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# Taxation Issues

for the

# Mining Industry

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*A Report by the Intergovernmental  
Working Group on the Mineral Industry*

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# Introduction

This report has been prepared by the sub-committee on taxation (the sub-committee) of the Intergovernmental Working Group on the Mineral Industry (IGWG). The report examines Canada's mineral taxation regime in light of the economic crisis, and represents the views of a majority of participants. It is divided into three main sections: situational analysis, considerations, and recommendations.



# Situational Analysis

## THE ECONOMY

Canada was in the midst of a record-setting period in its mineral exploration history when worldwide economic conditions took a turn for the worse in September 2008. The worldwide economic downturn greatly reduced the demand for minerals and metals, apart from gold and uranium. Consequently, metal prices declined significantly. Compounding the effect of lower prices, severe credit restrictions and increased risk aversion amongst investors made it very difficult for junior exploration companies<sup>1</sup> to raise equity financing. As a result, current and planned expenditures on exploration and deposit appraisals were curtailed significantly, despite the maintenance or improvement of federal-provincial-territorial tax incentives for exploration.

## EXPLORATION

Based on the federal-provincial-territorial Survey of Mineral Exploration, Deposit Appraisal and Mine Complex Development Expenditures,<sup>2</sup> exploration and deposit appraisal activity reached \$2.8 billion in expenditures in 2008, an amount similar to the one recorded in 2007. This appears to be a plateau at the top of the upward trend that had been initiated in the early part of the decade. Total company spending intentions for 2009 point to a clear break from that trend with forecast expenditures of \$1.5 billion. While it is still too early to say if this reduced amount of exploration activity is indicative of things to come, the \$1.5 billion total remains a respectable amount when compared to expenditure levels recorded in the late 1990s and early 2000s.

## BASE-METAL RESERVES

The current economic downturn, and associated reduction in exploration levels, has exacerbated Canada's long-standing decline in base-metal reserves, which is an ongoing policy concern for governments. The causes of the decline are multiple and complex. However, industry is concerned that current tax incentives are focused in a way that encourages exploration in greenfields areas where new base-metal reserves are less likely to be developed.

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<sup>1</sup> Junior mineral exploration companies with no revenue from mining operations.

<sup>2</sup> The numbers for 2008 are preliminary estimates and those for 2009 are based on company spending intentions. Because the downturn happened so quickly, companies, and by extension the results of the survey, did not fully reflect its impact on their plans and projects. As a result, the reader should be aware that the 2008 totals could be overestimated and that, for 2009, some companies were unable to provide their spending plans at the time of the survey exercise.

## **ENVIRONMENTAL AND SOCIAL ISSUES**

Corporate social responsibility (CSR) activities are believed to be vital to ensure the competitiveness of industry. Being involved with communities and developing a harmonious long-term relationship with people of nearby settlements can serve to enhance a company's reputation and to facilitate an expansion of its domestic and international businesses. This is particularly important for the mining industry, which operates mines that are often located in remote areas where they become a dominant but temporary activity that can cause large environmental and social disturbances.

# Considerations

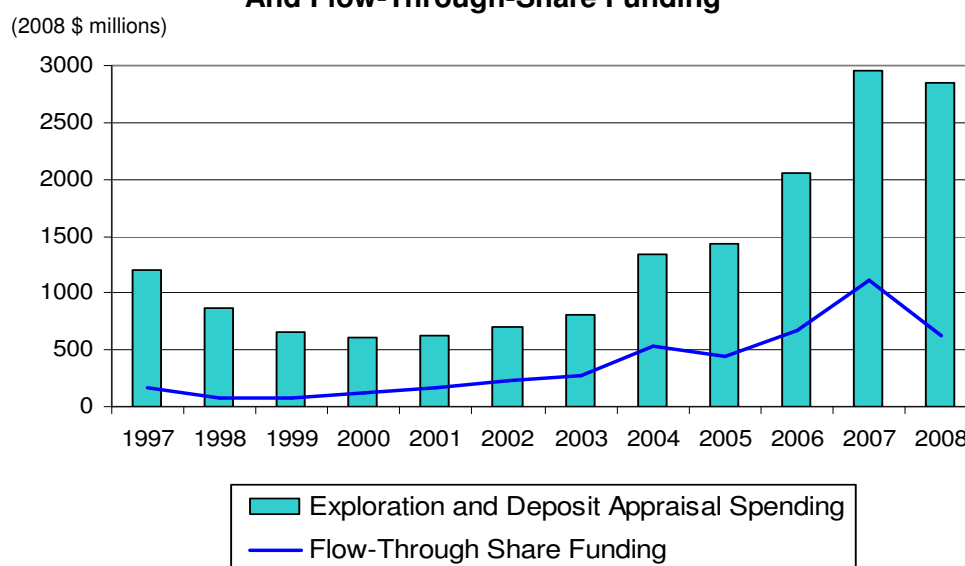
## SHORT-TERM ISSUES

### Mineral Exploration Tax Credit Extension

Natural Resources Canada (NRCan) extended its ongoing analysis of flow-through-share (FTS) incentives for mineral exploration to cover the period from 2000 to 2008. While several country-specific factors may have important effects on the level of exploration spending, the analysis seems to suggest that Canadian tax incentives for exploration were relatively more important in the 2000-2003 period than afterwards.

Between 2000 and 2008, junior companies (with the help of almost \$4 billion in FTS funding raised since the introduction of the Mineral Exploration Tax Credit [METC])<sup>3</sup> overtook senior companies as the leading exploration group in Canada. However, there is evidence suggesting that FTS-related exploration incentives were not equally relevant throughout the period. As shown in Figure 1, FTS use increased after the 2000 introduction of the 15% METC. Their use actually intensified as a proportion of total exploration spending up to 2003, when exploration financed by FTS represented close to 50% of total exploration and deposit appraisal spending. From 2004 onwards, however, the intensity of their use decreased gradually with FTS funds financing less than 20% of total spending in 2008.

**Figure 1**  
**Exploration and Deposit Appraisal Expenditures,**  
**And Flow-Through-Share Funding**



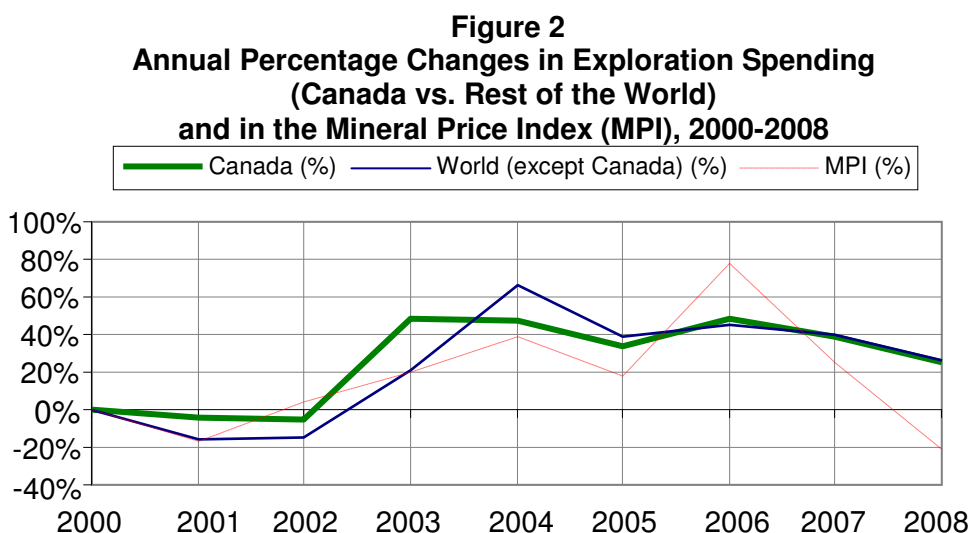
Source: NRCan.

<sup>3</sup> Companies with revenues from mining operations.

This suggests that, from 2000 to 2003, when traditional sources of financing were less accessible, FTS were seen as an important source of financing, particularly for junior companies. From 2004, exploration companies had increasing access to sources of venture capital other than FTS and, accordingly, FTS-related tax incentives became relatively less attractive (see *Annex I. Exploration by Flow-Through Shares* for recent financing data).

Figure 2 illustrates the annual changes in exploration spending that occurred in Canada and in the rest of the world relative to the annual changes in the metal price index. One can see that Canada outperformed the rest of the world in terms of exploration spending growth from 2000 to 2003, with Canada surpassing Australia as the leading destination of mineral exploration investment. During this period, exploration spending in Canada actually increased at a faster rate than metal prices.

In contrast, exploration expenditures in 2004 increased more in the rest of the world than in Canada, while exploration spending from 2005 to 2008 increased at about the same rate in the two regions, even though tax incentives continued to be available in Canada throughout the period.



Source: MEG data.

When prices are low and decreasing (as was the case from 2000 to 2001), incentives help mitigate the fall in exploration spending by allowing FTS funds to partly replace other sources of financing. This suggests that exploration incentives may be most relevant when prices are at the bottom of the cycle and are starting to recover (as was the case from 2001 to 2003). Presumably, at this point, investors may accelerate their investment in exploration because there is an expectation of financial gain, and incentives serve to compensate for part of the risk of an early investment. When tax incentives are available, exploration for gold and other precious commodities appears to be the principal beneficiary. Junior companies tend to react faster to anticipated or actual price increases in the precious metal commodities. They are more sensitive to positive price movements for commodities such as gold because of more rapid capital gain appreciation potential for shareholders, shorter lead times to production, lower capital costs, and less daunting infrastructure challenges.

However, when commodity prices reach higher levels and progress to the peak of the cycle, exploration funds become more easily accessible to junior companies through regular share issues and other financing means, and the availability of incentives may have less of an impact on exploration spending growth.

The temporary 15% METC is due to expire on March 31, 2010. The Government of Canada will need to assess whether a further extension is merited.

It is recommended that the sub-committee continue its analysis of flow-through-share incentives for exploration.

### **Canadian Exploration Expense (CEE) - Eligibility Rules**

With rapidly growing exploration expenditures, especially in the North and in remote regions of Canada, it is important that the tax treatment of community consultations and baseline environmental studies be well understood. Companies, and most particularly junior companies who are responsible for a large part of the mineral exploration spending, now have more certainty on the eligibility of their expenses for CEE treatment.

It has been suggested, however, that accountants and tax practitioners could benefit from further clarification concerning the CEE eligibility of other exploration-related costs, such as exploration work performed in offices located outside mining properties.

It is recommended that the sub-committee investigate opportunities to hold awareness sessions on Canadian Exploration Expense eligibility rules.

### **Canadian Exploration Expense - Overhead Costs**

To reduce the impact of the current financial crisis on the mineral exploration sector in Canada, the Prospectors and Developers Association of Canada (PDAC) proposes to allow financing and legal costs related to the structuring of flow-through-share arrangements to qualify as CEE for renunciation under such arrangements.

Expenses that qualify as CEE only include expenses incurred for the purpose of determining the existence, location, extent and quality of a mineral resource in Canada. CEE explicitly excludes overhead costs (such as head office costs, financing and legal costs, etc.) on the grounds that such costs are not incurred directly in relation to the exploration activity per se. The same exclusion applies to all mineral, oil and gas, and renewable energy and conservation projects for which CEE are incurred.

Overhead costs incurred in relation to mineral exploration activities are normally treated as Canadian Exploration and Development Overhead Expenses (CEDOE). CEDOE are fully

deductible by the exploration company and the portion that is not deducted can be carried over indefinitely. However, they are not eligible for the METC and cannot be transferred to FTS investors. CEDOE include administration, management, or financing of exploration and development, and salary, wages, or other remuneration or related benefits paid to a person whose duties were not all or substantially all directed towards exploration or development activities.

Part of the attractiveness of flow-through shares for investors is the assurance that the full proceeds of their investment for which they get a CEE tax deduction are used directly in exploration activities that have the potential to increase the value of their holding. Allowing overhead expenses as CEE may not be in the best interest of shareholders since it would reduce the proportion of investment directly engaged in exploration. It could also introduce confusion as to which part of the investment is engaged in productive activities.

Special tax treatment is accorded to CEE on the grounds that qualifying activities are directly related to exploration. Extending CEE treatment to financing and legal expenses would not directly stimulate mineral exploration, although it has been argued that it may allow companies that currently have no other means of financing other than FTS to carry on their exploration business.

*There is no strong rationale for allowing overhead expenses as CEE only for mineral exploration financed by flow-through shares. Any such extension would likely have to be accorded to all industries and agents carrying out qualifying activities, and the tax revenue loss to government could be significant.*

## **LONG-TERM ISSUES**

### **Declining Base-Metal Reserves**

As noted in the sub-committee's 2008 report to Mines Ministers, there has been a significant decline in Canadian mineral reserves over the past 25 years in all major base metals. Additions from new and existing mines have been insufficient to offset ore depletion. This decline is being exacerbated by the recent fall in base-metal prices and the closure of mines.

The causes for the decline in nonferrous metal reserves are numerous and complex, and most of them are not linked to the tax system. Notwithstanding this, tax incentives are focused on exploration in greenfields areas, partly premised on the risk in such areas. New base-metal reserves, however, are more likely to be developed in the short term in the vicinity of existing or former producing mine operations.

The current focus on encouraging greenfields exploration activity has resulted in a stronger junior mining sector, in the discovery of a number of new areas of interest, and in the advancement of many projects. Industry is fully supportive of the continuation of these measures.

In 2008, the Intergovernmental Working Group on the Mineral Industry tasked the sub-committee on taxation (the sub-committee) to continue its detailed analysis of, and interdepartmental consultations on, two industry proposals to incent exploration near operating mines and on closed mine sites. These two proposals (one concerning the adoption of an automatic rule to allow a new mine status for mines closed for five years or more, and the other concerning the introduction of

new incentives for deep drilling near operating mines) continue to be studied by the sub-committee.

### *New Mine Status – 60-Month Rule*

The income tax law currently makes a fundamental distinction between a new mine and a mine that has come into production as far as the tax treatment of exploration, development, and capital costs is concerned. Expenses related to a new mine are treated more favourably than similar expenses incurred in relation to a mine that has come into production on the grounds that the process to bring a new mine into production is more costly, more uncertain, and takes more time than the process to extend the life of an existing mine.

The introduction of an automatic 60-month rule was proposed by industry as a way to incent exploration on the sites of mines that have been closed for five years or more. The proposed introduction of the rule was intended to provide more certainty on the CEE eligibility of exploration carried out on such properties and to reduce the administrative cost of ruling on a new mine status.

At issue is whether or not the application of a 60-month rule would result in decisions that conform to the policy principles noted above, the wording of the *Income Tax Act*, and court decisions. More specifically, is a mine closure of 60 months long enough to ensure that mine sites have lost the characteristics of a mine<sup>4</sup> and that all exploration and development expenses are incurred for the purpose of discovering a new mineral resource or bringing a new mine into production?

To verify this hypothesis, NRCan reviewed the technical opinions that it had sent to the Canada Revenue Agency during the 1999-2009 period in relation to all advance tax rulings that dealt with the determination of a new mine status. There were 23 new mine status requests (or 2.3 requests per year) examined by NRCan during the period from 1999 to 2009. Nine requests were related to projects in the vicinity of operating mines, ten were related to mines closed for five years or more, and four were related to mines closed for less than five years.

Based on the analysis, the sub-committee is of the opinion that the proposed measure would not provide a reliable alternative to the existing determination process. Given the relatively high proportion of properties closed for five years or more that failed to meet the conditions for a new mine status (30%), case-by-case examinations still appear to be necessary to ensure a consistent application of the law.

At the provincial level, a number of provinces have an automatic rule to determine a new mine status. The R.R.O. 1990, REGULATION 769 of Ontario's *Mining Tax Act*, in its section 7, states that "For the purposes of section 3.1 of the Act, for taxation years of operators ending after April 30, 1991, a mine shall be considered to be a new mine that has come into existence after May 20, 1987, (c) where the mine resumes production in reasonable commercial quantities after having been closed down after May 20, 1987 for a continuous period of at least 60 months. *Reg. 817/94, s. 1.*" Newfoundland and Labrador also has a comparable rule while New Brunswick

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<sup>4</sup> Removal of buildings and installation, and rehabilitation of the site.

uses a 120-month rule. Manitoba uses ministerial discretion to determine a new mine status. Finally, British Columbia is also considering introducing a 60-month rule.

*Evidence suggests that, except for particularly complex cases, delays in reaching a decision on new mine status determinations are relatively short (less than 100 days). They could be made significantly shorter for requests requiring a fast response (such as those related to prospective flow-through-share issues) if such requests were assigned top priority and if requirements for the determination were made known to the relevant audience in advance of submissions.*

It is recommended that the sub-committee investigate opportunities to hold awareness sessions on the requirements for determining new mine status.

### *Incenting Exploration Near Operating Mines*

Exploration expenses related to an operating (or formerly operating) mine do not generally qualify for greenfields exploration tax incentives (i.e., CEE tax treatment and related tax incentives such as access to flow-through-share financing, and the 10% corporate preproduction mining expenditure credit). Instead, such expenses are often treated as operating expenses, especially if they are part of the normal mining sequence that progressively extends, and gives access to, the incremental ore reserves that are required for the continuous mining operations.

CEE tax treatment may be available if it can be demonstrated to tax authorities that the exploitation of ore reserves, found as a result of the exploration activity, would require a new mine and would not materially use existing mining infrastructure and workings. For this demonstration to be made, NRCan, on behalf of the Canada Revenue Agency, must conduct a technical examination of all facts relative to the exploration project and possible future mining plans. It has been contended (but not clearly demonstrated) that the technical examination process is lengthy and that its results are unpredictable.

Ongoing exploration is generally considered low risk since it normally occurs at the periphery of already defined reserves for the purpose of following up their continuity and delimiting their lateral or vertical extensions. However, not all exploration conducted in an operating mine is of an ongoing, low-risk nature. Exploration risk increases significantly when ore zones are discontinuous and where their distribution does not follow a known pattern. In this type of environment, the risk factor increases sharply at depths greater than 300 metres as exploration targets become elusive and move significantly below known reserves and underground infrastructure. A decision to undertake underground exploration becomes more difficult when a high level of risk is combined with a large project cost. Such is the case when the purpose of the exploration is to find sufficient underground reserves to justify the sinking of a new deep shaft and the construction of related underground workings.

Industry notes that targeted tax incentives are focused on greenfields exploration, although some projects in the vicinity of an existing mine exhibit comparable risks. Industry has proposed that CEE be accorded to exploration projects that meet certain objective criteria that would be tied to the level of risk. The Quebec Mining Association (QMA) made a specific proposal that used

distance criteria (400-metre lateral distance and 150-metre vertical distance from the periphery of known reserves). This proposal was supported by The Mining Association of Canada (MAC).

The QMA proposal was examined by the IGWG tax sub-committee. It represented an interesting approach, but would have been challenging to administer. For example, the application of the proposed lateral distance criterion would not be able to exclude expenses incurred in a strata-bound deposit environment, which involves much less risk than greenfields exploration. MAC has suggested another approach that involves treating all underground expenses currently treated as Canadian development expenses as operating expenses. While this approach would be simple to administer and implement, it would not directly reduce the cost of deep underground exploration (it would rather reduce the cost of development).

In order to facilitate further analysis and discussion of this industry proposal, NRCan has requested technical input from several mine operators in the following areas:

1. Description of the detailed conditions and circumstances under which, and reasons why, deep drilling/exploration projects fail to qualify as CEE under current tax rules;
2. Identification of selected deep mining projects that are currently on hold but would go ahead if expenses were treated as CEE, including project-specific cost analysis; and
3. Suggestions of amendments to proposed distance criteria or other criteria that:
  - a. could separate higher-risk exploration from routine exploration, and
  - b. would be measurable and verifiable by technical audits.

Industry submissions are being sent to NRCan for review. They will be examined to help the sub-committee evaluate this issue.

It is recommended that the sub-committee continue its detailed analysis and consultations on the industry proposals for Canadian Exploration Expense eligibility for high-risk exploration carried out in the vicinity of operating or formerly operating mines.

## **Environmental and Social Issues**

In September 2007, the Government of Canada clarified the circumstances under which costs associated with community consultation and environmental baseline studies were eligible for CEE under the *Income Tax Act*. This clarification came in the form of a guide that was released by the CRA and announced in a letter to the PDAC. The PDAC has made the table clarifying these expenses available to its members by posting it on its web site.

Industry has also expressed concerns that the tax treatment of various types of environmental and social expenses are not clearly spelled out and are not well understood by the principal stakeholders. It suggests that uncertainty about the tax treatment of these expenses may make it difficult and costly for industry to plan effectively.

A first task for the tax sub-committee could be to document the tax treatment of certain environmental and social expenses incurred by the mineral industry with a view to explaining

how the activities related to those expenses are recognized and encouraged, and to examine how the information could be effectively communicated to stakeholders. Specifically, the tax sub-committee could focus its work on those expenses that have increased significantly in the past 10 years, namely: community consultation costs incurred beyond the exploration stage, expenses related to Impact and Benefits Agreements (IBAs) between Aboriginal communities and mining companies, and expenses related to the rehabilitation of closed or abandoned mines.<sup>5</sup>

It is recommended that the sub-committee undertake to document the tax treatment of major types of expenses the industry must incur to fulfill its environmental and social responsibilities.

It is recommended that the sub-committee undertake an evaluation of the tax treatment of rehabilitation work carried out on orphaned/abandoned mine sites, in cooperation with the National Orphaned/Abandoned Mines Initiative (NOAMI).

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<sup>5</sup> Research and compilation of information on policy aspects of abandoned mines is the responsibility of NOAMI.

# Recommendations

It is recommended that:

- the sub-committee continue its analysis of FTS incentives for exploration;
- the sub-committee investigate opportunities to hold awareness sessions on:
  - CEE eligibility rules, and
  - the requirements for determining new mine status;
- the sub-committee continue its detailed analysis and consultations on the industry proposals for CEE eligibility for high-risk exploration carried out in the vicinity of operating or formerly operating mines;
- the sub-committee undertake to document the tax treatment of major types of expenses the industry must incur to fulfill its environmental and social responsibilities; and
- the sub-committee undertake an evaluation of the tax treatment of rehabilitation work carried out on orphaned/abandoned mine sites, in cooperation with NOAMI.



# Annex I: Exploration by Flow-Through Shares

Preliminary figures provided for 2008 by Gamah International indicate that mining equity financings raised \$11.5 billion, representing a 46% decrease from 2007. The number of issues fell from 2820 in 2007 to 1135 in 2008, a drop of 60%. The size of the issues, however, increased from \$7.5 million to more than \$10 million.

On the other hand, flow-through-share (FTS) issues raised \$626 million for mineral exploration in Canada in 2008, an amount about 42% lower than in 2007 (\$1.07 billion). The number of issues in 2008 was also reduced by 43% from 609 to 348, while the average size of the issues edged up by 2%.

In the first four months of 2009, mining equity financing raised nearly \$6 billion, 34% higher than that in the same period of 2008. While the number of issues actually decreased by 45%, the size of the issues increased dramatically from \$10 million to \$24 million.

In the same period, however, FTS issues raised only \$60 million. This is compared with nearly \$200 million in the same period of 2008. The number of issues in the first four months of 2009 also decreased by 72%, although the size increased from \$2 million to \$2.2 million.

**Table 1**  
**Total Mining Equity and FTS Financings, 2007 vs. 2008**

	2007		2008		Change	
	Total Equity	FTS	Total Equity	FTS	Total Equity	FTS
Total Equity/FTS Raised (\$M)	21 283.2	1 070.8	11 545.3	625.5	-46%	-42%
Total Number of Issues	2 820.0	609.0	1 135.0	348.0	-60%	-43%
Average Issue Size (\$M)	7.5	1.8	10.2	1.8	35%	2%

Source: Gamah International.

**Table 2**  
**Total Mining Equity and FTS Financings, 2008 Q1 vs. 2009 Q1**

	2008 (Jan.-Apr.)		2009 (Jan.-Apr.)		Change	
	Total Equity	FTS	Total Equity	FTS	Total Equity	FTS
Total Equity/FTS Raised (\$M)	4 299.9	197.8	5 782.6	60.3	34%	-70%
Total Number of Issues	428.0	97.0	237.0	27.0	-45%	-72%
Average Issue Size (\$M)	10.0	2.0	24.4	2.2	143%	10%

Source: Gamah International.



