Taxation Issues

Relating to Exploration and TO THE RESTRUCTURING OF RESOURCE TAXATION

A Report by the
Intergovernmental Working Group
on the Mineral Industry

2003 MINES MINISTERS' CONFERENCE
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Executive Summary

A number of important changes to Canadian mining taxation have occurred in recent times with the introduction in 2000 of the federal Investment Tax Credit for Mineral Exploration (ITCE) and harmonized provincial tax credits, the federal Budget 2003 proposals to improve the taxation of resource income, and the current discussions regarding Canadian Exploration Expenses (CEE). Industry associations, provincial/territorial governments and Natural Resources Canada (NRCan) have come together under the auspices of the Intergovernmental Working Group on the Mineral Industry (IGWG) to discuss these issues and produce this report for the attention of Canada's Mines Ministers and federal/provincial/territorial departments of Finance. The report examines the effectiveness of the ITCE, issues surrounding the definition of CEE in light of the new realities of Canadian exploration and mining, and provincial/territorial issues arising out of the proposed changes to resource taxation.

The report is divided into three main sections. The first one is an update of the analysis presented in the September 2002 *Tax Credits for Mineral Exploration Flow-Through Shares* report. The second and third sections, on issues relating to the definition of CEE and on federal income tax restructuring, are collections of views from the different stakeholders aimed at identifying issues for attention and suggesting ways to proceed.

The ITCE was introduced in October 2000 amid drastically lower mineral exploration levels, declining ore reserve levels and weak metal prices. A number of provincial/territorial incentives were also introduced around that time or shortly thereafter in the form of harmonized tax credits (British Columbia, Ontario, Saskatchewan and Manitoba) or refundable tax credits (Quebec and Yukon). The analysis conducted for the 2002 report concluded that these measures should be extended to the end of 2004 because of a slow start to the program and continuing depressed exploration levels. It was also recommended that eligible spending be allowed to take place up to one full year after the expiry of the program. These recommendations were adopted by the Mines Ministers and by the federal government in its 2003 Budget.

The analysis shows that, in their third year, these tax credits resulted in increased exploration spending aided by a stronger gold price and exciting diamond discoveries, but with continuing depressed base-metal prices. At $684 million, forecast exploration and deposit appraisal expenditures for 2003 are climbing to more historically normal levels of spending. Furthermore, surface exploration (grass-roots) and junior company spending, both targeted by the tax credits, are up significantly from the depressed, pre-ITCE years and a significant number of new mineral discoveries have been linked to these tax credits. Along with mildly recovering senior company expenditures and the finding by the Metals Economics Group that Canada accounted in 2002 for the largest share of the world's larger companies' exploration budgets, these findings point to a recovering Canadian exploration sector. In light of continuing depressed base-metal prices and a stabilization of the gold market, questions remain, however, on how to ensure that these discoveries are developed into actual mining operations. As the program is getting into its fourth and currently scheduled final year, there is a need to continue monitoring flow-through share financing activity to be able to complete the analysis of program effectiveness. Based on program results and the continuing decline of base and precious metal reserves, and given the prevalence of poor metal market conditions, both The Mining Association of Canada (MAC) and the Prospectors and Developers Association of Canada (PDAC) are requesting an extension of the program beyond 2004.

The limited discussions around the clarification of the eligibility of expenses for CEE treatment have resulted in an industry submission that warrants further consideration. Industry has set forth arguments in favour of: clarifying the status of feasibility study costs, detailing the criteria for the inclusion of certain depreciable assets into CEE, and applying CEE treatment to costs of exploring for extensions of a mineralized zone in an existing mine. Furthermore, industry has highlighted as a policy priority the inclusion of community and Aboriginal consultations and environmental baseline studies. Certain provinces have expressed the wish to see both Finance Canada and the Canada Customs and Revenue Agency (CCRA) actively participate in further deliberations on these complex issues that currently fall outside the terms of reference of this IGWG working group.

It is clear that federal income tax restructuring will undeniably affect the mining industry. However, it appears from the proceedings of the working group that whether these changes are positive or negative for the industry could depend on provincial/territorial adjustments to the federal measures. Because of the interdependence of some provincial/territorial tax regimes with the federal one, the elimination of the resource allowance will result in some provinces and the territories deriving more income from the mining industry than was previously the case. Unless these provinces and the territories adjust their own corporate income tax regimes, the federal corporate income tax reduction for mining companies will be cancelled 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.

With the addition of the CEE and tax reform issues to the evaluation of the tax credits, the working group saw both its mandate and membership greatly increase. The participation of industry associations (PDAC, MAC and the Canadian Fertilizer Institute) helped focus discussions around immediate issues of concern for industry.

The working group respectfully submits this report to Canada’s Mines Ministers.

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Section 1 – Tax Credits for Mineral Exploration Flow-Through Shares (Evaluation Update)

1.1 Introduction

The federal ITCE was introduced in October 2000 as a temporary measure to moderate the impact on mining communities of sharply declining mineral exploration expenditures. A number of harmonized and non-harmonized provincial/territorial measures were also announced around that time so that the overall level of mineral exploration incentives in Canada was greatly increased. However, most of the announced measures, including the ITCE, were of a temporary nature and required a quick and timely evaluation in order to provide decision-makers with the analysis needed for deciding on program extensions or modifications.

The Mines Ministers, at their 2001 conference, decided to form an intergovernmental working group to study the question. This working group produced a report titled *Tax Credits for Mineral Exploration Flow-Through Shares* and tabled it at the 2002 Mines Ministers' Conference in Winnipeg. The Mines Ministers endorsed the recommendations of this report and they recommended that the ITCE be extended to the end of 2004 and that companies be allowed to incur expenses up to a full year after the expiry of the program. The federal Minister of Finance, the Honourable John Manley, accepted these recommendations and the two measures were announced in his 2003 Budget.

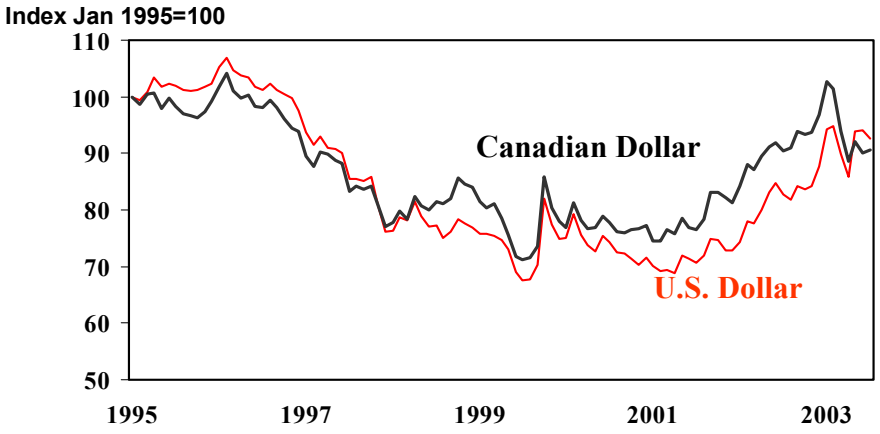
The evaluation of the success of a tax program that has been in existence for less than three years is not an easy task, especially when it relates to mineral exploration where the best indicator of success, new mine development, only takes place several years after the initial discovery. The following analysis on the combined effects of the federal ITCE and other provincial/territorial incentives on levels of exploration spending, financing activity and discovery success provides an update to the report initially presented to Canada's Mines Ministers in Winnipeg in September 2002.

1.2 Evaluation Context

1.2.1 Changes in Metal Market Conditions

As reported in last year's report to Mines Ministers, low metal prices represented the most important factor in explaining the dramatic decline in exploration spending that occurred between 1997 and 1999. While prices improved somewhat in 2000, as measured by NRCan's metals price index (based on the prices of gold, silver, copper, zinc, lead and nickel), they remained relatively weak in 2001 and 2002. The first six months of 2003 show a marked improvement due to a stronger gold price. While the higher price of gold was welcome news for explorationists and producers, the rising strength of the Canadian dollar versus the American currency moderated its impact as this appreciation drove down the price of gold in Canadian dollars (Figure 1). Nevertheless, even in Canadian dollar values, the gold price remains well above its level in the later part of the 1990s through to 2002. Market conditions for diamonds, which are not accounted for in NRCan's metals price index, remained favourable and contributed to a strong exploration effort for the discovery of more diamond deposits in many parts of the country.

Figure 1 - Index of Monthly Average Gold Price, January 1995 to July 2003



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Source: Minerals and Metals Sector, Natural Resources Canada, based on data from Kitco.com and Bank of Canada.

1.2.2 Changes in Canada's Ore Reserves

According to statistics compiled from publicly available company information, the reserves of Canada's traditionally most important mineral commodities (copper, nickel, zinc and gold) continued to decline in 2001. While this can be expected with the weak prices received for copper and zinc, it is somewhat surprising to see nickel continue to decline despite a relatively stronger price performance and the recent addition of new production capacity. Early indications are that the reserves of these metals also declined in 2002. Once again, diamonds are in a class of their own since their reserves do not represent a cause for concern at this time.

1.2.3 Changes in Policy Context

1.2.3.1 Federal-Provincial Initiatives Taken After 2002

1.2.3.1 (a) Federal Initiatives

On February 18, 2003, the federal budget included a number of proposed changes to the corporate income tax system for resource companies. This budget announced a change to the current system of taxation of resource income by phasing in, over a period of five years, the following changes:

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

A technical paper was released on March 3, 2003, by Finance Canada to provide greater details on the proposed changes. This paper includes an implementation schedule for the various proposed measures.

The 2003 Budget also announced the elimination of the current federal capital tax by:

– Starting in 2004, increasing the capital threshold at which the tax applies from $10 million to $50 million; and
– Reducing the rate of the capital tax in stages over a period of five years so that by 2008 the tax will be completely eliminated.

These changes to the resource income tax system are part of a continued process by the Department of Finance to reform the corporate income tax system. In the February 28, 2000 Budget, the Minister of Finance had announced a phased reduction of the federal corporate income tax from 28 to 21%, but had excluded mining, oil and gas, and manufacturing on the basis that these industries already enjoyed tax preferences that reduced their average effective tax rates below that applying to other industries.

The February 2003 budget also extended the Investment Tax Credit for Exploration program by another year until the end of 2004 for raising funding and to the end of 2005 for completing the exploration work.

1.2.3.1 (b) Provincial/Territorial Initiatives

The governments of Manitoba, Saskatchewan and British Columbia have extended the length of their flow-through tax credit programs to correspond with the February 2003 budget extension of the federal ITCE program. The Government of British Columbia also provides a 20% Mineral Exploration Tax Credit for exploration expenses not financed by flow-through shares.

At the same time, since Ontario's program was introduced without a sunset date, no extension was needed to correspond with the federal extension.

In terms of other tax policy measures to provide an incentive to industry, provincial governments are reducing their capital taxes. The Government of British Columbia has eliminated its corporation capital tax effective September 1, 2002. In its 2003 budget, Ontario has scheduled to reduce capital tax rates by 10% on January 1, 2004, with an intention to eliminate the capital tax by the time the federal government eliminates its capital tax. Currently the Ontario capital tax rate is 0.3% of a corporation's taxable paid-up capital above $5 million.

Having already begun a phase-in of corporate income tax reductions, Ontario is currently reviewing the phase-out of the resource allowance and phase-in of the deductibility of Crown royalties and mining taxes.

In its June 12, 2003 budget, the Government of Quebec announced changes to its tax incentives for mineral exploration. The flow-through share system will continue to be available for individual investors up to the end of 2004, when it will be completely replaced by the new tax credit for resources paid directly to companies conducting exploration. However, a reduction in the level of assistance will apply regarding flow-through shares issued after June 12, 2003. The maximum additional deduction available for surface mineral exploration expenses incurred in Quebec will be reduced from 75% to 31.25%. For underground mineral exploration, the additional deduction will be reduced from 25% to 10.42%.

Other tax benefits currently available for flow-through shareholders are falling under the announced moratorium. As a result, the measure that currently allows companies that issue flow-through shares to transfer 15% of the proceeds of the issue to individual investors as issuing expenses is suspended indefinitely, as is the measure that allows a taxpayer to shelter from capital gains taxation an amount of up to the purchase cost of the shares. The series of refundable and non-refundable tax credits that are currently granted to exploration companies not issuing flow-though shares are also being scaled back by 25%. Thus, the maximum tax credit rate applicable will be 45% instead of 60%. The 25% reduction will apply uniformly to the refundable and non-refundable portions of the tax credits.

The Yukon government has continued its Yukon Mineral Exploration Tax Credit (YMETC). This tax credit is a refundable corporate and personal income tax credit of 25% of eligible mineral exploration expenditures incurred by eligible individuals and corporations conducting off-mine-site exploration in the Yukon between April 1, 2001 and March 31, 2004.

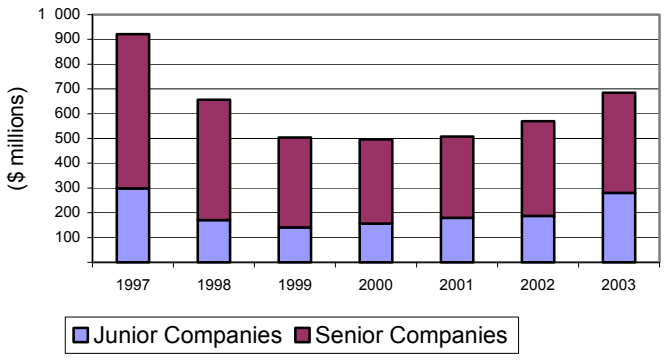
1.3 Evaluation of the Effectiveness of Tax Credits (Federal Analysis)

1.3.1 Changes in the Levels of Exploration

1.3.1.1 Exploration Spending at the Grass-Roots Level

The most recent statistics from the federal-provincial/territorial Survey of Mineral Exploration, Deposit Appraisal and Mine Complex Development Expenditures show a remarkable recovery of total exploration and deposit appraisal expenditures in Canada in 2003. While the company spending intentions estimate of $684 million is still well below the $921 million recorded in 1997, it represents quite a recovery from the low of $497 million that was recorded in 2000 after three years of steady decline (Figure 2).

Figure 2 - Exploration and Deposit Appraisal Expenditures in Canada, by Type of Company, 1997-2003



Since the tax credits covered by this report are aimed at increasing grass-roots exploration spending, most of the remaining analysis in this section will focus on exploration-phase spending. For the purposes of the above-mentioned federal-provincial/territorial survey, the exploration phase is defined as the work carried out to search for, discover and carry out the first delineation of a previously unknown mineral deposit to establish its potential economic

value (tonnage, grade and mineability) and to justify further work. It is akin to what is colloquially referred to as "grass-roots exploration." Deposit appraisal, on the other hand, includes the work carried out to bring a delineated deposit to the stage of detailed knowledge required for a production feasibility study. It is also known as "advanced exploration."

1.3.1.1 (a) Exploration and Deposit Appraisal Spending by Type of Company

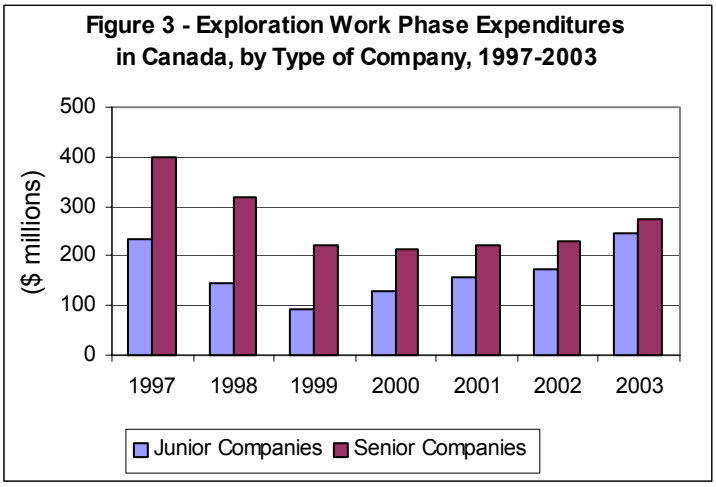
The strong decline in junior company spending between 1997 and 1999 prompted Canadian governments to introduce the tax credits studied in this report. During that period, junior exploration and deposit appraisal spending went from $298 million to $141 million, a decline of over 50% (Figure 2). It then rose gently in 2000 to $156 million and more strongly in 2001 when it reached $180 million. In 2002, it remained relatively steady at $191 million. If company spending intentions are accurate, it is in 2003 that junior spending will have really gained strength. The expected total of $281 million would bring junior spending close to the last peak recorded in 1997.

As for senior company spending, it declined significantly between 1997 and 2001, going from $623 million to $328 million. The numbers for 2002 and 2003 are more encouraging with respective totals of $383 million and $404 million.

1.3.1.1 (b) Exploration Spending at the Grass-Roots Level

In terms of junior spending for the exploration (grass-roots) phase only, the data on Figure 3 show that, after falling from 1997 to 1999, junior exploration expenditures recovered nicely and, at an expected $246 million for 2003, will likely exceed the 1997 total of $233 million. This would represent a remarkable comeback for junior spending at the grass-roots level. Senior companies are also expected to increase their grass-roots spending in 2003. However, their expected total exploration-phase spending of $275 million falls far short of the $401 million recorded in 1997.

Figure 3 - Exploration Work Phase Expenditures in Canada, by Type of Company, 1997-2003



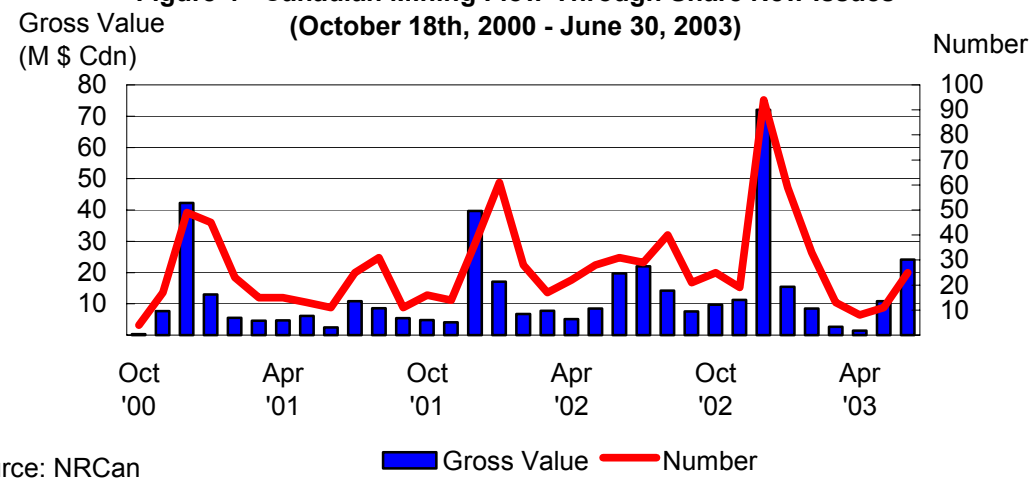
It is interesting to note that the rising trend in junior exploration spending began in 2000, the year of the introduction of the ITCE and other provincial tax credits, while the positive trend in senior grass-roots spending began a year later in 2001. Junior exploration spending has also been growing at a more rapid pace than senior spending.

1.3.1.2 Exploration Financed by Flow-Through Shares

Publicly traded companies that issue flow-through shares (FTS) communicate their intentions with press releases and are required to file documents with securities industry regulators. NRCan has compiled a database on these FTS filings. This database is used to calculate FTS mine financing levels.

Since the inception of the ITCE in October 2000 to the end of June 2003, over $425 million has been raised from 741 separate issues (See Figure 4).

Figure 4 - Canadian Mining Flow-Through Share New Issues (October 18th, 2000 - June 30, 2003)

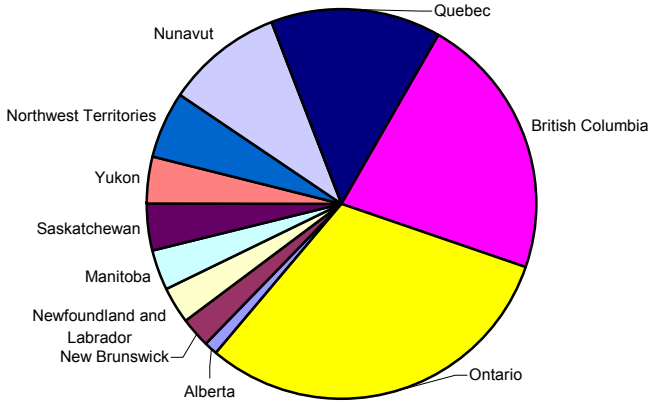


Source: NRCan

FTS amounts raised in 2002 ($202 million) were almost double the amount raised in 2001 ($110 million). While 2003 has started out slower than 2002, there has been some improvement in financing amounts in the months of May and June and some larger financings were announced in August. The number of FTS issues in 2002 (415) was also almost double the number in 2001 (256). For the first half of 2003, there were 149 FTS issues.

Of the 741 issues recorded in the NRCan database, roughly 75 % provide information on the province/territory where the projects financed by FTS would be located. As is illustrated in Figure 5, in terms of the regional distribution of the number of projects financed by FTS, the vast majority (around 75%) are located in Ontario, British Columbia, Quebec and Nunavut.

Figure 5 - Number of Projects Financed by FTS, by Jurisdiction (October 18, 2000 to June 30, 2003)

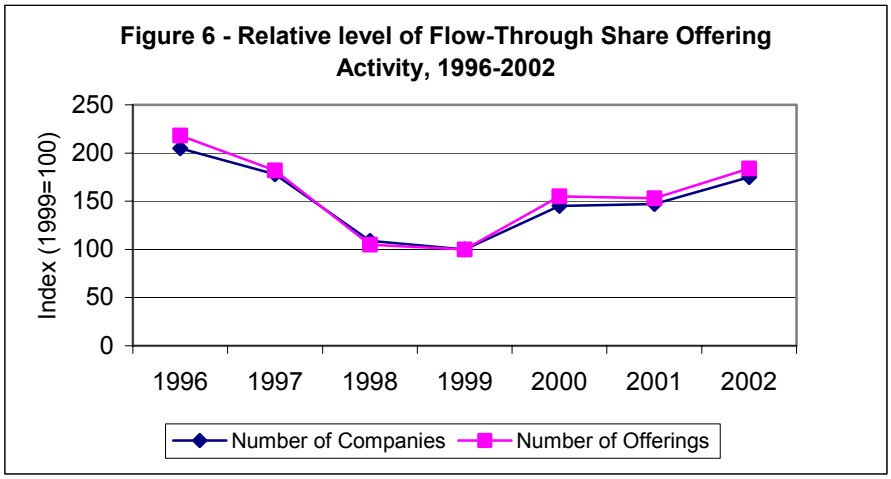


1.3.1.3 Exploration Financed by Tax Credit-Bearing FTS

The FTS mechanism and the ITCE are both provisions of the *Income Tax Act*, which is administered by the CCRA. Companies contemplating or proceeding with an issue of FTS, whether ITCE-related or not, have to meet certain filing requirements in order to have their expenditures recognized as transferable to individual investors. The information contained on the forms submitted to CCRA by issuing companies represents a valuable source of data on the use of FTS, the ITCE and related provincial/territorial tax credits.

Through a Letter of Understanding with CCRA, NRCan has been granted access to certain types of aggregate data on FTS offerings, sales and renunciations, as well as on expenditures qualifying for the ITCE and harmonized provincial/territorial tax credits. In an effort to better understand the workings of these incentives and to provide provinces/territories and the federal government with more complete data, CCRA has modified its tax forms (T-100 and T-101) starting in 2002 to better reflect the geographical distribution of the tax credits and the type of commodities sought with the funds raised. It has also increased the analytical coverage of previously existing information. Since the ITCE was only introduced in October 2000, the data available on tax credit eligible expenditures are limited to the years 2000, 2001 and 2002. Information for calendar year 2003 will be available around mid-2004 after the forms filed for the 2003 taxation year have been received and compiled by CCRA. As part of its commitment to CCRA to ensure confidentiality of data, the following NRCan analysis is based mostly on indices built from the actual respective total amounts for FTS offerings, sales and renunciations.

First presented in last year's report to the Mines Ministers' Conference, the indices based on the number of companies planning FTS offerings and on the total number of planned offerings both show significantly increased interest by companies in the FTS mechanism after the introduction of the ITCE and other harmonized tax credits in 2000 (Figure 6). In fact, both the number of companies planning offerings and the number of offerings planned have increased from the low of 1999 (the base year of the indices) to 2002 levels that are almost similar to the ones recorded in 1997 when exploration spending was just coming off the peak of 1996. While the levels of 2001 were similar to those of 2000, it must be remembered that the economic outlook during the last quarter of 2001 (when FTS financing usually peaks) was very uncertain.



A look at the typical size of planned FTS offerings between 1996 and 2002 reveals that most offerings (about 55%) amounted to less than $250 000. About 20% fell within the $250 000-$500 000 range and another 13% within the $500 000 to $1 million range. Most of the remaining 12% of proposed offerings fell within the $1 million-$5 million range.

The amounts reported to CCRA on the T-100 form for offerings are not always fully subscribed. The amounts of FTS sales would actually provide a better idea of the success of FTS as an exploration financing mechanism, but with the added difficulty that these statistics usually overlap over a two-year period as some financings initiated in one calendar year are often only completed in the next year or, in rare cases, even later, when they would be tallied by CCRA. A look at FTS sales by two-year period since 1996 confirms the trend outlined by the offerings indices in that after dropping dramatically in 1998-1999, FTS sales started to pick up again in 1999-2000 and had reached levels in 2001-2002 that were almost comparable to those of 1996-1997.

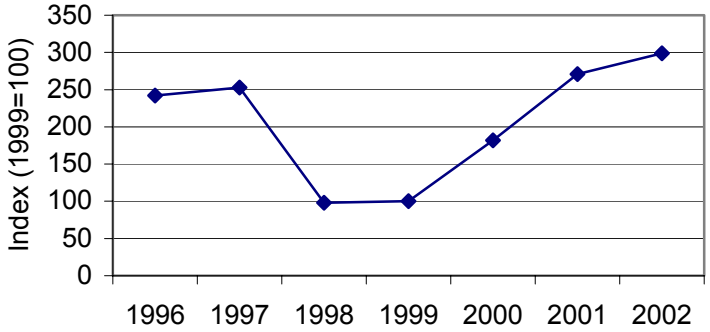
When it comes to the actual size of the FTS sales, it becomes even clearer that the majority of FTS financings are undertaken by junior mining companies. Over the 1996-2002 period, a full 64% of all FTS issues actually resulted in raising $250 000 or less. Another 27% of financings ranged between $250 000 and $1 million and the remaining 9% was mainly composed of financings ranging between $1 million and $5 million. A look at the evolution of the different ranges over the years reveals that the number of financings recovered more strongly in the less than $250 000 range while the number of financings in the other ranges never really returned to the levels recorded back in 1996.

The size distribution of FTS offerings and sales confirm the importance of FTS financing to junior mining companies. The small average size of the offerings and sales also raises the issue of how much money is actually left to spend in the field after the cost of raising this money is factored in. In light of these observations, it becomes clear that the junior mining sector has an important stake in the current deliberations on Canadian securities reform, especially when it comes to reducing issuing costs.

The most important statistic when it comes to measuring FTS financings is the total amount of mining expenses actually renounced by companies to their investors in any given year. Renunciations are important because they measure the amount of money that was actually

spent on exploration work. However, renunciations are even more difficult to measure on a yearly basis than sales because they can occur over a period of three years depending on the timing of the financing, the spending of the money and the use of the look-back rule. Nevertheless, a look at a yearly index of renounced Canadian Exploration Expenses (CEE) still clearly shows the drop in FTS use in 1998 and 1999 and the strong recovery that started in 2000 and gained strength in 2001 and 2002 (Figure 7).

Figure 7 - Relative Level of Flow-Through Share Renunciations, 1996-2002



The importance of the look-back rule cannot be overlooked when it comes to FTS financing. The ability of a company to incur expenses in the year following the year of the financing while still providing investors with an income tax deduction for the year in which they purchased the shares is an important component of the FTS mechanism. The data supplied by CCRA show that expenses renounced under the look-back rule amount to approximately 40% of all expenses renounced over the period 1996-2002.

While increases in exploration spending may in part be explained by other factors such as improved gold prices and additional diamond discoveries, the above analysis suggests some positive impact of the ITCE on FTS, junior mining company and grass-roots exploration financing. Still, there is one more set of statistics provided by CCRA that really helps evaluate the effectiveness of the ITCE and that is the total amount of expenses that are planned to be renounced to investors under that program per year. CCRA estimates that for the first three years of the ITCE program, almost $375 million in FTS-financed expenditures were eligible for the ITCE tax credit program ($64 million in 2000; $102 million in 2001; $208 million in 2002).

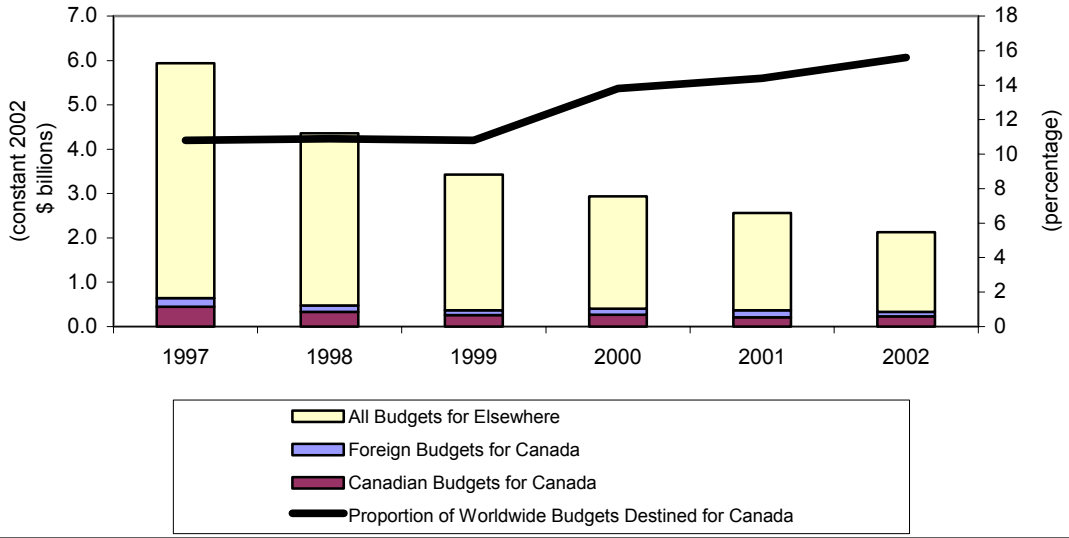
The 2000 total of $61 million was achieved in only two months (the program was announced in October). The slower uptake in 2001 may be an indication of disturbing world events and an uncertain economic outlook. The 2002 level is probably closer to what could be achieved with this incentive (with the help of provincial/territorial incentives, an improved outlook for gold and diamond exploration success, but with generally depressed base-metal market conditions).

1.3.1.4 Canada's Share of Worldwide Exploration

Data from the Metals Economics Group (MEG) show that Canada's share of worldwide exploration budgets of companies spending more than US$3 million remained relatively constant between 1997 and 1999 (Figure 8). It increased significantly in 2000 and again in

2001 and 2002 so that Canada was expected to be the recipient of almost 16% of total spending by the world's largest exploration companies. For the first time in 10 years, Canada has become the world's favourite destination for large company exploration capital. While this resurgence in the interest of large mining corporations in exploring for minerals in Canada may not be directly linked to the ITCE, it has been mentioned by MEG as one of the reasons why Canada has performed so well in the past two years. Some of this spending by larger foreign companies is undoubtedly linked to projects involving Canadian junior mining companies.

Figure 8 - Exploration Budgets of the World's Larger Companies for Canada and Elsewhere, 1997-2002



1.3.2 Regional Distribution of Exploration Spending

The statistics from the federal-provincial/territorial survey show that Ontario should dominate Canadian exploration and deposit appraisal spending in 2003 with an impressive total of $212 million. Quebec ($124 million), Nunavut ($82 million), British Columbia ($72 million), the Northwest Territories ($56 million) and Saskatchewan ($53 million) will follow. Besides Ontario, the Yukon, Nova Scotia, British Columbia and Saskatchewan deserve mention, as their spending levels will show significant improvements. Of the provinces/territories with harmonized tax credits or other tax-related incentives (e.g., Quebec and the Yukon), only Manitoba does not show a significant improvement in 2003 compared to the previous year.

When looking strictly at off-mine-site expenditures by junior mining companies, it can be observed that only New Brunswick and Alberta will experience declines in spending in 2003. Manitoba, which will experience a decline in overall exploration and deposit appraisal spending, will actually see its junior off-mine-site spending increase by 71% to $7.6 million. Other large percentage increases in off-mine-site junior spending will occur in Nova Scotia, the Yukon and Saskatchewan. In total, $246 million (36%) of the total $684 million in exploration and deposit appraisal expenditures forecast for 2003 will be accounted for by junior spending on the exploration phase.

Some difficulties remain as far as linking the CCRA data on FTS financing and ITCE use and the data of the federal-provincial/territorial survey on exploration and deposit appraisal spending. The recent changes to the CCRA tax forms to collect more information on where the money is actually raised and spent and on what commodities are sought will eventually provide very useful information. Initially, however, some companies were confused between reporting the location of their corporate offices and the location of the exploration work and in what classification the combination of minerals they were seeking fell into. Until there is a better understanding of the information requested, the working group decided to refrain from drawing conclusions from the existing data.

1.3.3 Distribution of Exploration Spending by Commodity

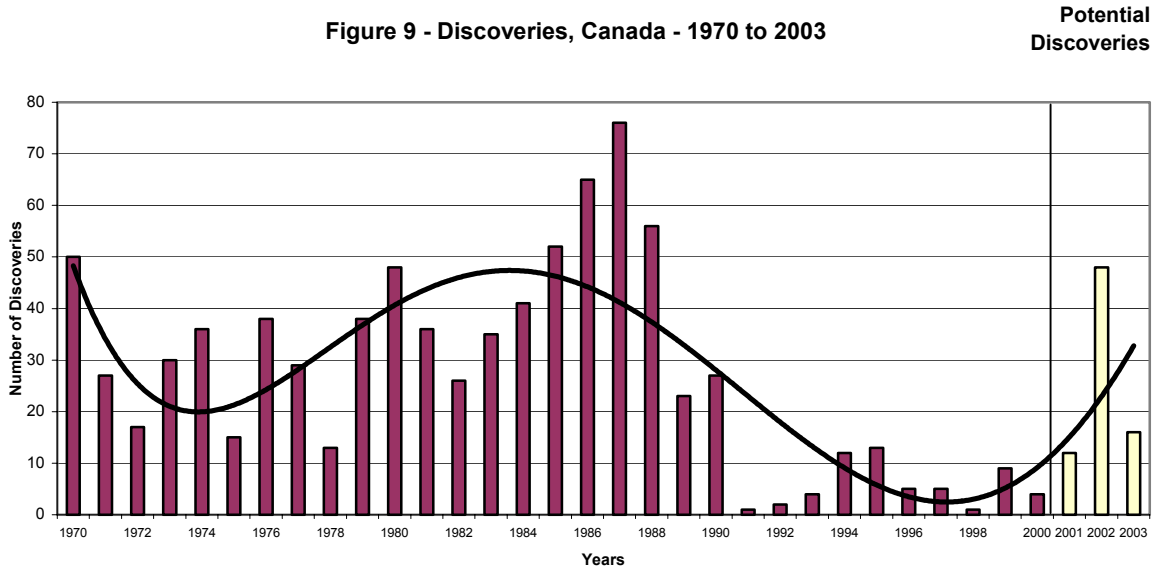
In 2002, gold (precious metals) remained the most sought-after commodity in Canada, followed by base metals and then diamonds. In terms of percentages, precious metals accounted for approximately 40% of recorded spending intentions while base metals (25%) and diamonds (22%) generated almost similar interest from exploration companies.

1.3.4 Discovery Successes Since Inception of Program

In the final analysis, the measure of success of any exploration program or incentive program for exploration is how many potentially economic mineral deposits and ultimately new mines can be attributed to the program.

Figure 9 is a graphical representation of the number of mineral discoveries made between 1970 and 2003. The data shown on this figure are drawn from three sources.

Figure 9 - Discoveries, Canada - 1970 to 2003



The first source is the discovery database compiled by NRCan, which uses the following definition to identify discoveries:

> **Discovery of a deposit**: "the discovery date is taken as the date of the first significant drill hole or trench intersection of economic interest that justifies a subsequent deposit delineation program. In other words, a discovery refers to a mineral deposit sufficiently attractive to have warranted the expenditure necessary to establish its

> tonnage and grade." The type of tonnage and grade referred to here is one that would fall into the "probable category" where the level of knowledge requires that both the continuity of the controlling geological structures and the continuity of the mineral content is supported by a systematic but relatively widely spaced drilling grid.

The second source is the annual report entitled *Overview of Trends in Canadian Mineral Exploration*, produced by the Intergovernmental Working Group on the Mineral Industry (IGWG), and updates provided by the provincial and territorial representatives on this working group.

The final source of information is the Prospectors and Developers Association of Canada (PDAC) compilation of discoveries by jurisdiction and commodity.

The first source, the NRCan discovery list, has been used to compile the discoveries from 1970 until 2000. The NRCan discovery criteria are objective and relatively accurate since the determination of when a discovery was made is based on a three-year or greater history using the benefit of hindsight.

For the "discoveries" during the period 2001-2003, the information is less reliable, as these possible or probable discoveries may not result in a mineral resource being outlined and their number will be greater. For this period, the IGWG data have been combined with the PDAC data using the PDAC definition:

> "A discovery is defined as a new mineral occurrence, which has sufficient demonstrable three dimensional and grade potential to warrant additional publicly financed expenditure."

However, it has not been verified that all IGWG listed discoveries match this definition. One additional qualifier that has been used to reduce the number of potential discoveries is the elimination from the list of the discovery of the host rock (e.g., kimberlite) or the geological mineral bearing zone (e.g., epithermal vein) where there is no indication of potentially economic mineralization. It should be noted that the IGWG list has 75 potential discoveries during the period of availability of the ITCE whereas the PDAC list has 68. However, the PDAC database lists only potential discoveries financed by flow-through shares as opposed to the IGWG list, which covers all discoveries.

Given the limitations of using three different sources to compile the discovery chart (Figure 9), certain observations can be made:

- The number of discoveries or potential discoveries made rose dramatically since 2000, which coincides with the introduction of the ITCE.
- Since discoveries are often only known after the results of the summer fieldwork becomes available, the 2003 figure, which is now much smaller than the one for 2002, could increase significantly.
- The types of mineral discoveries made during the last three years, ranked in order of number of discoveries, are: gold, diamonds, nickel-copper-platinum group metals, copper-gold, copper-zinc, magnesium and emerald.
- The major mining jurisdictions are the ones with the most discoveries. These provinces also offer additional tax credits or other tax incentives. The exception is Nunavut, which has benefited from the diamond exploration moving eastwards from the Northwest Territories.

1.4 Evaluation of the Effectiveness of Tax Credits (Provincial/Territorial Analysis)[1]

1.4.1 Yukon

1.4.1.1 Yukon Mineral Exploration Tax Credit (YMETC)

The Yukon government introduced the YMETC in 1999 as a short-term incentive to help stimulate the mining exploration sector. The YMETC is a refundable corporate and personal income tax credit of 25% of eligible mineral exploration expenditures claimed by eligible individuals and corporations conducting off-mine-site exploration in the Yukon. The YMETC was to be in effect for two years, from April 1, 1999, to March 31, 2001. Since then, the tax credit amount has increased from 22% to 25% and the eligibility period has been extended to March 31, 2004. The tax credit is subject to annual review.

The following lists the total dollar amount of the claims processed against Yukon income tax revenues since the inception of the tax credit:

For the taxation year 1999: $1.2 million
2000: $1.8 million
2001: $1.9 million
2002: $2.1 million (estimate)

For reference, exploration expenditures for the Yukon are listed as:[2]
1999: $12.7 million
2000: $11.2 million
2001: $7.8 million
2002: $7.2 million (preliminary)
2003: $7.9 million (estimate)

1.4.1.2 Effect of YMETC on Yukon Exploration

The Yukon government has offered the YMETC for five years, despite sluggish exploration numbers. One factor in this decision is the strong indication by companies that the YMETC positively influences their decision to carry out exploration spending in the Yukon. This was illustrated through letters of support for the YMETC and the results of a survey commissioned by the Yukon government and carried out by the Yukon Chamber of Mines in the fall of 2000 where a majority of responding companies indicated that the YMETC had assisted them in raising investor funds, had an impact on decisions to shift work to the Yukon, and in general had allowed them to lever additional spending on their Yukon-based programs.

There is no cap on the amount of the tax credit that can be claimed and, given the unpredictable nature of mineral exploration expenditures, the YMETC is subject to annual review.

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[1] Some of the provincial/territorial analysis is based on preliminary 2003 company spending intentions data contained in the 2002 federal-provincial/territorial survey of exploration expenditures, as opposed to the federal analysis, which is based on a revised company intentions survey compiled in August 2003.
[2] Source: Natural Resources Canada, Exploration and Deposit Appraisal Expenditures, 2000-2003.

1.4.1.3 Effect of the ITCE on Yukon Exploration

Any federal incentive designed to assist companies in raising investment capital to spend on exploration is strongly supported by the Yukon government. It is recognized that most junior companies working in the Yukon have benefited from the ITCE. One area of concern to the Yukon is the inability of the Yukon to offer harmonized "add-on" flow-through tax credits to supplement the ITCE due to a small population base and federal administration (until 2003) of mining taxation in the territory.

1.4.2 Northwest Territories

In October 2000, the federal government announced a temporary 15% investment tax credit (ITCE) for investors in flow-through shares of mineral exploration companies. At the same time, the federal government invited provincial governments to complement the federal tax credit with their own similar tax incentives in order to make exploration investments in their own jurisdictions more attractive. Currently, British Columbia, Ontario, Saskatchewan and Manitoba offer their own flow-through share tax credits to supplement the ITCE.

The Northwest Territories (NWT), on the other hand, is not currently resourced to effectively offer add-on incentives. The territory has a very small operating budget and receives little income from resource royalties as these are paid to the federal government. Furthermore, territorial add-on incentives would be applicable only to investors that paid territorial tax. Such measures are unlikely to generate significant amounts of investment given the small territorial tax base. Thus, the NWT is not positioned to offer tax incentives to complement the federal ITCE and must rely on the federal government to provide effective incentives.

The impact of the ITCE on exploration activity in the NWT is examined below.

1.4.2.1 Claim Staking

Claim staking in the NWT peaked in 1993 following the discovery of diamonds in 1991 in the Lac de Gras area. Exploration in the territory returned to historic levels in 1998. However, exploration activity has been on the increase since 2000 owing to a combination of factors, including:

- The introduction of the ITCE;
- A renewed interested in diamond exploration consequent to a number of recent discoveries in Nunavut – notably in the Coronation Gulf, Rankin Inlet and Melville Peninsula areas and on Victoria Island; and
- The steadily improving gold price.

Figures 10 and 11 show the increase in exploration activity in the NWT since 1999. Of particular importance is the upward trend in hectares staked, a positive indicator with respect to potential future grass-roots exploration spending. The dip in both graphs in the July-December 2001 period is ascribed to negative investor sentiment subsequent to the September 11 terrorist attacks. The dip was, however, short-lived in both cases.

FIGURE 10
NUMBER OF CLAIMS RECORDED IN THE NWT

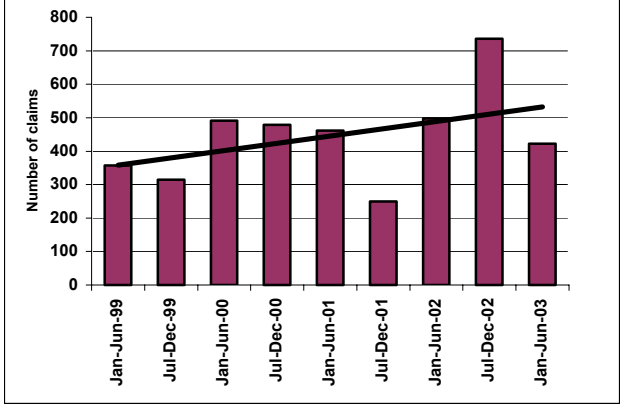
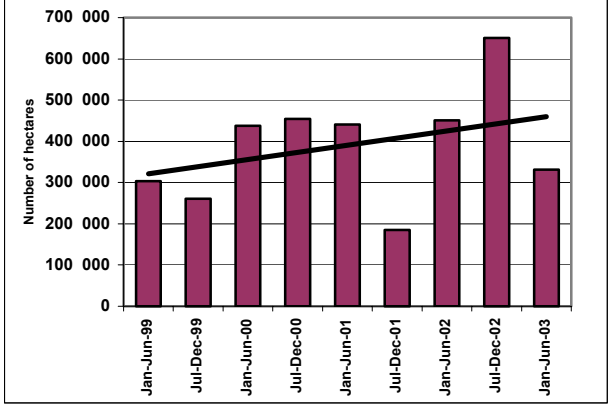


FIGURE 11
HECTARES STAKED IN THE NWT



1.4.2.2 Exploration Expenditures

Exploration expenditures in the NWT from 1999 to 2003 (the latter being company spending intentions) are depicted in Figure 12 and Figure 13. The increase in 2001 expenditures can be ascribed, again in part, to the introduction of the ITCE. The decline in expenditures in 2002 and 2003 is due to a number of factors, including:

- The temporary cessation of activities at the Snap Lake diamond project during final permitting;
- The scaling back of deposit appraisal expenditures at De Beers' Kennady Lake project; and
- Negative sentiment in the diamond market in the period following the September 11 terrorist attacks.

However, diamond prices, in tandem with demand, are recovering. Exploration expenditures are therefore expected to increase in 2004.

Junior companies are the main beneficiaries of the ITCE and are generally the first to discover new mineral deposits. Annual exploration expenditures in the NWT by these companies over the last three years have remained relatively constant at around $12 million (Figure 13). In contrast, expenditures by senior companies over the same period have declined sharply from $72 million in 2001 to an expected $38 million in 2003. When juxtaposed against the declining expenditures of the seniors, the fact that exploration expenditures by junior companies remained at constant levels suggests that the ITCE had a positive impact on exploration in the territory by facilitating the juniors' access to financing.

FIGURE 12
EXPLORATION EXPENDITURES IN THE NWT

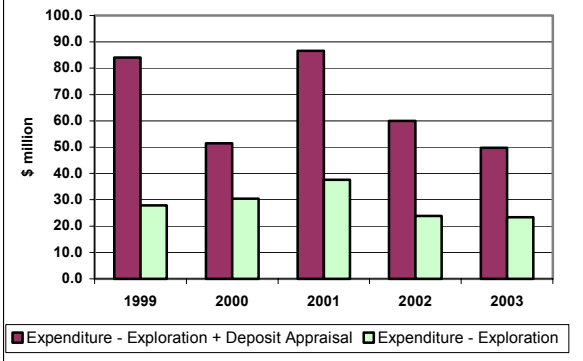
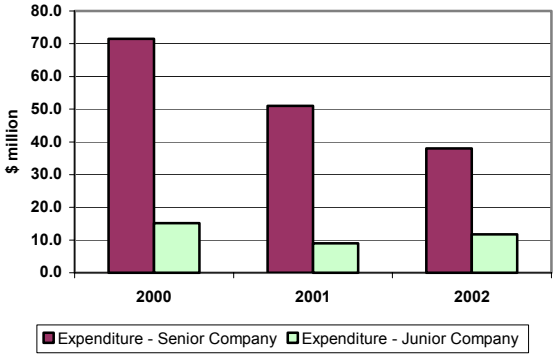


FIGURE 13
COMPANY EXPLORATION EXPENDITURES IN THE NWT



1.4.2.3 Evaluation of the ITCE in the NWT

Assessing the impact of the ITCE on exploration activity in the NWT is complicated by the fact that exploration is focused almost entirely on diamonds. Hence, vagaries in the diamond market, along with discoveries elsewhere in Canada, have a marked impact on overall exploration expenditures in the NWT. The effectiveness of initiatives designed to stimulate exploration, such as the ITCE, may therefore not be clear when juxtaposed against these other issues. Nonetheless, the available data as detailed above suggest that the ITCE had a positive effect on exploration in the territory.

The junior exploration sector forms an integral component of the NWT economy. Hence, the Government of the Northwest Territories (GNWT) has a vested interest in initiatives that bolster the junior sector. To this end, the GNWT strongly supported the introduction of the ITCE in October 2000 and is pleased to note that the credit has been extended by one year to December 31, 2004. This, together with the 12-month "look-back" rule applicable to the ITCE, will now allow qualifying exploration costs to be incurred until December 31, 2005.

1.4.3 British Columbia

Industry associations, such as the BC and Yukon Chamber of Mines and the Prospectors and Developers Association of Canada, and company representatives have uniformly praised the federal government's ITCE program and related provincial initiatives such as British Columbia's Mining Flow-Through Share Tax Credit (BC MFTS) program. Those programs were complimented by improved perceptions regarding the British Columbia investment climate, generally higher metal prices, and improved capital market conditions to support a major and ongoing upturn in British Columbia exploration activity. There are a number of significant British Columbia exploration companies that have issued FTS that could qualify for the above credits. A brief sample includes projects listed in Table 1.

Table 1

Company	Date	Property	Amount
DRC Resources Corp.	July 24, 2002	Afton Copper-Gold Project	$2.1 million
Heritage Explorations Ltd.	July 7, 2003	Eskay Creek Properties	$2.0 million
Northgate Exploration Limited	December 23, 2002	Kemess North and region	$1.445 million
Redcorp Ventures Ltd.	April 29, 2003	Tulsequah Chief	Up to $1.60 million
Lateegra Resources Corp.	June 24, 2003	Clone Property	$0.225 million
Sultan Minerals Inc.	July 23, 2003	Kena Property and in Manitoba	$0.250 million

Some industry observers believe that there has been a significant lag between the introduction of the ITCE (October 18, 2000) and MFTS (July 30, 2001) and funding for British Columbia exploration. This lag is due to the time it has taken for investor perceptions to change, explorationists to identify opportunities (high mineral potential, competitive costs, stability, etc.) and financings to be completed. That being the case, British Columbia exploration expenditures could continue their rapid increase in 2003 through to at least the end of 2005.

Evaluation of the effectiveness of tax credit programs to support mineral exploration in British Columbia is hindered by the absence of accurate data for actual 2002 exploration expenditures and 2003 intentions. However, the attached data for "exploration" and "deposit appraisal" (from the National Mining Exploration Survey completed by NRCan and the British Columbia Ministry of Energy and Mines - data for 2002 and 2003 are still to be published), which can serve as a proxy for grass-roots exploration, indicate that there has been a significant recovery in grass-roots exploration in British Columbia (i.e., almost 150% in two years).

Table 2

EXPLORATION	1997 Actual	1998 Actual	1999 Actual	2000 Actual	2001 Actual	2002 Actual-Prelim.	2003 Revised Forecast-prelim.
Exploration	71 523 940	35 039 168	21 097 435	27 707 052	25 397 919	32 723 533	45 445 502
Deposit Appraisal	43 693 455	19 475 968	20 212 730	8 044 735	3 739 169	6 501 759	26 389 950
Mine Complex Development	61 798 179	70 465 450	40 478 978	35 386 560	36 261 682	29 308 801	13 665 740
Total Exploration (Exploration + Deposit Appraisal)	115 217 395	54 515 136	41 310 165	35 751 787	29 137 088	39 225 292	71 835 452

Note: 2002 and 2003 not released and may be adjusted slightly. Expect release within a couple of weeks.

Mineral exploration investment decisions are influenced by a number of factors and the above data provide no insight regarding the direct significance of the federal ITCE or the BC MFTS programs in funding those expenditures. Moreover, there could be significant revisions to the 2003 estimates in response to metal prices, capital market conditions, significant discoveries, etc.

An informal review of company press releases indicates that a significant proportion of the financings involve flow-through shares (FTS). Furthermore, it appears that where companies with relatively advanced properties (i.e., have defined a mineral resource) raised

funds on relatively good terms, financings for less well-defined properties often involve considerable dilution. It is possible that considerably less exploration would have been done on the less well-defined targets if the tax credit programs were not in place. Similarly, Ministry of Energy and Mines field staff advise of conversations with industry representatives that indicate that the tax credit programs made important contributions to funding several promising exploration programs.

A review of the major issuers of FTS indicates that most of the financings were for grass-roots exploration on gold and gold-copper targets and could be eligible for the ITCE and BC MFTS. FTS financings were also done for base metals, industrial minerals and coal, and some of that exploration would not be eligible for the ITCE and BC MFTS.

The British Columbia Mining Exploration Tax Credit (METC) program provides a 20% refundable provincial tax credit on non-FTS funded, eligible BC mineral exploration and effectively compliments the BC MFTS. Analysis of data for the METC indicates that the value of credits in fiscal year 2003 was lower than for fiscal year 2002. This decline is attributed to the upturn in BC mineral exploration that has accompanied introduction of the FTS-based tax incentive programs and stronger capital markets with a resulting shift of exploration from prospectors and mining companies to junior exploration companies.

Finally, a separate data set (also from the National Exploration Survey, published in March 2003) indicates that the province's share of Canadian mineral exploration has improved noticeably in 2003 to 10.5% of total Canadian exploration and deposit appraisal spending.

Again, while this improvement is due to a number of factors, the federal and provincial tax credit programs to encourage grass-roots mineral exploration have definitely played a significant role. This conclusion is consistent with the March 12, 2003, presentation to the Prospectors and Developers Association of Canada convention by Mr. Jason Goulden of the Metals Economics Group that showed that Canada was the only major mining jurisdiction to have sharply higher levels of exploration in 2000 through 2002.

In summary, the available data and comments by industry experts indicate that the tax credit programs are making significant, albeit not quantifiable, contributions to higher levels of grass-roots mineral exploration in British Columbia and to British Columbia's relative attractiveness for mineral exploration in Canada.

1.4.4 Saskatchewan

In 2001, Saskatchewan implemented a Mineral Exploration Tax Credit that offers a 10% income tax credit on specific mineral exploration activities for investors paying Saskatchewan income tax. The tax credit is harmonized with the federal Investment Tax Credit for Exploration (ITCE). This additional tax credit program was expected to increase mineral exploration expenditures in the province by approximately $2 million annually.

Mineral exploration expenditures in the province increased in 2002 and are expected to continue to rise in 2003. It is difficult to determine the direct impact that the tax credits have had on exploration spending since other factors, such as improved gold prices, successful diamond exploration, reduced royalty rates, enhanced geoscience and the introduction of other exploration incentives, have also contributed to the increase.

In Saskatchewan, junior companies are the principal employers of flow-through shares and the associated exploration tax credits, and a number of these companies have taken advantage of the program. Saskatchewan residents have claimed tax credits of approximately $300 000 through the provincial flow-through share program.

At this time, the information necessary to conduct a thorough analysis and evaluation of the tax credit program in isolation of other factors is not available. However, the Prospectors and Developers Association of Canada (PDAC) reports that three discoveries in the province have been financed through flow-through shares and the related tax credits since the inception of the federal program. The province continues to work with industry to improve reporting of the exploration programs and discoveries that are financed with flow-through shares.

1.4.5 Manitoba

All flow-through share numbers are either anecdotal or garnered from the review of company press releases. NRCan estimates that slightly over $24 million will be spent in exploration in Manitoba in 2002. Manitoba is aware of $3.8 million, or approximately 16% of total exploration expenditures for 2002, that has been raised via flow-through share financing for mineral exploration activity in the province. Of that, approximately $175 000 will be eligible for the Manitoba Mineral Exploration Tax Credit. At present, Manitoba is aware of $6.1 million raised via flow-through share financing in 2003 for mineral exploration activity in the province, of which approximately $350 000 may be eligible for the Manitoba Mineral Exploration Tax Credit.

1.4.6 Ontario

Flow-through shares are sold under special agreement between exploration companies and investors. The company issues these shares and agrees to "flow through" eligible exploration expenses to the investors who may then report these as deductions to reduce their taxable income. For the past decade, flow-through share investors in Ontario have received these tax deductions at a rate equivalent to 100% of their investment, provided funds invested were spent on eligible exploration activities in Canada as defined by the CCRA.

Ontario was the first Canadian jurisdiction to make new improvements in support of sustained mineral exploration investment by including a flow-through enhancement in the Ontario spring 2000 provincial budget. The budget announced a 30% tax deduction for Ontario investors investing in companies conducting Ontario-based exploration projects. In late 2000, the Government of Canada responded by announcing its ITCE program. Ontario subsequently converted its deduction plan to the 5% Ontario Focused Flow-Through Share Tax Credit to harmonize tax provisions and simplify the tax process for the mineral exploration investor.

For investors in Ontario-based exploration flow-through share financings completed after October 18, 2000, the new federal tax credit is non-refundable and is available until December 2004. The Ontario tax credit is refundable and has no assigned sunset date.

The Government Incentive (GI) Exemption in Ontario also limits the sale of flow-through shares in a single offering to 50 purchasers. There is, however, no upper or lower limit on the amounts negotiated with an individual shareholder. In this respect, flow-through shares are one of the few exempt market investments available to Ontario-resident middle-income investors wishing to make an investment of any size. To proceed with a privately placed flow-through financing under this exemption, the company essentially creates an offering

memorandum. This document emulates disclosure provided in a prospectus, offering the investor the fullest range of information possible on the company and its exploration assets but without the attached due diligence burden of a prospectus. No similar specific exemption exists in Alberta and British Columbia, but flow-through shares can be sold through the capital raising rules mentioned previously. These are set out in Multilateral Agreement 45-103 of the British Columbia and Alberta Securities Commissions.

Over the past five years, Ontario exploration expenditures have climbed dramatically from $87 million in 1999 to a forecast of more than $180 million in 2003 (Table 3). The amount of financing raised with flow-through shares for exploration has also risen from $19 million in 2000 to $72 million in 2002. In concert with other Ontario government initiatives such as a reduced mining tax and improved geological data, the flow-through share program is playing a critical role in the dramatic increase in exploration expenditures. Its significance is also reflected in the increasingly important contribution of junior companies conducting exploration in Ontario. The percentage of total exploration expenditures by junior companies has risen from 25% in 1999 to current levels of 35% in Ontario and the same trend is occurring at the national level. This trend is directly related to the increasing number of juniors issuing flow-through shares.

Table 3: Ontario Total Exploration Expenditures

	1999	**2000**	**2001**	**2002**	**2003**
Expenditures $ Millions	87.4	117.9	113.6	140.2	183.4
Percentage Change from Previous Year		+35%	-4%	+23%	+31%

The first confirmed issue of flow-through shares to be used for exploration in Ontario occurred in October 2000 and the value of flow-through shares issued in the last three months of 2000 reached $19 million (Table 4). In 2001, its first full year of implementation, the flow-through share program raised $48 million. In 2002, the second full year of operation, the value of shares issued climbed to an impressive $72 million. During the first four months of 2003 the value was close to $10 million. The value of shares issued in 2003 may surpass 2002 as more companies and investors become aware of the program and realize the enormous tax benefits. The number of companies participating increased significantly from 26 in 2000 to 67 in 2001 and 94 in 2002. If the trend continues, there should be another increase in the number of companies participating in 2003.

Table 4: Ontario Flow-Through Share Financing

	2000 (Oct.-Dec.)	2001	2002	2003 (Jan.-April)
Value of Shares	$18 986 653	$48 219 448	$72 308 556	$9 690 448
No. of Companies	26	67	94	32
No. of Transactions	28	98	140	40

Source: Natural Resources Canada/Ontario Ministry of Northern Development and Mines

A statistical analysis of 2003 data shows (Table 5) that the flow-through capital raised by each company is less than $1 million and only four of the 32 financings exceeded $500 000. The average financing in 2003 is $242 261 compared to $577 982 in 2002 and $445 000 in 2001. The data indicate that the transactions conducted in 2003 are for smaller amounts than previous years, but this may change by year-end since most transactions occur in the final quarter. Flow-through funds raised in 2003 are mainly being directed to exploring for gold near Timmins and Red Lake, diamonds in Temagami and the James Bay area, and platinum group metals and nickel in Sudbury and Thunder Bay. Many of the companies issuing flow-through shares have spent millions exploring in Ontario with some of the projects moving on to the advanced exploration stage.

Table 5: Statistical Analysis of 2003 Flow-Through Share Financing

	Total	Average	Median	Mode
2003 (01-04) Flow-through:	$9.7	$242 261	$208 000	$100 000

1.4.7 Quebec

1.4.7.1 The Flow-Through Share System in Quebec

Besides the 15% credit and the 100% basic deduction allowed by the federal government, an individual in Quebec could claim a tax deduction from the Quebec government, before June 2003, of up to 175% of his/her flow-through-share investment if the funds are for surface exploration in Quebec. This 175% deduction can be broken down as follows:

- A basic deduction of 100% of the cost of flow-through shares purchased to finance eligible exploration expenses (Canadian Exploration Expenses (CEE));
- An additional deduction of 25% when the exploration expenses were incurred in Quebec by a corporation that is not mining any mineral resources; and
- An additional 50% deduction for surface exploration.

These tax benefits apply to mining and oil and gas exploration expenses incurred in Quebec.

In the Budget Speech of June 12, 2003, the Quebec government announced that the Quebec flow-through share system would be extended to December 31, 2004, after which time the

system should be completely replaced by the refundable tax credit for resources. Until then, a corporation may choose either of these two measures.

Since June 12, 2003, Quebec's *Taxation Act* has enabled an individual in Quebec to benefit from a tax deduction of up to 131.25% (175% before June 12, 2003) of his/her flow-through investment used to finance surface mining exploration in Quebec. This includes a basic deduction equivalent to 100% of the cost of flow-through shares purchased to finance eligible exploration expenses, a further deduction of 10.42% when the exploration expenses are incurred in Quebec by a corporation that is not mining any mineral resources, and an additional deduction of 20.83% for surface exploration. Also, the Quebec taxation system no longer provides for the deemed capital gains exemption when the share is sold. Finally, corporations may no longer choose not to deduct their issuance expenses related to flow-through shares, in which case the individual could claim up to 15% of the investment cost for the same year.

Taking into consideration the Quebec and federal tax benefits, the net after-tax cost of a $1000 investment in flow-through shares issued after June 12, 2003, amounts to about $330 for the individual in Quebec in the highest marginal tax bracket.

1.4.7.2 The Refundable Tax Credit for Resources

This measure, introduced in 2001, consists of direct tax assistance to corporations for eligible exploration expenses incurred in Quebec (contrary to the flow-through share system where the corporation renounces its eligible expenses to an investor). As of June 12, 2003, this credit is taxable.

Therefore, a mining company may obtain a tax credit of up to 45% of eligible exploration expenses incurred in Quebec, that is, a 15% refundable tax credit for resources for a producer and 30% for a junior exploration company (18.75% and 33.75% respectively, in the North), and a non-refundable tax credit of 30% for a producer and 15% for a junior company (26.25% and 11.25% respectively, in the North).

The tax credit is given to eligible corporations that incur exploration and development expenses in Quebec. An eligible corporation is a corporation that has an establishment in Quebec and operates a business there, while eligible expenses are those that enable an individual to claim a deduction of at least 110.42% within the framework of the current flow-through share system.

1.4.7.3 Participation of Institutional Investors

Exploration companies in Quebec rely on a number of institutional investors who often acquire an interest in projects in Quebec and elsewhere in Canada.

SIDEX (*Société d'investissement dans la diversification de l'exploration*) is a limited partnership created in 2001 by the Quebec government. Its mission is to invest in the capital stock of companies with exploration projects with the ultimate goal of diversifying the mining industry in Quebec, both in terms of the commodities extracted and in terms of mineral-producing regions. SIDEX has an initial capitalization of $50 million over five years provided by two partnerships: the Government of Quebec (70%) and the FTQ Solidarity Fund (30%).

SODEMEX and SODEMEX II (*Société de développement des entreprises minières et d'exploration*) are limited partnerships held by Capital d'Amérique CDPQ and SGF Minéral Inc. They help to develop the mining industry in Quebec through holdings in junior exploration companies and mining producers. They also influence the secondary market, thereby helping to improve the liquidity of the company's shares. The total capital invested by the limited partners increases to $32 million.

SOQUEM Inc. (*Société québécoise d'exploration minière*), which is owned by SGF Minéral inc., annually devotes more than $10 million, with its partners, to off-mine-site exploration in Quebec. This represents about 10% of all exploration investments within Quebec.

Finally, the FTQ Solidarity Fund and the *Fondaction CSN* (labour-sponsored venture capital funds) contribute to financing exploration companies, usually by acquisition of debentures.

1.4.7.4 Development of Financing and Exploration Expenses in Quebec

As illustrated in Table 6 below, flow-through funding for exploration projects in Quebec reached $14.64 million in 2002, compared to $9.98 million in 2001 and $10.17 million in 2000.

Table 6: Public Funding Raised in Quebec for Exploration and Investment in Exploration and Development in Quebec by Junior Companies, 1999-2002, $ million

Year	Flow-through funding raised in Quebec for projects		Project funding that is not flow-through		Portion of funding that is not flow-through for projects in Quebec by the institutional investors described above	Investment in exploration and development by junior companies in Quebec	Average price of gold in US$/oz
	within Quebec	outside Quebec	within Quebec	outside Quebec			
1999	5.9	1.3	10.4	11.1	28%	32.6	279
2000	10.2	2.1	15.3	22.0	37%	27.0	279
2001	10.0	0.8	18.5	12.7	21%	34.2	271
2002	14.6	0.2	21.5	32.0	53%	40.6	310

Source: Compiled by the Quebec Ministry of Natural Resources

Project funding that is not flow-through for exploration projects in Quebec also improved, reaching $21.5 million in 2002, compared to $18.5 million in 2001 and $15.3 million in 2000. However, if not for Sidex's participation, which accounted for more than $2 million in 2001 and almost $9 million in 2002, funding through common shares would not have performed this way. Indeed, the participation of funders supported by the public or para-public sector (Sidex, CDPQ, Sodemex, Fonds FTQ, Fonds CSN), which cannot obtain flow-through shares, accounted for more than 32% of both flow-through funding and funding that is not flow-through raised in Quebec for exploration activities in Quebec. Exploration and mining companies, as well as the executives of mining exploration companies, accounted for 5% of both flow-through funding and funding that is not flow-through raised in Quebec for mining activities in Quebec. Investments with the general public-buy prospectus, offering memorandum, or private placement accounted for 51% of the funding raised in Quebec for

exploration activities in Quebec. Finally, investment funds and limited partnerships invested 12% of the funding raised in Quebec for exploration activities in Quebec.

Expenses for exploration, development, and off-site mining by junior exploration companies reached $40.6 million in 2002, compared to $34.2 million in 2001 and $27.0 million in 2000.

According to discussions with representatives of a number of exploration companies and the financial community, the improved levels of flow-through funding are largely due to the improved prospects for the price of gold and, to a lesser extent, to the possibility of finding diamonds.

1.4.7.5 Conclusion

The improvement in exploration expenses in Quebec is the result of all the tax incentive measures, the intervention of para-governmental providers of funds, the improved prospects for the price of gold, and the growing interest with respect to the potential for finding diamonds.

December 31, 2004, will mark the end of the transition period for companies to switch from the flow-through share system to the refundable tax credit for resources. At that time, the tax benefits from the flow-through share system will be phased out.

1.4.8 New Brunswick

In 2003 New Brunswick launched a major initiative to stimulate exploration activity in the province. A major supplement in the *Northern Miner* and a number of pamphlets and brochures promoting the mineral and hydrocarbon potential in New Brunswick were produced and circulated to industry at various conferences across North America. The promotional information has been well received by industry and renewed interest in New Brunswick has been very encouraging.

Increased exploration activity has resulted in significant finds of gold, potash and natural gas. Further good news has been the expressed new interest by Noranda Inc. in the Bathurst Camp. During the 2003 Cordilleran Round-Up, most of the prospectors attending from New Brunswick were able to option their properties and similar success was evident at the 2003 PDAC in Toronto.

1.4.9 Nova Scotia

Nova Scotia has experienced a significant increase in precious-metal exploration as a result of the recent increase in gold prices. This has sparked renewed interest by the government in encouraging exploration investment in this sector. The platform of the recently re-elected government includes a commitment to "establish a tax credit for qualified mineral exploration to encourage responsible expenses related to flow-through shares." No timeframe has been specified for the establishment of this tax credit but the commitment is indicative of the positive attention that the sector is attracting in Nova Scotia.

Although Nova Scotia has not yet introduced a tax credit with respect to investment in flow-through shares, some money raised in flow-through offerings has been invested in projects here. To date, this amounts to about $725 000 in three projects. This represents a significant contribution to exploration investment in a province where annual exploration levels in the last two years have been close to $3 million.

1.5 Industry Views

Note: The following text has been supplied by the Prospectors and Developers Association of Canada (PDAC). The views reflected are those of the industry and do not necessarily accord with the views of the Working Group.

FUTURE OF THE ITCE "SUPER" FLOW-THROUGH SHARE PROGRAM

1.5.1 Introduction

Between October 18, 2000 and June 30, 2003, approximately $450 million has been raised to qualify for Canadian Exploration Expenses (CEE). Not all of the funds raised would qualify for the federal tax credit program as only certain CEE expenditures qualify and only individual investors are eligible for the tax credit. The two most common flow-through type financings are:

- Private placements that commonly include ITCE and provincial top-ups where applicable, but which tend not to be publicized and are of limited availability; and

- Investment partnerships or funds which "advertise," such as the dominant CMP group, but which are rarely if ever able to offer potential investors either provincial top-ups or even ITCE. As "blind pools," partnerships have no way of knowing when they raise money or how the money will be allocated to exploration companies and spent. By just allowing investors "regular" flow-through (100% write-off), the funds also maintain flexibility to switch sectors and place money in oil and gas flow-through share issues as happened in 2001 and to a lesser extent in 2002.

1.5.2 Cost to the Federal Government

What is the cost to the federal government? The initial cost to the federal government of the investment tax credit is 15% minus the investor's federal marginal rate. This is because, in the year following, individual investors have to reduce their Cumulative Canadian Exploration Expense pool by the amount of investment tax credit that they claimed, an adjustment that results in the tax credit being taxable.

Subsequent tax recoveries from individuals also occur as capital gains when the flow-through shares are sold. The shares are deemed to have been received "free" or have a "zero" cost base. Since the money raised is spent on exploration programs across Canada, further tax recoveries are made with respect to job-related income tax deductions and taxes on consumables such as drill bits, rods, fuel, filters, food and other supplies. As the exploration service sector becomes more engaged with assaying and additional financing when warranted, tax recoveries continue due to the multiplier effect.

1.5.3 Program Success

Although the $450 million raised is about half of what the PDAC in 1999 had hoped would be raised by this time, the program is considered to be a success for the following reasons:

- The money stays in Canada. The program has encouraged some companies to return to Canada (e.g., Candente in Newfoundland and Labrador), encouraged others to drill deeper (e.g., Miramar beneath its Hope Bay, Boston and Suluk deposits in Nunavut) and generally assume more risky grass-roots projects than they would otherwise have

done (e.g., Stornoway 'et al' looking at the Melville Peninsula for nickel and platinum group metal potential and finding diamonds – the reverse of Voisey's Bay).

- The program is a model of innovative and "smart" regulation in that it requires no extra administration for disbursement of what in effect are transfer payments, nor is there a requirement for government officials to pick "winners." Economic activity is mainly confined to rural and northern Canada, permitting jobs to be sustained or created in areas with limited choice of wage opportunities, including Aboriginal communities.

- In 2001, the first full year of ITCE enhanced flow-through activity, CEE eligible financings more than doubled to $165 million from the $75 million of 1999, the last full year of "regular" 100% flow-through CEE. Activity levels increased again in 2002 with $207 million raised. This has been achieved with minimal foregone federal revenues.

- The Metals Economics Group (MEG) reports that in 2002 Canada overtook Australia for the first time in eight years as the most active mine exploration country in the world. MEG attributes Canada's relatively better performance in an otherwise downward trend in global mineral exploration expenditures to be due in part to the attractiveness of flow-through shares.

- The program is well organized, easy to understand and focused. Since mining companies represent approximately 28% of all issuers listed on the Toronto Stock Exchange (TSX) and the TSX Venture Exchange (TSX-V), the economic activity created in raising flow-through funding in Canada's financial centres is significant.

- In 2002, 91% of the number of mining equity financings worldwide were for TSX and TSX-V listed issuers and although most were not eligible for CEE, 32% of the world's equity capital raised for mining companies was for TSX and TSX-V issuers. These percentages illustrate Canada's global competitiveness, but also underscore the fact that if mine operating and service sector jobs are to be maintained in Canada, a healthy domestic exploration sector is essential.

- A survey of Vancouver-based exploration companies in January 2003 by Ontario's Ministry of Northern Development and Mines indicated that fully one quarter of those company presidents interviewed said that their companies were only exploring in Canada because of "super" flow-through shares, their main assets being offshore (Bill McGuinty, pers. com.). This confirms that ITCE has helped bring back some very experienced professionals to support domestic sustainability while also helping Canada compete globally.

- To June 30, 2003, the discovery rate for grass-roots exploration increased dramatically to two per month since the program was introduced on October 18, 2000, a rate not achieved since the high levels of the late 1980s.

- The resulting 68 grass-roots discoveries benefit nearby communities and jurisdictions. Unlike high-tech start-up companies or many other entrepreneurial ventures, mineral deposits cannot be relocated to big cities, warmer climates or tax "havens" outside Canada. Operations and jobs stay local.

- National, provincial and territorial geoscience databases and mineral inventories are enhanced, particularly with third dimensional information from drilling, a type of information not provided by government-sponsored geoscience programs. While today's discoveries may not immediately attract the financing required to advance them, changes in technology, access, commodity prices and other parameters with an impact on mineral economics will allow discoveries in inventory to provide focus for future investigation.

- Officers and directors of junior mine exploration companies report that the program has been a "life saver" in terms of keeping their corporations viable during very difficult market conditions, which have included the melt down of the high-technology sector and major U.S. corporate scandals.

- The three territorial governments, which have negligible investor bases with which to participate, have requested a preferential federal tax credit rate for exploration done north of the 60th parallel.

- Additional provinces are still considering harmonizing with the federal program.

- Canada's major mine exploration competitors, such as Australia, South Africa, Chile and Brazil, are considering adopting similar tax incentive measures.

Excluding diamond discoveries, the PDAC estimates that seven of the metallic mineral discoveries as presently known will likely be permitted within the next decade as operating mines and an additional five will eventually be mined.

1.5.4 Industry Recommendation

The PDAC recommends that the ITCE program be extended another three years.

1) Mine exploration requires protracted, highly technical work, even after an initial discovery. Planning programs, consulting with community, revising plans and coordinating with contractors, frequently in remote locations, require long-term commitments. This is difficult in a cyclical business at any time. One-year extensions of flow-through funding exacerbate planning difficulties. A three-year renewal of the ITCE program is more in keeping with the longer time lines that are necessary to provide continuity to remote exploration programs where year-round access is rarely possible.

2) The ITCE program was introduced to assist the mine exploration sector to find funding while investor confidence and interest were low. Liquidity remains a serious problem. <u>While the industry awaits the return of investor confidence, a significant exploration effort can still be sustained by the continuation of the ITCE program</u>. On the other hand, failure to extend will immediately reduce exploration activity with a concomitant drop in mineral discoveries and their associated economic activity across the country.

3) Internal departmental and third-party monitoring keeps governments informed of exploration activity levels.

4) On June 3, 2002, the Mines and Finance ministers from all three governments north of the 60th parallel co-signed a letter to Minister Manley requesting that a preferential ITCE

rate be introduced to assist their jurisdictions because they have insignificant numbers of resident potential investors. In so doing, the territorial ministers clearly recognize that exploration activity levels equate to discoveries of new mines.

5) Certain provinces continue to show interest in harmonizing with the ITCE program, which is an indication of the increasing awareness that some jurisdictions have with respect to the sustainability of future jobs.

Section 2 – Issues Relating to the Definition of Canadian Exploration Expenses (CEE)

2.1 Introduction

In its April 2000 Report, *Productivity and Innovation: A Competitive and Prosperous Canada*, the House of Commons Standing Committee on Industry recommended that the government consult with the mining industry to clarify the definition of CEE. Since then, a number of discussions have been held on this issue but limited progress was made due to the precedence taken by the tax-restructuring process. After the release of the detailed resource taxation-restructuring plan in Budget 2003, a new round of discussions was initiated under the auspices of the Intergovernmental Working Group on the Mineral Industry (IGWG) to formally identify and examine outstanding issues relating to the definition of CEE.

As is normally the case, Finance Canada and the CCRA attended only as observers to the IGWG meetings. Since both organizations were already generally aware of the nature of CEE issues presented, the main purpose of the discussions was to clarify the application of current income tax rules relevant to the issues for the benefit of industry and the provinces; expose provinces/territories to the CEE issues raised by industry so that they may appreciate their implications on tax and mineral policies and on tax administration; and give provinces/territories the opportunity to provide initial feedback to the federal government and industry on the pertinence and importance to them of the CEE review.

Issues that were identified by industry are:

1. Tax status of exploration expenses incurred in the vicinity of an existing mine;
2. Clarifying circumstances in which certain depreciable assets could be eligible CEE;
3. Clarifying the status of feasibility study cost as eligible CEE;
4. Inclusion of community consultation cost as eligible CEE; and
5. Inclusion of baseline environmental studies as eligible CEE.

The following subsection will provide a snapshot of the policy intent of tax rules relevant to these issues. It will also briefly explain how these tax rules are currently administered by the CCRA. Since industry is the initiator of these discussions, industry views will then be presented in a separate subsection, followed by provincial/territorial comments on these views.

2.2 Policy Intent of Existing Legislation and Current Administrative Practices

2.2.1 Exploration in the Vicinity of an Existing Mine

The policy intent of paragraph (f) of the definition of CEE in subsection 66.1(6) of the *Income Tax Act* (ITA) is to encompass expenditures relating to finding new mineral resources in Canada, but not for extending existing, developed orebodies.

The purpose test for the exploration expenses described in paragraph (f) of the CEE definition, commonly referred to as “grass-roots” exploration, is any expense incurred “for

the purpose of determining the existence, location, extent or quality of a mineral resource in Canada." Explicitly excluded from the scope of the definition, however, is any expense related to a mine that has come into production "or to be related to a potential or actual extension thereof." This exclusion has the effect of focusing eligibility on mineral resources that have not yet been developed.

2.2.2 Depreciable Property

The introduction in 1997 of paragraph (l) of the definition of CEE was intended to clarify that depreciable property of any prescribed class would generally not be eligible for CEE treatment.

2.2.3 Feasibility Studies

The classification of costs of feasibility studies depends on the nature of the study and the purpose for which it was undertaken. The cost of some feasibility studies may qualify as CEE while others do not. CCRA considers that the cost of feasibility studies with respect to the acquisition of equipment, facilities or the production process do not qualify as CEE. The cost of bankable feasibility studies undertaken for the purpose of obtaining financing or the cost of a study to determine whether to bring a mineral resource into production also would not qualify as CEE.

2.2.4 Community and Aboriginal Consultation Costs

CCRA considers that consultation costs incurred as part of the permitting process are generally classified as Canadian Development Expenses (CDE) since they are incurred for the purpose of acquiring a right, licence or privilege to prospect, explore, drill or mine for minerals. Consultation costs that are not included in the CDE pool would not likely qualify as CEE unless they are incurred for the purpose of bringing a new mine into production.

2.2.5 Environmental Baseline Studies

As is the case for consultation costs, CCRA considers that costs related to environmental baseline studies are CDE when they are required to be undertaken as part of the permitting process. The cost of other such studies would not likely qualify as CEE unless they are incurred for the purpose of bringing a new mine into production.

2.3 Industry Views

The following extract from an industry submission to the Minister of Finance has been supplied by The Mining Association of Canada (MAC) and the Prospectors and Developers Association of Canada (PDAC). The views reflected therein are those of members of the industry and are not necessarily in accord with the views of the Working Group.

2.3.1 Exploration in the Vicinity of an Existing Mine

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 their view, at some point between additional quantification of a known reserves 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 made as follows:

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 their 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.

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.

Industry proposes 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:*

    - *The drilling or development is at least "x" metres in any direction from existing workings;*
    - *The drilling or development is at least "x" metres in any direction from known inferred resources; and,*
    - *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.

2.3.2 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 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).*
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> *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.

2.3.3 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 it

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, 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. To ensure that feasibility study costs are treated as CEE, the *Income Tax Act* should be amended or revisions to the present interpretation should be confirmed.

2.3.4 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 Canada. With due respect, the PDAC consider 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 recommend that these costs be categorized as CEE.

2.3.5 Environmental Baseline Studies

The Prospectors and Developers Association 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 mitigation 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. PDAC is available to assist in the further development of this issue.

2.4 Provincial/Territorial Views

2.4.1 Manitoba

Manitoba supports and would participate in a multi-party consultation that includes the provinces, federal government and minerals industry to review issues related to the CEE definition.

2.4.2 Saskatchewan

Saskatchewan is interested in continuing discussions and analyses regarding the definition of Canadian Exploration Expenses, in order to improve the understanding of the issues that have been raised and to assess the implications of any potential changes.

2.4.3 Alberta

Alberta would want to be involved in any multi-party consultation process that involves the provinces, the federal government and industry to review issues related to the CEE definition.

2.4.4 British Columbia

2.4.4.1 First Nation (FN) and Community Consultations and Environmental Studies

The costs of environmental studies are generally relatively low and community consultations are not usually an issue until a mineral resource has been defined and project feasibility work begins. Activities such as till surveys, water sampling programs, etc., can provide both geological information and environmental baseline data.

First Nations consultation must occur when a Crown-permitted activity may lead to the infringement of Aboriginal rights and/or title in British Columbia. It is the Ministry of Energy and Mines' policy to refer exploration and mine development permit applications to the affected First Nations for review and comment. It is possible that minimal consultation may be necessary for initial exploration programs. Consultation helps to provide direction on mitigation measures and future accommodation that may be necessary to address potential right and title infringements. While the exact legal requirements for First Nation consultation may be further defined by the courts, it is clear that consultation is a legal requirement for mineral exploration and development.

Preliminary research suggests that the costs for First Nations consultations, accommodation and related studies can range from being negligible and incidental to relatively large. The uncertain requirements and costs of First Nations consultations could make them fundamentally different from the other costs that are usually incurred to acquire title or a permit.

It appears that consultations and studies are required by:

- The Ministry of Energy and Mines as a condition to granting a coal licence or lease (Ministry policy), or
- The Environmental Assessment Office during its project certification process, or
- The Ministry of Energy and Mines as a permit condition can be CDE.

Similarly, environmental studies undertaken as part of an exploration program to determine the existence, location, extent and quality of a mineral resource involve modest incremental costs and can be CEE. The tax treatment of other kinds of pre-production First Nation and community consultations and environmental studies is determined by the particular circumstances. Junior exploration companies' ability to operate could be adversely affected if those costs become significant and receive unfavourable tax treatment.

CCRA is reported to require that at least 90% of explorationists' time be in the field for their costs to qualify as CEE. This could be problematic if a significant portion of that person's time was spent doing community or First Nations consultations and consultations were not considered exploration. Similarly, there could be problems if consultations could be considered CEE and the consultations were done by head-office specialists, in which case they could be CEDOE.

It is arguable that First Nations and community consultations, and environmental studies that are integral to the legal, socially acceptable and environmentally responsible development of sub-surface resources should be accorded appropriate tax treatment for the related expenditures. This prompts three related questions: Should consultation and environmental

expenditures, whether incurred to acquire title, as a permit condition or in the normal course of business, be treated as CEE, CDE or a current expense? If they can qualify as CEE, should it be possible to renounce them under a FTS agreement? If they can be renounced under a FTS agreement, should they be eligible for the ITCE?

2.4.4.2 Preliminary Position

In the interests of supporting tax policies that contribute to a sustainable mining industry, the British Columbia Ministry of Energy and Mines would support further review and analysis of the implications of policies that:

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

2.4.4.3 Rationale

Implementation of those measures would eliminate the uncertainty that currently exists regarding the tax treatment of those expenditures and facilitate the efficient financing of mineral exploration in Canada. The current uncertainties require that additional conventional, non-FTS financings be raised to fund those and other activities that are not, or may not be, CEE.

Companies are unlikely to undertake the identified activities frivolously and the associated costs are likely to be reasonable. Corporate governance, financial market conditions and cost containment pressures will all work to ensure that cost-effective and appropriate consultations and environmental studies are undertaken. Furthermore, for junior exploration companies, unnecessary expenditures imply additional dilution of shareholders' equity and that dilution could make it more difficult to fund current and future exploration programs.

The costs will be further contained by the ability of government legislation, policies and processes to influence the consultation requirements and environmental programs. Appropriate tax treatment will help to ensure that the benefits of governments' requirements more than justify the related costs.

The recommendations recognize the opportunity costs of the activities. The resources and funds that are used in First Nations and community consultations cannot be used in exploration. Unfavourable tax treatment would lessen the impacts of government programs to support exploration, aggravate adverse industry perceptions regarding Canada's environmental and consultation policies, and make it more difficult to attract risk capital.

First Nations and community consultations add financial risk to the exploration and development process and the costs should be treated in a manner similar to conventional exploration expenditures. Where consultation and exploration processes are very different, the failures can be equally bad for a project as it is not unusual for promising projects to be stalled or frustrated by the results of court cases, public reviews or consultations. The consultations and studies are arguably costs of determining the economic and social "quality" of the resource and can be as important as grade and tonnage in assessing the feasibility of developing it as a mine. Furthermore, consultation processes, where negative results could preclude development, arguably have as much "downside" risk as conventional exploration.

These risks are aggravated by the absence of clear standards or objectives for consultations and the possibility that escalating social demands will reduce the benefits of exploration successes that the company would otherwise realize.

Finally, favourable tax treatment will lessen the financial impacts of those expenditures on the mining industry and improve Canada's competitiveness for mining industry investments. The proposed tax measures will provide clear government support for the related consultations and studies and will help mitigate industry concerns regarding the impacts of those activities on the competitiveness of Canada for mining investments. With both Canadian governments and industry contributing to a sustainable mining industry, Canada's role as a leader in the development of responsible policies will be reinforced.

Section 3 – Federal Income Tax Restructuring for the Resource Industries

3.1 Background

The 2003 Budget announced the phased elimination of the federal capital tax for all industries except the financial sector, and the phasing in, over a five-year transitional period, of the following changes to the federal taxation of resource income: a reduction in the federal corporate income tax rate on resource income from 28% to 21%; a deduction for actual provincial and other Crown royalties and mining taxes paid and the elimination of the 25% resource allowance; and a new 10% tax credit for qualifying mineral exploration expenditures. The phase-in of these changes begins to take effect on January 1, 2003, and will be fully implemented by January 1, 2007.

A technical paper released on March 3, 2003, included a detailed implementation schedule for the various proposed measures. On June 9, 2003, the Minister of Finance tabled a Notice of Ways and Means Motion in Parliament to implement the resource taxation-restructuring plan. The legislation received First Reading on June 13, 2003, the day on which Parliament rose for the summer break. Consideration of the legislation will continue when Parliament reconvenes.

The review of the federal resource taxation structure highlighted a number of important problems that made the replacement of the resource allowance a priority for the Government of Canada.

The resource allowance can provide tax deductions in excess of or lower than actual mining taxes and royalties paid, and does not reflect true costs. The incentives or disincentives to invest that result are essentially arbitrary and distort economic signals.

The resource allowance also creates an arbitrary line between expenses taken into account before or after the resource allowance. Costs deducted *after* the resource allowance are deductible at a premium rate of 28% while costs deducted *before* are effectively deductible at only 21% (resource revenues are taxed at 21%). As a result, allocation of expenses for tax purposes gives rise to ongoing disputes between taxpayers and the CCRA, thereby creating uncertainty for investors and increasing the cost of compliance and administration.

Prior to the budget release, the federal government held extensive consultations with the industry to ensure that the new regime would be internationally competitive overall, while providing for a simpler, more equitable treatment of all sub-sectors.

Fully implemented, the new structure will result in the same federal corporate income tax rate imposed on resource income as on other corporate income, and will allow deduction of actual costs of provincial and other Crown royalties and mining taxes incurred instead of an arbitrary allowance.

Establishing a common statutory federal rate of corporate income tax for all sectors and treating costs more consistently, both across resource projects and between the resource sector and other sectors of the economy, will promote the efficient development of Canada's

resource base. The new tax structure will be simpler. It will provide for streamlined tax compliance and administration and send clearer signals to investors.

While all mining firms will benefit from a lower rate of corporate income tax, individual firms' tax bases will be affected differently by the removal of the resource allowance and provision for deductibility of Crown royalties. The actual net impact of the new structure on a particular firm will depend on the mix of projects undertaken by each firm, the financing structure of the firm, and the size of accumulated tax pools carried forward from previous years. Also, it will depend on their exploration expenditures and therefore the extent to which they avail themselves of the new corporate mineral tax credit.

The elimination of the federal capital tax by 2008 will be of significant benefit to the capital-intensive mining sector. Taking into account this change, it is anticipated that the new taxation regime for mining should result globally in a lower tax burden for this industry.

3.2 Account of Discussions

3.2.1 Industry

Through the IGWG forum, industry had the opportunity to express concerns related to the effects of the federal corporate income tax restructuring plan on provincial/territorial taxes.

In large part, potential tax increases could stem from larger incidental provincial income tax receipts from mining. Many provinces and the territories rely on the calculation of federal taxable income in the computation of their own corporate income tax. Provinces that have a separate corporate income tax system (Alberta, Ontario and Quebec) may wish to harmonize their income tax rules with the revised federal ones. 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. The exception will be British Columbia and Saskatchewan because these provinces already have rules in place to effectively allow royalty payments as a deduction instead of the resource allowance. In their case, the federal changes will not affect the provincial tax base.

3.2.2 Provinces/Territories

3.2.2.1 Alberta

Alberta is pleased that the federal proposal recognizes that all sectors of the economy should be taxed at the same rate, and that royalties are a legitimate cost of doing business. However, Alberta also believes that the federal government could have extended the tax cut to the resource sector more quickly than the lengthy implementation period proposed. The Alberta government is consulting with industry and will provide feedback to the federal government on its proposal.

3.2.2.2 Manitoba

Manitoba is evaluating the impacts of the 2003 federal budget measures on the mining sector within the context of an overall study of the key issues that have an impact on the global competitiveness, investment attractiveness, and sustainability of the minerals sector in Manitoba.

3.2.2.3 New Brunswick

The New Brunswick government is committed to creating a competitive fiscal and business environment as outlined in its strategic economic growth agenda, *Greater Opportunity: New Brunswick Prosperity Plan*. The government strongly believes that lower taxes and strong financial management are essential to make New Brunswick a stronger place to invest and create jobs. New Brunswick will ensure that it has a competitive taxation regime to attract new job-creating investment and reward economic success.

Since 1999, New Brunswick has reduced the general corporate income tax rate from 17% to 13% effective January 1, 2003. Also, the small business corporate income tax rate was decreased from 7% to 3% and small business thresholds were increased from $200 000 to $400 000 of active business income. These lower tax rates apply to all sectors of the economy including the mining sector.

New Brunswick is currently evaluating the impact of the 2003 federal budget measures on the mining sector.