment Regulations* and the *Environmental Assessment Board Regulations*.

The Government of Nova Scotia has undertaken a “one-window” approach to reviewing, permitting and monitoring mine development projects in Nova Scotia. The process involves the Nova Scotia departments of Natural Resources and Environment and Labour, as well as other provincial, federal and municipal government agencies, as determined on a project-by-project basis, and streamlines the review process for both government and the mining industry.

Industrial development projects are grouped as either **Class 1** or **Class 2** under the *Environmental Assessment Regulations*.

Class 1 undertakings are usually smaller in scale and may or may not cause significant environmental impacts or be of concern to the public. A public review of a proponent's initial submission or registration is required and the Minister decides if a more detailed review and/or public hearing is required. These types of developments include, but are not limited to, mines, certain highways, and waste or dangerous goods-handling facilities.

Class 2 undertakings are typically larger in scale and are considered to have the potential to cause significant environmental impacts and concern to the public. These types of developments include, but are not limited to, solid waste incinerators, petrochemical facilities, and pulp and paper plants. These undertakings require an environmental assessment report and formal public review, which may include hearings. The public hearings are conducted by the Environmental Assessment Board, which consists of representatives selected from various professional, industrial and labour groups.

Most mineral development projects are Class 1 projects. The process for environmental assessment of a Class 1 project is as follows:

Registration and Advertising

The project is registered with the Department of Environment and Labour and within seven days the proponent must publish a Notice of Registration in a provincial and local newspaper, which informs the public on how to obtain details of the registration.

Screening

Class 1 projects are subjected to a screening process to allow input from various government agencies and the public. This information is received by the Administrator and is used to determine if further environmental information is required to assess the project.

Government Directives for Subsequent Action

Within 25 days of the project's registration, after having reviewed all pertinent information, the Minister must issue one of the following five directives:

The project is approved to proceed

If there are deemed to be no adverse effects or no significant environmental concerns that may be caused by the undertaking, or the proponent has reasonably demonstrated that any concerns can be mitigated, the project may be approved to proceed. Some conditions may be attached to the project's release.

More information is necessary

The proponent might be advised that insufficient registration material has been submitted and that more details must be supplied concerning the project.

A Focus Report is necessary

If the initial review indicates that there may be limited adverse effects or environmental problems, a Focus Report may be required to address these issues. The Focus Report will concentrate on specific issues arising from the registration document.

An Environmental Assessment Report (EAR) is required

An Environmental Assessment Report may be required if there is the potential for adverse effects or significant environmental concerns. Examples of the criteria used to determine the need for a full Environmental Assessment Report include:

- I. location, size, and scope of the project,
- II. nature and sensitivity of the area, or
- III. outstanding public concerns.

The EAR involves a structured process that offers the public the greatest opportunity for formal involvement. The public is invited to submit comments and assist with preparation of the Terms of Reference for the EAR. The process may involve solicitation of written public comments on the EAR or the Minister can refer the EAR to the Environmental Assessment Board to conduct public hearings. This is generally done for

projects that are of significant public concern or when the project is expected to have a significant social or environmental impact.

The project is rejected

If review of the environmental information indicates that there is a strong possibility of adverse environmental or socio-economic impacts that cannot be adequately controlled or mitigated, the Minister can reject the project.