PDAC COMMUNIQUÉ

NOVEMBER 2000

THE NEW FEDERAL EXPLORATION INVESTMENT TAX CREDIT

A Brief Explanation

On October 18, 2000, the Honourable Paul Martin, Federal Minister of Finance, introduced an Economic Statement, popularly referred to as a “mini-budget,” which included a temporary *Exploration Investment Tax Credit* for flow-through share investors. This measure is specifically designed to re-stimulate investor interest in mine exploration in Canada, which has been severely impacted by a deep and protracted down cycle over the past four years affecting the sector worldwide.

The Exploration Investment Tax Credit (EITC) is a response by the federal government to a concerted effort by the Prospectors and Developers Association of Canada over the past twelve months to garner industry consensus across the country and develop national political support for the introduction of a federal exploration incentive.

The mini-budget also included the lowering of the inclusion rate for the federal capital gains tax from 66 2/3% to 50%, an important measure designed to stimulate investment and entrepreneurship across all sectors, including the mining industry.

The objective of this *Communiqué* is to present the facts and implications of the EITC based on information available as of November 3, 2000. The information and calculations set out below were assembled with the assistance of the PDAC Taxation Committee and officials in the federal government. However, investors are encouraged to consult with their own professional tax advisors.

What is it and how does it work?

The EITC will be available to those individuals (other than a trust) who invest in flow-through shares. Currently the investor who purchases flow-through shares is allowed to deduct up to 100% of the cost of those shares against personal income tax. The EITC will add to that benefit in the form of a 15% tax credit (see part (a) on Table 1).

The EITC is a temporary measure covering eligible exploration expenditures incurred after October 17, 2000, and before 2004. The sunset provision means that exploration expenditures have to be incurred by no later than the end of the day on December 31, 2003.

The fact that this is a non-refundable tax credit, not a tax deduction, means that it will act to reduce federal income taxes to the maximum extent of the federal income taxes payable in that year or in any following year.

Normally tax credits are applicable to an individual, corporation, partnership or trust. In this case, however, the EITC will be available only to individuals. The expenses eligible to earn the credit can be renounced to the individual directly, or indirectly through a partnership of which the individual is a member.

The investor may choose to carry forward the flow-through share deduction and apply it to a future year instead of using it in the current year. At this time, it is not clear whether this provision will apply to the EITC.

Use of the tax credit will also act to reduce the investor's Canadian Exploration Expense (CEE) pool by the amount of the tax credit claimed.

What exploration expenditures will be eligible?

The EITC is designed to stimulate *grassroots exploration.* It is limited to activity conducted from or above the surface of the earth and for the purpose of determining the existence, location, extent or quality of a mineral resource as defined in the *Income Tax Act* (see Appendix B and C below). Eligible expenditures will include prospecting; geological, geophysical and geochemical surveys; and drilling (rotary, diamond, percussion or other methods). Bulk sampling and the construction of underground access to a mineral resource (shafts, declines, adits, drifts, etc.) will not be eligible.

How will it relate to potential provincial tax credits?

Whereas the current flow-through share deductions apply to both federal and provincial income taxes, the EITC applies only to the federal portion. However, the federal government has encouraged provincial governments to complement the EITC with a similar tax incentive at the level they consider appropriate. If provinces decide to introduce a tax incentive, there are a number of different options available with respect to how they may choose to structure it. Some jurisdictions may decide to introduce an enhanced deduction or their own tax credit, the exact mechanics of which may or may not be the same as the EITC. Others may introduce a tax incentive which is restricted to investors who reside in that jurisdiction and to exploration work conducted in that jurisdiction.

When will it come into effect?

The EITC is in effect as of October 18, 2000, on the basis of a Ways and Means Motion that was passed by parliament on October 19. The motion will require a corresponding Ways and Means Bill to be eventually passed by parliament in order for it to become law. However, the substance of tax measures introduced by a Ways and Means Motion is usually maintained in the subsequent bill. As such, it is unlikely that the EITC will be affected by the outcome of the upcoming election.

Due to the nature of parliamentary schedules, long periods of time can occur between the passing of a Ways and Means Motion and the corresponding bill (for instance, the Ways and Means Bill for the 2000 federal budget has yet to receive final reading in parliament). Because of this, it is a long-standing practice of Canada Customs and Revenue to administer budget items which have been passed as a motion, but not yet as a bill, as if they were already in effect. All the tax changes in the mini-budget, including the EITC, will be treated in this manner.

How does the EITC compare with the former Mineral Exploration Depletion Allowance (MEDA)?

As illustrated by the comparison of part (a) to part (b) in Table 1, it can be concluded that the EITC benefit to the investor would be marginally better than the federal portion of the Mineral Exploration Depletion Allowance (MEDA) which existed in the 1980s, were this program to be re-introduced today.

The potential for a distinction between the EITC and MEDA occurs at the provincial level. For MEDA the funds could be spent anywhere in Canada to receive the tax savings. For the EITC it depends entirely on whether or not the provinces and territories introduce a tax incentive and how it is structured. As stated earlier, provinces may decide to restrict their tax incentive to residents of that province or extend it to residents of other Canadian jurisdictions.

Table 1: Illustration of new federal tax credit vs. former Mineral Exploration Depletion Allowance (MEDA)

Investor incurs grassroots exploration expenses	$ 1,000.00			
Federal tax rates for different investors	29%	26%	22%	16%
a) *Federal tax reduction from current flow-through shares (FTS) deduction plus the EITC*				
Equity investment	$ 1,000.00	$ 1,000.00	$ 1,000.00	$ 1,000.00
Less EITC at 15%	- $150.00	- $150.00	- $150.00	- $150.00
Net deductible expense[1]	$850.00	$850.00	$850.00	$850.00
Value of federal tax deduction	$246.50	$221.00	$187.00	$136.00
Plus EITC at 15%	$150.00	$150.00	$150.00	$150.00
Total net federal tax reduction	$396.50	$371.00	$337.00	$286.00
b) *Federal tax reduction from current flow-through shares (FTS) and the former Mineral Exploration Depletion Allowance (MEDA)*				
Equity investment	$ 1,000.00	$ 1,000.00	$ 1,000.00	$1,000.00
MEDA premium (133%)	$ 1,333.33	$ 1,333.33	$ 1,333.33	$ 1,333.33
Federal tax reduction	$386.57	$346.58	$293.26	$213.28

(1) This amount will not reduce the $1,000 to $850 in the year in which the flow-through share is purchased, the CEE is deducted, and the credit is claimed. The $150 investment tax credit will be included in income in the following year. As a result, the table shows the net effect to the taxpayer over a two year period.

Appendix A Excerpt from the Ways and Means Motion to Amend the Income Tax Act, as presented to the House of Commons by the Honourable Paul Martin, Minister of Finance, October 18, 2000

"Flow-Through Shares

That the definition "investment tax credit" in subsection 127(9) of the Act be amended to provide a 15 per cent non-refundable investment tax credit to an individual (other than a trust) for expenses

(a) incurred by a corporation after October 17, 2000 and before 2004,

(b) renounced in favour of the individual (directly, or indirectly through a partnership of which the individual is a member) pursuant to a flow-through share agreement made after October 17, 2000,

(c) incurred in conducting mining exploration activity from or above the surface of the earth for the purpose of determining the existence or location of a mineral resource described in paragraph (a) or (d) of the definition "mineral resource" in subsection 248(1) of the Act, and

(d) that would be described in paragraph (f) of the definition "Canadian exploration expense" in subsection 66.1(6) of the Act, if that paragraph were read without the words "digging test pits and preliminary sampling" in subparagraph (iv) thereof, and that the individual's cumulative Canadian exploration expense at any time in a taxation year be reduced by the amount of this credit claimed for a preceding taxation year."

Appendix B Definition of "mineral resource" as it appears in subsection 248(1) of the federal *Income Tax Act*

"mineral resource" means

a) base or precious metal deposit

b) a coal deposit

c) bituminous sands deposit or oil shale deposit, or

d) a mineral deposit in respect of which
   i) the Minister of Natural Resources has certified that the principal mineral extracted is an industrial mineral contained in a non-bedded deposit,
   ii) the principal mineral extracted is ammonite gemstone, calcium chloride, diamond, gypsum, halite, kaolin or sylvite, or
   iii) the principal mineral extracted is silica that is extracted from sandstone or quartzite

Appendix C Definition of grassroots exploration as it appears in Section 66.1(6) of the federal *Income Tax Act*

f) any expense incurred by the taxpayer (other than an expense incurred in drilling or completing an oil or gas well or in building a temporary access road to, or preparing a site in respect of, any such well) for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada including any expense incurred in the course of
   i) prospecting
   ii) carrying out geological, geophysical or geochemical surveys
   iii) drilling by rotary, diamond, percussion or other methods, or
   iv) trenching, digging test pits and preliminary sampling,
   but not including
   v) any Canadian development expense, or
   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.

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