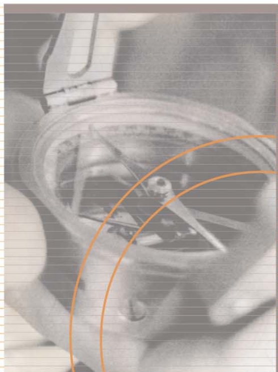

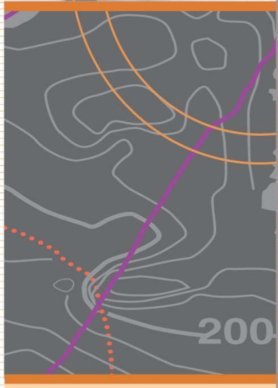

TAX Credits

for Mineral Exploration Flow-Through Shares

A preliminary report by the Intergovernmental Working Group on the Mineral Industry

Northwest Territories

Yukon

British Columbia

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Manitoba

Ontario

Québec

Canada

2002 MINES MINISTERS' CONFERENCE
WINNIPEG, MANITOBA

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An Evaluation of the Investment Tax Credit for Exploration in Canada and Related Provincial/Territorial Tax Incentives for Exploration

2002 MINES MINISTERS' CONFERENCE
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Northwest Territories
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Executive Summary

The most recent downturn in exploration expenditures in Canada, which began in 1997, led to a significant reduction in the country's reserves of gold and base metals with consequent mine closures and job losses. In response to this difficult situation, affected stakeholders (mining industry, communities, provinces/territories) embarked on a broadly based campaign for a federal tax incentive that culminated in the October 2000 introduction of the 15% federal Investment Tax Credit for Exploration (ITCE). Provincial tax credits that were harmonized were introduced during the following two years.

The underlying causes for the decline in exploration and mining activity are global in extent and beyond the control of any single government. Metal prices remain at levels well below those of 1996, before the current downturn began, and hopes of economic recovery in major consuming nations appear to be repeatedly set back by events such as the September 2001 terrorist attack, lack of investor confidence in the equity markets as a result of suspect disclosure practices of major public companies, conflict in the Middle East, and faltering national economies.

While the Canadian exploration sector must continue to contend with these external factors, Canadian governments have an interest in determining whether or not, and to what extent, recently adopted measures have helped the industry withstand these difficult times. This preliminary report was therefore prepared for Canada's Mines Ministers who, at their 2001 Conference in Québec City, recognized the need to evaluate the ITCE and other related tax credits.

The working group that was struck from members of the Intergovermental Working Group on the Mineral Industry (IGWG) determined that there are three immediately apparent ways of measuring the success of the federal ITCE and provincial/territorial tax credits. The first is to measure the amount of money raised for flow-through shares (FTS), where the investor receives the ITCE; the second is to measure the evolution of various exploration activity indicators; and the third is to measure the number of discoveries of new mineral deposits that were funded by ITCE-eligible expenditures.

In measuring the amount of money raised using the ITCE, the study group was faced with significant difficulties in obtaining reliable and timely data. Aggregate corporate income tax data on FTS sales, renunciations and ITCE eligible expenditures from the Canada Customs and Revenue Agency will provide useful information when they become available in a revised and more comprehensive format for the full period since the introduction of the ITCE. In the meantime, the trends from the data related to intentions to raise FTS funds do show a rising interest in that financing mechanism since the inception of the ITCE.

Currently, the most useful data are a compilation of information available from the System for Electronic Document Analysis and Retrieval (SEDAR) database, which is maintained by the stock exchanges. These data and the data available from Gamah International, which also incorporate information from company press releases, show that while the ITCE has not raised funds to the extent ($300 million per year) anticipated by the Prospectors and

Developers Association of Canada (PDAC), it has been a lifeline for junior mining companies. FTS financings raised approximately $110 million in 2001, the only full year since the program inception.

The federal-provincial/territorial survey of mineral exploration, deposit appraisal and mine complex development expenditures provides various breakdowns of exploration spending, including one by junior and senior companies. This survey shows that junior exploration spending has risen steadily since the introduction of the ITCE. Assuming that FTS financings are concentrated in the hands of junior companies and that many FTS financings would involve the use of the ITCE, this rising trend points to the ITCE and related credits achieving their goal of supporting the junior exploration sector and encouraging more grass-roots exploration.

A separate working group, led by the PDAC and including Natural Resources Canada and Queen's University, has analyzed the discoveries made since 1970 and concluded that, in general, the discovery rate per dollar expended has declined over time, although the rate of discovery of new mineralization per dollar spent is higher now than it was during the boom years of FTS and the Mining Exploration Depletion Allowance (MEDA) from 1986 to 1988.

On an international basis, Canada has managed to increase its share of exploration funded by the worldwide exploration budgets of larger mining companies and is well placed to supply mineral commodities to the world markets as economic circumstances improve.

In conclusion, the ITCE has been reasonably successful in maintaining access to exploration financing for junior mining companies in the current difficult economic and financial times. But due to the timing of the introduction of harmonized provincial tax credits and the time it took for industry and investors to adjust to the program, the uptake on the ITCE has gone through a slow start and the program is just beginning to show signs of realizing its anticipated potential (about $96 million has been raised by FTS financings in 2002 to the end of July).

Looking forward, industry has requested an extension to the program and that consideration be given to making certain adjustments to the tax credit mechanism. The working group is of the opinion that the ITCE should be given more time to meet its objectives and yield meaningful results for the industry and the communities that rely on mining as their principal source of income and employment. Accordingly, the working group is recommending that:

- *the ITCE program and the harmonized provincial tax credits should be extended to December 31, 2004, with consideration given to a further one-year extension;*

- *the spending ("look-back") period allowed under the ITCE for carrying out the exploration work should be extended until one full year after the program's proposed closing date to conform with the period normally available for undertaking the FTS-financed exploration work; and*

- *the mandate of the working group should be extended until the end of 2003 to allow for careful analysis of the recommendations for improving the tax credit/FTS mechanism and updating the evaluation of the effectiveness of the tax credits (as more extensive and reliable data become available).*

Based on further analysis and consultation, the working group will provide additional comments on the options for extending and improving this tax credit program in a revised edition of the report to be released by the end of 2002 for the relevant federal and provincial/territorial governments.

A preliminary report by
the Intergovernmental Working Group for the Mineral Industry

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1. Foreword

Many companies that explore in Canada raise money through an equity financing method known as the flow-through share (FTS) mechanism, which is a means to increase public participation in "grass-roots" exploration. FTS financing allows the mineral exploration firm to pass eligible Canadian Exploration Expenses (CEE) through to the investor. The investor can then deduct 100% of eligible expenses from taxable income for income tax purposes. FTS are only available in the resource and renewable energy sectors and represent one of the few remaining tax shelters in the Canadian tax system. From the mid- to late-1990s, about 15% of total exploration spending in Canada was financed by FTS.

By 2000, Canada's grass-roots exploration sector had become particularly affected by the combination of a cyclical downturn that began in 1997 and the increased competition for global risk capital from the high technology industry. There was agreement among all stakeholders that action was needed to encourage FTS financing and stimulate grass-roots exploration. Provincial/territorial initiatives were put in place but industry (particularly the Prospectors and Developers Association of Canada) and the communities believed that a national, tax-based incentive program was necessary to create the stimulus required for incremental investment in mineral exploration. This increased spending would bring an immediate economic benefit to northern communities and sustained benefits in terms of new mineral discoveries to replace diminishing ore reserves at producing mines.

An investment tax credit for investors in FTS of mineral exploration companies was implemented in the Economic Statement of October 18, 2000. This Investment Tax Credit for Exploration (ITCE) is designed to assist junior mining companies in raising new equity through the issuance of FTS. The ITCE applies to specific preliminary mineral exploration expenses that are incurred after October 17, 2000, but before January 1, 2004. Since the introduction of the ITCE, the provinces of British Columbia, Ontario, Saskatchewan and Manitoba have introduced harmonized tax credit programs to complement the federal program.

At the 2001 Mines Ministers' Conference (MMC), a working group was created under the auspices of the Intergovernmental Working Group on the Mineral Industry (IGWG) to report to the 2002 MMC on the effectiveness of the federal and provincial/territorial tax credits for exploration and to provide recommendations on existing and potential tax incentives for exploration to the Department of Finance by the end of 2002. The working group comprises representatives from the governments of Quebec, Ontario, Manitoba, Saskatchewan, British Columbia, the Yukon and the Northwest Territories, and from Natural Resources Canada.

The objectives of this working group are:

- to accumulate available information on mineral exploration spending, particularly on money raised using FTS linked to the ITCE and provincial tax credits;
- to analyze the information and evaluate the performance of the ITCE in terms of stimulating investor interest and increasing mineral exploration investment, and creating jobs and economic growth in rural Canada;
- to evaluate possible options for improvement or replacement of the ITCE; and
- to recommend a course of action after the planned termination date of the temporary measure.

After a year of collaborative work, the working group is respectfully submitting this preliminary report to Canada's Mines Ministers at their 2002 conference in Winnipeg, Manitoba, and is asking for their input in preparing a revised edition of the report for the attention of the federal and provincial/territorial departments of Finance.

2. Industry Context

Statistical and Contextual Background to the Introduction of the ITCE

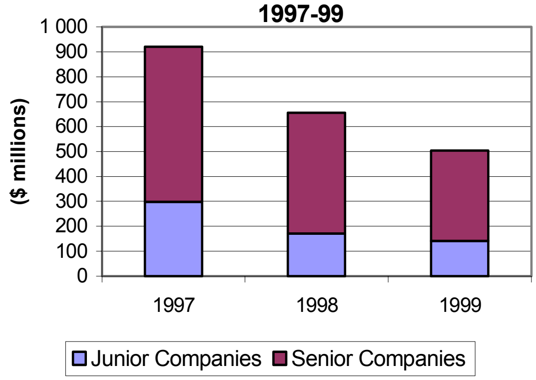
2.1 Introduction

This section summarizes the state of and outlook for mineral exploration in Canada prior to the October 2000 introduction of the ITCE. While the analysis presented below is based on the latest data available for the period prior to October 2000, the trends shown by these data reflect and reinforce those that were identified at the time of developing the ITCE policy option.

2.2 Mineral Exploration and Deposit Appraisal Spending in Canada

Statistics from the federal-provincial/territorial Survey of Mineral Exploration, Deposit Appraisal and Mine Complex Development Expenditures show that combined exploration and deposit appraisal spending in Canada declined dramatically between 1997 and 1998, dropping by $265 million (29%) from $921 million to $656 million (**Figure 2.1**). Spending continued to decline in 1999 when it dropped to $504 million. During this period, the spending decline was most pronounced for junior companies, which are mainly exploration enterprises with no production income. Their spending dropped by 53% compared to 42% for "senior companies" that have production income.

Figure 2.1
Exploration and Deposit Appraisal Expenditures in Canada, by Type of Company, 1997-99

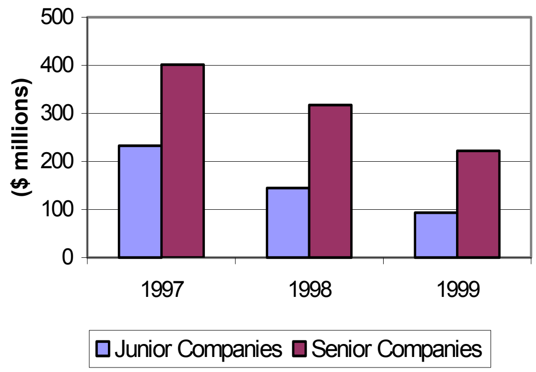


2.2.1 Exploration (*Grass-Roots*) Versus Deposit Appraisal Spending (*Advanced Exploration*)

In the federal-provincial/territorial survey, exploration 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. Deposit appraisal includes the work carried out to bring a delineated deposit to the stage of detailed knowledge required for a production feasibility study.

The exploration component (which the ITCE is focussed on) of total exploration and deposit appraisal spending decreased from $634 million in 1997 to $463 million in 1998 (a drop of 27%) **(Figure 2.2)**.

Figure 2.2
Exploration Work Phase Expenditures in Canada, by Type of Company, 1997-99



Deposit appraisal, on the other hand, went from $287 million to $193 million (a drop of 33%). In 1999, exploration expenditures dropped by a further 32% to $315 million while deposit appraisal spending, buoyed by advanced work on diamond properties, stayed at almost the same level as in 1998 with spending of $190 million. Therefore, at the time of reaching a decision on the ITCE, expenditures on the exploration phase were in sharp decline.

2.2.2 Composition of the Canadian Mineral Exploration and Deposit Appraisal Industry

Companies involved in mineral exploration and deposit appraisal spending in Canada are usually subdivided into junior companies and senior companies. In general terms, a senior mining company derives its income from mining or other business ventures and can direct part of that income towards its exploration and deposit appraisal projects. Junior companies, on the other hand, usually have no regular source of income and must finance their exploration and deposit appraisal activities through the issuance of shares. The ITCE was introduced to help the latter finance their exploration projects by making these junior companies' shares more attractive to investors.

An analysis of the distribution of exploration and deposit appraisal project operators over the period 1997-99 shows that there were 684 project operators in 1997, 529 of which were junior companies. The total number of project operators declined steadily from 1997 to 1999 when a total of 532 companies managed exploration projects in Canada. Most of that decline was accounted for by junior companies, their number going from 529 in 1997 to 409 in 1999. This decline in the number of junior mining companies that managed projects was the result of a number of factors, including low metal prices, lack of financing, and the conversion of a number of juniors to dot.com companies.

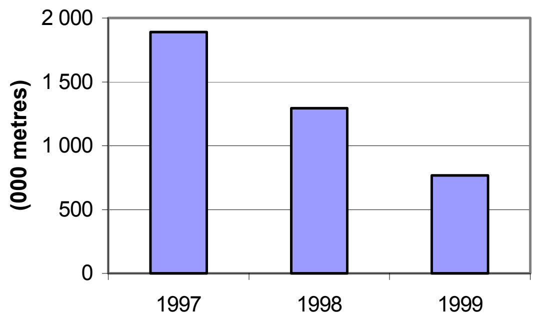
Along with their reduced relative importance, in terms of number of industry participants, junior companies also decreased their overall exploration and deposit appraisal spending over the period 1997-99 (**Figure 2.1**). In 1997, junior companies spent $298 million on exploration and deposit appraisal activity, accounting for 32% of the total of $921 million for that year. By 1999, total junior spending had gone down to $141 million, a 53% decline from the 1997 level. In terms of spending on the individual work phases, junior companies saw their spending on the exploration phase tumble between 1997 and 1999, with spending on that phase going from $233 million to $93 million, a decline of 60% that raised many concerns about the ability of junior companies to sustain their long-term participation in the Canadian mineral discovery process (**Figure 2.2**).

2.2.3 Other Indicators of Exploration and Deposit Appraisal Activity in Canada

2.2.3.1 Diamond Drilling

Diamond drilling is the most widely used drilling method for locating and evaluating a mineral deposit. Diamond drilling statistics, therefore, constitute a valuable indicator of exploration activity. The diamond drilling statistics shown in **Figure 2.3** are from the Canadian Diamond Drilling Association (CDDA) and they cover about 50-60% of total Canadian contract diamond drilling activity. For the purpose of this report, this source of diamond drilling data was selected over data from the federal-provincial/territorial survey and from Statistics Canada because of its ability to provide the most up-to-date picture of diamond drilling levels in Canada.

Figure 2.3
Surface Diamond Drilling in Canada, 1997-99



After reaching a high of 1.9 million metres in 1997, surface diamond drilling, as reported by the CDDA, dropped by 32% to 1.3 million metres in 1998. It dropped even further in 1999, to 768 000 metres, a decline of 41%. Although not shown here, data from the other two sources exhibited similar declining patterns despite having higher annual totals. Underground diamond drilling is not considered here because this type of activity does not qualify for the ITCE and is usually mostly conducted by senior mining companies.

2.2.3.2 Claim Staking

Claim staking is another indicator of mineral exploration activity that can be useful, especially at highlighting emerging trends or areas of interest. However, claim staking can also be misleading as this is a relatively inexpensive stage of mineral exploration and cannot be directly related to future spending. In addition, the growing popularity of map staking among Canadian jurisdictions has resulted in the staking of larger areas than would have previously been the case. The areas of new mineral claims staked in Canada went from a high of 44 million hectares in 1997, a direct result of a major map staking rush for diamonds in Alberta, to 7.9 million hectares in 1998 and 5.4 million hectares in 1999.

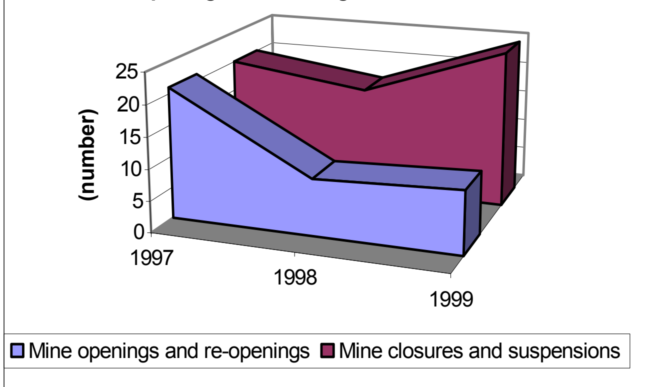
2.2.4 Canadian Reserves of Selected Major Metals

A goal of mineral exploration is to replace depleted ore reserves and add to mining production capacity. In the few years preceding the introduction of the ITCE, the ore reserve levels of selected major metals in Canada continued to decline and, in the case of copper, zinc and lead, reached their lowest levels in 1999 since at least the very early 1980s. Despite an increase in 1998, nickel reserves were also at a low point in 1999. Gold reserves reached a high of over 1700 tonnes in 1996 and then declined steadily to just over 1300 tonnes in 1999. Diamonds represent an exceptional case as the emerging Canadian diamonds industry kept adding to its reserves during the pre-ITCE period.

2.2.5 Mine Openings and Closings in Canada

The state of the Canadian mining industry over the period 1997-99 can be easily summarized by looking at the number of mine openings (including re-openings) versus the number of mine closures (including production suspensions) over that period (**Figure 2.4**).

Figure 2.4
Mine Openings and Closings in Canada, 1997-99



After exceeding the number of mine closings in every year from 1994 to 1997, the number of mine openings dropped significantly in 1998 and 1999 to result in the overall loss of 22 mining operations during the period 1997-99. In addition to these mine closures, there were a number of production cutbacks at Canadian mining operations, which added to the number of job losses suffered by this industry. The difficulties encountered by the mining industry had a profound impact on the exploration sector as lower profitability and mine closings, as well as the prospect of continued weak metal prices, caused many producing companies to curtail their exploration efforts.

2.2.6 Worldwide Mineral Exploration Trends

Canada was not the only jurisdiction to suffer from low mineral exploration levels during the 1997-99 period. Statistics from the Metals Economics Group[1] reveal that, after peaking at $5.2 billion in 1997, the exploration budgets of the world's larger companies began a sharp downward trend to reach $3 billion in 1999. During that period, the proportion of worldwide budgets destined for Canada remained relatively stable at around 11%. This indicated that international investors did not see any improvement in the Canadian climate for exploration investment compared to elsewhere in the world.

2.3 Economic Factors and Investment Climate Variables

2.3.1 Metal Prices

A number of factors and events came into play during the period 1997-99 and affected mineral exploration levels in Canada and abroad, the most important being low metal prices. Natural Resources Canada's (NRCan) metals price index (based on the prices of gold, silver, copper, zinc, lead and nickel) demonstrates clearly this weakening of metal prices. More specifically, copper, which was selling at an average price of US$1.18/lb in June 1997, had dropped to an average price of US$0.65/lb in June 1999. The price of nickel stood at US$3.20/lb in June 1997. In June 1999, it averaged US$2.36/lb. As for zinc, its price was US$0.61/lb in June 1997 and averaged US$0.45/lb in June 1999. Similarly, gold, which sold at US$340.83/oz in June 1997, was selling for an average price of US$261.40/oz in June 1999.

[1] *Corporate Exploration Strategies: A Worldwide Analysis*, Metals Economics Group, Halifax, Nova Scotia.

This prolonged weakness in metal prices generally reflected world production in excess of world demand and was worsened by the fallout from the Asian financial crisis, which dramatically cut demand for primary materials in Asian countries. The price of gold was further affected by the anticipation of additional sales of the precious metal by central banks and the International Monetary Fund.

2.3.2 Financing Difficulties and Investor Confidence

The principal contributing factor affecting access to equity financing by junior companies has been general commodity market conditions facing the mining industry during this period, as discussed in Section 2.3.1. However, this factor is beyond the control of any government and this section will focus on institutional issues particular to Canada.

Since the mid-1990s certain conditions prevailing in the securities marketplace have negatively affected the access to equity financing for companies engaged in the speculative area of mineral exploration. These conditions include the decreasing liquidity of junior company stocks during this period and the effects of consolidation of stock exchanges within Canada. The elimination of the Canadian Dealing Network (CDN) "over the counter" trading platform and the merging of the former Vancouver and Alberta stock exchanges into the Canadian Venture Exchange (CDNX), subsequently acquired by the Toronto Stock Exchange (TSE) to form the TSX Venture Exchange (TSX-VEN), has caused a significant realignment of the junior markets and raised concerns about decreased visibility of mining stocks to investors.

Another factor has been a recent wave of regulatory change, including some new restrictions, aimed at setting higher standards for firms raising funds with equity financing. New regulatory requirements have impacts on the creation of instruments to raise equity and the target market for their sale. These requirements include:

- National Instrument 43-101 Standards of Disclosure for Mineral Projects, which involves changes to guidelines for technical reporting and defines the role and responsibilities of a “qualified person”; and
- Ontario Securities Commission Rule 45-501 Exempt Distributions, which defines new "means test" limits for accredited investors.

All these factors may have an impact on the ability of exploration companies to issue new FTS and other equity financing in coming years. A more detailed description of some of these factors is contained in Appendix 2 of this report.

3. Policy Context

3.1 Federal-Provincial Initiatives Taken Before 2000

3.1.1 Federal Initiatives

In its December 1994 report, *Lifting Canadian Mining Off the Rocks*,[1] to the House of Commons, the Standing Committee on Natural Resources made the following recommendations to address the problems being faced by the mineral exploration industry:

- implement new tax measures to encourage Canadian mineral exploration;
- modify the *Income Tax Act* to reduce taxable capital gains on the disposition of FTS; and
- enable the exploration activity funded by FTS to be carried out over a period of one full year after financing (this particular recommendation was included in the 1995 federal budget).

In their joint submission[2] to the 1994 Mines Ministers' Conference, the Prospectors and Developers Association of Canada (PDAC) and The Mining Association of Canada (MAC) proposed specific tax incentive options to stimulate mineral exploration. These included: the reintroduction of the Mining Exploration Depletion Allowance (MEDA); eligibility of exploration expenditures for Research and Development investment tax credits; and a tax holiday for new mines.

In 1995, a motion[3] was put forward by the Member of Parliament and Parliamentary Secretary for the Minister of Natural Resources, George S. Rideout, that the federal government should consider implementing a new program of mining incentives that would encourage exploration and development in Canada.

In 1998, the federal Minister of Finance requested a meeting of representatives from mining communities, industry and government officials to discuss the low levels of mineral exploration in Canada and their impact on employment and rural communities. In January 1999, the Minister of Finance held a meeting at which community and industry leaders requested that the federal government consider tax incentive options to stimulate the use of FTS and increase mineral exploration expenditures. In February 1999, the Industry/Government Working Group on Mineral Exploration presented to Finance Canada its technical analysis of incentives in its report *Economic Opportunities for Rural Canada*.

3.1.2 Provincial/Territorial Initiatives

Since its budget of May 1992, the Quebec government has had a "bonus deduction" program for Quebec investors who buy FTS to finance mineral exploration in the province. In addition to the regular 100% deduction, the Quebec FTS program allows additional deductions for

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[1] The House of Commons Standing Committee on Natural Resources, Chairperson Robert D. Nault, *Lifting Canadian Mining off the Rocks*, First Session of the Thirty-Fifth Parliament, 1994, pp. 21, 27 and 28.

[2] The Mining Association of Canada and the Prospectors and Developers Association of Canada, Brief Submitted to the 51st Mines Ministers' Conference, Victoria, B.C., September 11, 1994.

[3] House of Commons Transcript from November 9, 1995 - debate on a motion that in the opinion of this House, the government should consider implementing a new program of mining incentives which would encourage exploration and development in Canada.

investments in mineral exploration companies that are not involved in mining operations and for investments that fund surface exploration.

In 1998, British Columbia introduced a 20% refundable tax credit for companies and individuals undertaking exploration work in the province.

In 1999, the Yukon introduced a 22% refundable tax credit available to companies and individuals for exploration work performed in the Yukon. The program was planned to be phased out on March 31, 2001.

3.2 Federal-Provincial/Territorial Initiatives Taken After 2000

3.2.1 Initiatives by Provinces/Territories

In its May 2000 budget, the Ontario government announced plans to provide an additional income tax deduction for FTS investments in mineral exploration companies that conduct work in Ontario. The Ontario government asked the federal government to provide similar enhancements to the FTS provisions of the federal income tax.

In August 2000, the British Columbia government announced that mining companies that qualify for the Mining Exploration Tax Credit (METC) could now pass the proceeds received under the tax credit program on to FTS investors.

3.2.2 Mines Ministers' Conference 2000

In its presentation to the 2000 Mines Ministers' Conference, the PDAC outlined a proposal for a Focused Flow-Through Share (FFTS) program as a means to assist the mineral exploration industry in Canada. It noted that the House of Commons Standing Committee on Industry recommended that the Government of Canada consult the mining industry to clarify the definition of Canadian Exploration Expenses and "make FTS investments more attractive for potential investors."[4]

In response to the concerns raised by the mining industry and representatives from northern communities, the Action Plan for the 2000 Mines Ministers' Conference contained the following recommendation to address the issue of encouraging mineral exploration:

> *Ministers noted the need to build on the initiatives taken by a number of governments over the past year in order to promote investment in exploration across Canada. In view of the major changes being experienced by the mineral exploration industry in every province and territory, Ministers recognized the need to put in place over the short term new initiatives to help the industry secure the capital necessary for its long-term sustainability.*[5]

3.2.3 Federal 2000 "Mini-Budget" and Follow-Up Provincial Initiatives

In the Economic Statement and Budget Update of October 18, 2000, the Minister of Finance announced a temporary 15% investment tax credit of investors in FTS of mineral exploration companies. This Investment Tax Credit for Exploration (ITCE) is designed to assist junior

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[4] House of Commons Standing Committee on Industry – *Report on Productivity and Innovation*, April 2000.

[5] *Action Plan 2000*, Federal, Provincial and Territorial Mines Ministers' Conference, Toronto, Ontario, September 12, 2000.

mining companies in raising new equity through the issuance of FTS and applies to eligible exploration expenses incurred after October 17, 2000, and before January 1, 2004.

Following the introduction of the federal ITCE, harmonized tax credit programs were announced by Ontario in December 2000, Saskatchewan in March 2001, and British Columbia in July 2001.

3.2.4 Mines Ministers' Conference 2001 and Further Provincial/Territorial Initiatives

At the September 2001 Mines Ministers' Conference, mines ministers expressed their support for federal-provincial/territorial initiatives to promote investment in mineral exploration. They also noted the need to evaluate the success of these initiatives in meeting their objectives. Therefore, the ministers asked members of the Intergovernmental Working Group on the Mineral Industry (IGWG) to study the effectiveness of the tax credits and to prepare a report on the results prior to the next Mines Ministers' Conference in the fall of 2002. An IGWG sub-group was established in October 2001 and it includes representatives from the federal and seven provincial and territorial mines departments and observers from Finance Canada and the Canada Customs and Revenue Agency (CCRA).

In September 2001, the Quebec government announced the extension of its existing enhanced deduction program for FTS until the end of 2003. Finally, as part of its April 2002 budget, the Manitoba government introduced the Manitoba Mineral Exploration Tax Credit (MMETC).

4. The Investment Tax Credit for Exploration (ITCE) in Canada

How It Works and What is Expected From It

4.1 Program Design

4.1.1 Rationale for a Tax Credit Mechanism

The tax credit mechanism offers a high degree of design flexibility and can be tailored to reach any particular target. To increase the cost-efficiency of the measure and facilitate its administration, benefits can be restricted to surface exploration and to companies meeting specific criteria of size and activity. A tax credit can be capped or driven by demand, of finite or indeterminate duration, refundable or non-refundable, and/or transferable to other taxation years or to other taxpayers.

From a tax policy perspective, an attractive feature of the tax credit is that, unlike a deduction, its calculation is made separately from the derivation of a taxpayer's taxable income. For the nine provinces having a personal income tax collection agreement with the Canada Customs and Revenue Agency, the taxable income is used as the basis for the provincial/territorial income tax calculation. Thus, a federal tax credit can be applied without interfering with the calculation of the taxpayer's provincial/territorial income tax and, as such, this tax instrument protects the integrity of the provincial/territorial tax base. If they wish, provinces/territories can choose to offer a similar tax credit at a rate that suits their policy objectives.

Also, a tax credit is a more equitable tax measure than a deduction because the tax-saving value of a tax credit is the same for all taxpayers, regardless of their marginal tax rates. Finally, a tax credit is more visible and transparent, both in terms of its cost to treasury and its benefits to taxpayers.

4.1.2 Characteristics of the ITCE Mechanism

The ITCE is a temporary, non-refundable, 15% federal investment tax credit available only to individual investors in FTS issued by exploration or mining companies that agree to incur eligible exploration expenses after October 17, 2000, and before January 1, 2004.

The ITCE was introduced in response to exceptionally depressed mineral market conditions beyond the normal cyclical nature of the industry. The government and industry believe that exploring for minerals in Canada is inherently a viable commercial business for private enterprises as well as a valuable activity for society. This activity is economically sustainable in the long run without the artificial support of permanent government assistance. However, pronounced price fluctuations can make mineral exploration appear to be an uneconomic proposition for investors during downturns and thus create a financial challenge for industry that can only be addressed by scaling down exploration budgets. A temporary interruption of exploration activity can cause insufficient replenishment of mineral reserves and a disruption to the industry's input infrastructure that may hinder its long-term performance and viability. From the point of view of government, a severe exploration slowdown means job losses, hardship and social pains in remote regions throughout Canada, as well as a loss of economic growth opportunities for the country. Thus, a temporary assistance program that stimulates exploration during an economic downturn and mitigates the negative effects of an exploration stoppage can be cost-effective in social terms.

The 15% rate was selected to provide investors with a level of financial assistance approximately equivalent to the 33 1/3% additional income tax deduction that was requested by industry.

The ITCE is only available to FTS investors because the junior mining companies that issue FTS are an important player in the search for precious-stone, base- and precious-metal deposits in Canada. As these companies usually have no operating income and are involved in speculative activities, they must rely on the equity markets, and particularly on FTS, as their main source of risk capital. FTS investors can realize a significant reduction in the after-tax cost of their investment thanks to special tax rules that allow them to deduct from their personal taxable income the exploration expenses incurred by the companies in which they invest. However, from 1996 onwards, the unattractive short-term outlook for mining and the emergence of alternative opportunities for risk capital made it difficult for junior companies to keep investors interested in mining exploration FTS. As shown in Chapter 2 dealing with the industry context, the junior mining companies were the hardest hit by the current exploration downturn facing mineral exploration. The ITCE is tied to the FTS mechanism to assist junior mining companies in raising new equity through FTS.

The ITCE is only available to individual investors on a non-refundable basis. The non-refundable character of the ITCE conforms to the normal investment tax credit rules. This means that the tax credit can be applied against a taxpayer's federal income tax otherwise payable for the taxation year in which the investment is made. If the tax credit exceeds the income tax otherwise payable in the year of investment, the excess can be carried back three years and carried forward ten years. The ITCE is only available to individual investors to prevent stacked FTS arrangements involving corporate subsidiaries and corporate shells. If allowed, such arrangements could have made the program complex to administer because it would have been very difficult to trace down the ultimate beneficiaries of the tax credit.

The ITCE applies only to preliminary mineral exploration activities conducted from or above ground. Sampling size is limited. Expenses incurred to explore underground or for the purpose of bringing a mine into production are excluded. The ITCE does not apply to oil and gas, coal, bituminous sands or oil shale.

Even in good times, mineral companies find it difficult to secure affordable sources of financing for surface exploration because investors consider this activity to be more speculative than advanced underground exploration or pre-production development. A compounding difficulty is that investors' aversion to risk grows with economic uncertainty, putting pools of risk capital out of reach for most junior mining companies. The ITCE is intended to partly compensate for the additional risk of preliminary exploration investment during cyclical downturns by reducing the up-front cost of the investment. Junior companies can thus pursue their most meaningful exploration projects with the hope that a mineral discovery will put them in a better position to benefit from a rise in demand for minerals during a subsequent economic upturn.

Exploration for oil and gas generally gets easier access to equity capital and other forms of financing, and junior companies are not normally exploring for bituminous sands and coal. This is why expenses incurred in exploring for these commodities are not eligible for the ITCE.

4.1.3 Integration of the ITCE With Harmonized Provincial/Territorial Tax Credits

The ITCE is available to all individual Canadian taxpayers investing in FTS that serve to finance qualifying expenses throughout Canada. Each harmonized tax credit, however, is only available to taxpayers filing a return in the specific province/territory that provides it. The availability of each provincial/territorial tax credit is further restricted to qualifying expenses within the province/territory.

Taxpayers residing or filing an income tax return in provinces/territories that provide additional exploration incentives are allowed to claim them in combination with the ITCE, but the use of any tax credit offered by provinces/territories will reduce the amount of expenses eligible for the ITCE and generally the amount of expenses deductible for both federal and provincial/territorial income tax purposes.

4.1.4 Implications of the ITCE Mechanism for Companies

From Section 4.1.3 above, it follows that a company that wants to avail itself of a harmonized tax credit to finance its exploration within a participating province/territory has to restrict its FTS offering to the residents of that province/territory. If the pool of investors of a particular jurisdiction is too small to support the financing of the company's projects located in that jurisdiction, the company may have no choice but to forego the use of the provincial/territorial incentive. As a result, the effectiveness of harmonized provincial/territorial tax credits is severely hampered in the case of less populated jurisdictions.

Companies with exploration assets in multiple jurisdictions would have to plan separate FTS financings for each province/territory in which they operate. They would also lose full discretion on the allocation of their exploration funds if they have to match funds to projects according to their respective provincial/territorial distribution. For the sake of efficiency, companies may wish not to constrain allocation of funds according to availability of harmonized provincial/territorial tax credits.

4.1.5 Implications of the ITCE Mechanism for Investors

Application of the federal ITCE and harmonized provincial/territorial tax credits generally enhances the value of a qualifying FTS investment by reducing its after-tax cost. But the fact that the benefits from provincial/territorial tax credits are restricted to residents and expenses incurred on projects in the contributing province/territory may have negative implications for investors. An investor would have to buy FTS from an offering that specifically funds exploration projects in his/her province/territory of residence to get full access to the provincial/territorial tax credit. In order to mitigate risk, the investor may have to consider investing in FTS that serve to finance a more balanced portfolio of exploration projects. This implies significantly reduced provincial/territorial tax benefits as well as complex calculations to figure out the taxpayer's ultimate after-tax cost.

4.2 Program Expectations

The level of exploration expenditures is market driven and depends on many factors other than federal government assistance. As a result, no specific quantitative targets were set for the tax measure.

The ITCE's general objective was to stimulate investment in high-risk grass-roots mineral exploration in Canada during the difficult times that prevailed at the end of 2000. Junior mining companies were the hardest hit by the depressed precious- and base-metal prices and the increased competition for risk capital. To that end, the temporary measure was designed to raise investors' interest in the stock of junior mining companies involved in the search for deposits of certain minerals, including base and precious metals.

Thus, the program's expectations are:

- increased FTS funding;
- increased exploration expenses by junior exploration companies;

- a stabilization or an increase of the mineral exploration activity in Canada at the grass-roots level in the areas of commodities targeted by the program (including base and precious metals, diamonds, precious stones and industrial minerals); and
- a flow of benefits from exploration to mining communities.

5. Evaluation of the ITCE and Harmonized Provincial/Territorial Tax Credits – Federal Analysis

5.1 Criteria for Evaluation

The evaluation of a tax credit program is not an easy task. In the case of the ITCE and other provincial/territorial mineral exploration tax credits, the exercise is further complicated by the shortcomings of existing data, the need to factor in the effects of a number of external variables, and a number of time-related considerations. These considerations include a steep investor learning curve, a short program life, and a delay in the availability of accurate tax data, potentially only years after the measure has expired. Still, there are a number of data sources that provide useful indicators of exploration activity and investor interest in FTS and tax credits. These sources of data represent the foundation of the analysis presented in this chapter and are further described in Appendix 1.

The evaluation of the tax credits is based on five main criteria: their relevance; their effectiveness at raising exploration levels; their cost-effectiveness; their effects on the overall costs of mineral discovery; and their ease of administration and compliance.

In terms of relevance, it has to be determined whether the program meets the expectations of the various stakeholders (junior mining companies and associations, mining communities, investors and governments) and whether its current form and duration will be sufficient to achieve the desired policy results. The effectiveness, or success, of the program really depends on its ability to influence mineral exploration spending through the increased use of FTS and, by extension, tax credits. Of course, many other factors, such as metal prices, stock market conditions and new discoveries, must also be accounted for in this type of analysis. Cost-effectiveness refers to the ability of the program to increase exploration spending at an acceptable cost to government. On the industry side, it refers to the impact of the incentives on items such as the cost of equity financing, drilling and other exploration services. The effects of the program on the overall costs of discovery are more difficult to quantify but are nevertheless important. An incentive program may result in a change in the composition of exploration property portfolios and alter the discovery success rate. Finally, it is important that such a program be easy to administer by the authorities and does not entail excessive compliance costs for the corporation.

5.2 Relevance

5.2.1 Acceptability of the Program

Generally, the program was well received by all the principal stakeholders. Industry leaders, including the Prospectors and Developers Association of Canada (PDAC), provided early and continuous public support to the program with favourable comments to the press and active involvement in the promotion of the tax credit to mining companies and the investment community. For example, the PDAC, the BC and Yukon Chamber of Mines, and the Quebec Prospectors Association organized a national awareness campaign in collaboration with Natural Resources Canada to inform the investment community of the advantages of using FTS and the ITCE to raise equity financing. The awareness campaign included a series of seminars in the four major financial centres in Canada (Montréal, Toronto, Calgary and

Vancouver) and an advertising campaign. A series of presentations were also delivered in smaller towns and in the context of mining events.

Provinces and territories have also been supportive of the program and several provinces have expressed this support by announcing harmonized tax credits or extending (in the case of Quebec) complementary tax deductions.

5.2.2 Timeliness

There are two dimensions to timeliness: the timing of the introduction of the program and the timing of its effective implementation. At the time the program was introduced, the mineral exploration industry was experiencing major difficulties in raising capital for its activities due to factors explained in details in Section 2 of this report. Also, expectations were that a recovery was not imminent. Thus, the ITCE announcement was made at a time when it was most needed. It was widely held that the assistance provided by the new ITCE should help preserve jobs, protect world-class Canadian expertise in a highly specialized activity, and stimulate grass-roots exploration across Canada.

Although the program announcement created interest among potential FTS issuers and investors, it took a certain period of time before industry could actually take significant advantage of it. The ITCE used an incentive vehicle (a tax credit) and related technical rules that were foreign to many FTS investors. The announcement also came with the expectation that harmonized provincial/territorial tax credits would follow. Many companies, therefore, may have decided to wait to see how provincial/territorial governments would react to the federal initiative so that they could understand the tax implications for investors on the basis of their province or territory of residence. As a result, the 2000-2001 financing campaigns could not draw on the advantages of the new program to the extent that industry had hoped for.

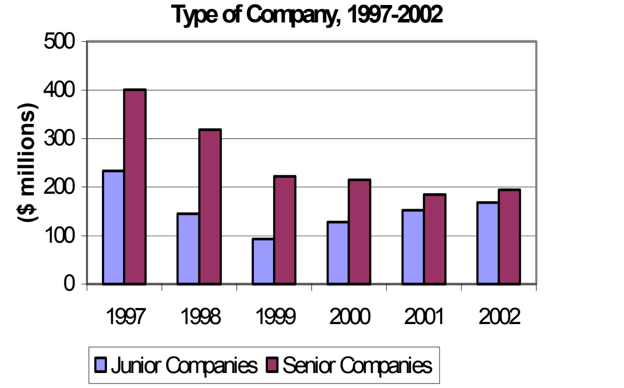
5.3 Effectiveness (or Success)

5.3.1 Changes in the Levels of Exploration, 2000-2002

5.3.1.1 Exploration Spending at the Grass-Roots Level

The data on **Figure 5.1** show that, after falling from 1997 to 1999, junior spending on the exploration work phase picked up in the last three years. Senior spending, on the other hand, appears to have reversed its negative course only in 2002. Under the survey definitions, the "Exploration Work Phase" is defined as the work carried out to search for, discover and perform the delineation of a previously unknown mineral deposit, to establish its potential economic value, and to justify further work. It is akin to what is colloquially referred to as "grass-roots exploration," the exploration phase that is the critical first step in the process that leads to replenishing mineral reserves and ensuring the sustainability of mineral production.

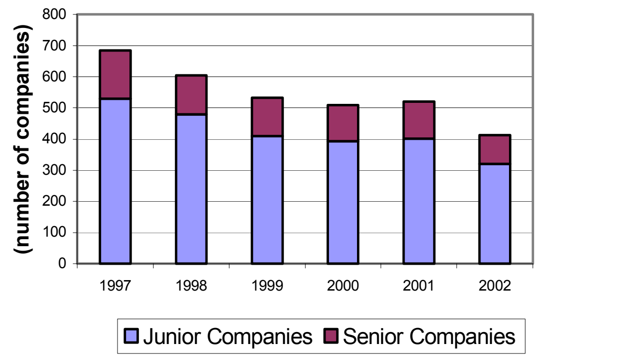
Figure 5.1
Exploration Work Phase Expenditures in Canada, by Type of Company, 1997-2002



It is important to note that the 2002 totals are based on a revised estimate of company spending intentions that was obtained from a survey conducted in the spring of 2002 to bolster the statistics collected in the aftermath of September 11, 2001. This limited-scope survey has raised the total 2002 exploration and deposit appraisal spending forecast from $428 million to $518 million and reaffirmed the positive trend in junior company spending that began in 2000.

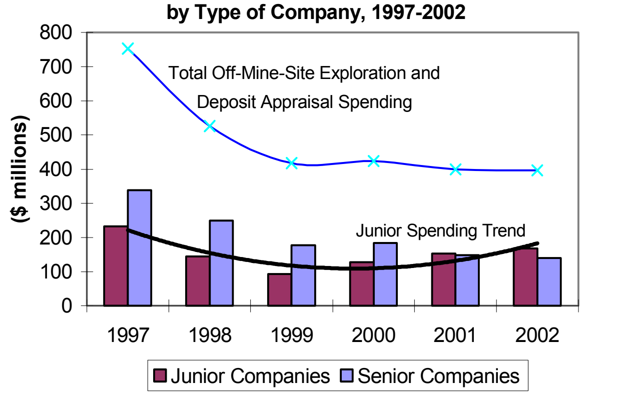
While the number of active junior companies and senior companies have both been on a downward trend since 1997, the junior sector has suffered the most. Many juniors were inactive between 1997 and 1999. The forecast reduction between 2001 and 2002 is likely the result of continuing consolidation in the junior sector and of new listing requirements in Canada's securities markets (see Section 2.3.2 on Financing Difficulties and Investor Confidence).

Figure 5.2
Project Operators Active in Exploration and Deposit Appraisal in Canada, by Type of Company, 1997-2002



The total off-mine-site exploration and deposit appraisal spending curve allows a comparison with the off-mine-site exploration for junior companies polynomial trend curve. The comparison reveals that junior off-mine-site spending was declining faster than overall off-mine-site spending in the 1997-99 period. In the period 2000-02, however, junior company spending actually grew at a faster pace. Therefore, at a time when overall off-mine-site spending was declining or stagnating, junior spending was actually growing.

Figure 5.3
Off-Mine-Site Exploration Work Phase Expenditures, by Type of Company, 1997-2002

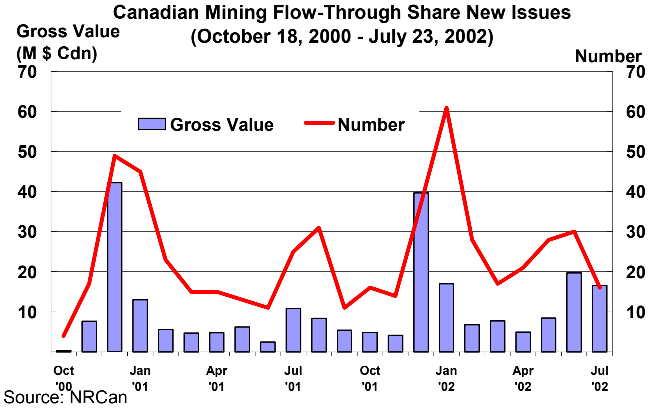


5.3.1.2 Exploration Financed by FTS Equity

Companies issuing FTS by means of a public placement normally communicate their intentions with press releases and have to file documents with securities industry regulators. NRCan has compiled a database on FTS issues that is based on such publicly available information. This database is used to calculate FTS mine financing levels and it also collects data on a variety of related topics.

The data show that, since the inception of the ITCE in October 2000 to July 23, 2002, over $240 million has been raised from 527 separate issues (**see Figure 5.4**). For 2002, preliminary half-year results indicate that the level of flow-through-share mine financing has nearly doubled from the previous year. This can be partly attributed to the recent surge in gold prices following the September 11th tragedy and the collapse of the high-tech sector as a major recipient of venture capital.

Figure 5.4
Canadian Mining Flow-Through Share New Issues
(October 18, 2000 - July 23, 2002)

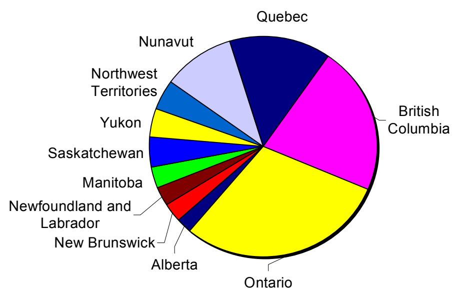


Source: NRCan

Assuming these preliminary results continue unabated, both the gross value and number of FTS new issues for 2002 will surpass the 2001 totals. This is a remarkable feat considering new equity issues across all industries have fallen over the past year.

Of the 527 issues recorded in the NRCan database, roughly 70% have yielded information regarding the location of the project and the type of commodity sought. **Figure 5.5** provides an early estimate on the distribution of the number of projects financed by new FTS issues by province and territory, with Ontario, British Columbia, Quebec and Nunavut accounting for most of the flow-through financed exploration projects.

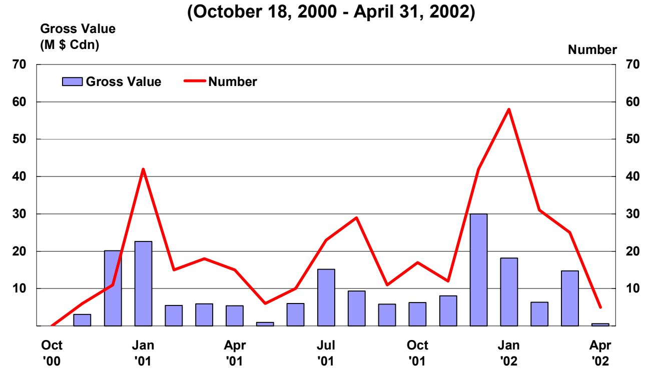
Figure 5.5
Number of Projects Financed by FTS, by Jurisdiction
(October 18, 2000 - July 23, 2002)



Source: NRCan

Gamah International Limited collects comprehensive data on junior company financing. In the case of FTS, both Gamah and NRCan have roughly similar methodologies, although Gamah provides less information for each specific issue. According to Gamah, preliminary results for the period of October 18, 2000, to April 31, 2002, indicate that over $184 million had been raised from 376 separate issues (**Figure 5.6**).

Figure 5.6
Canadian Mining Flow-Through Share New Issues
(October 18, 2000 - April 31, 2002)



Source: Gamah International Limited

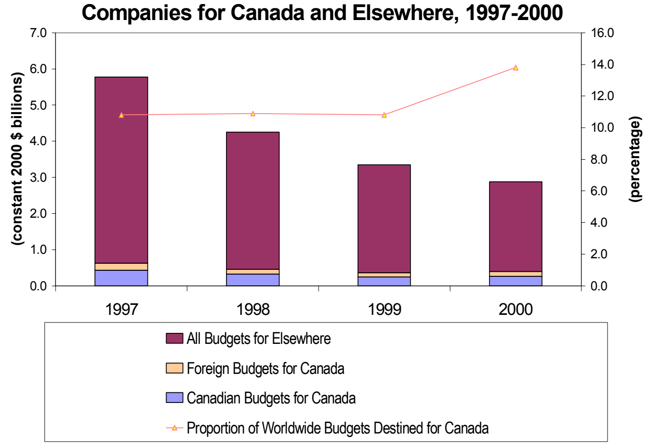
5.3.1.3 Ratio of FTS to Non-FTS Exploration Funding

Gamah International collects data on all junior financings, not only FTS issues. This type of coverage has allowed Gamah to conclude that approximately 21% of all junior financings that occurred between October 18, 2000, and April 31, 2002, were conducted by means of FTS issues.

5.3.1.4 Canada's Share of Worldwide Exploration Budgets

While Canada's share of the worldwide exploration budgets of companies spending more than US$3 million had remained unchanged during the 1997-99 period, it increased significantly in 2000 **(Figure 5.7)**. This resurgence in the interest of large mining corporations in exploring for minerals in Canada, as shown by the Metal Economics Group data, may not be directly linked to the introduction of the ITCE program since large companies do not normally finance their exploration activities via the FTS market. However, large international corporations are often involved in partnerships with Canadian junior mining companies, which increased their level of exploration activity in 2000 partly in response to the introduction of the ITCE program and its provincial/territorial counterparts.

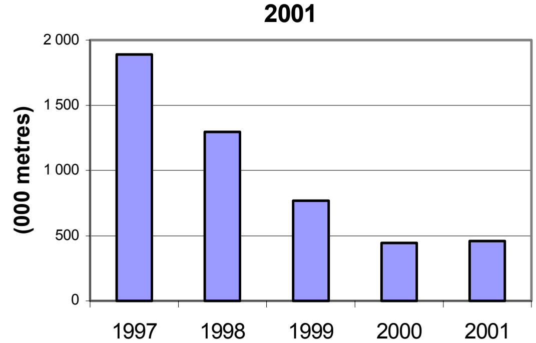
Figure 5.7
Exploration Budgets of the World's Larger Companies for Canada and Elsewhere, 1997-2000



5.3.2 Other Indicators of Exploration Activity

Figure 5.8 reveals that surface diamond drilling activity has declined dramatically since 1997. After reaching a low in 2000, surface diamond drilling started to show signs of recovery in 2001 (preliminary total). This is consistent with the fact that a large part of the drilling activity is undertaken by senior companies, which have reduced their exploration and deposit appraisal spending consistently since 1997. Early indications from the Canadian Diamond Drilling Association for 2002 are, however, that surface diamond drilling activity in Canada has picked up significantly.

Figure 5.8
Surface Diamond Drilling in Canada, 1997-2001



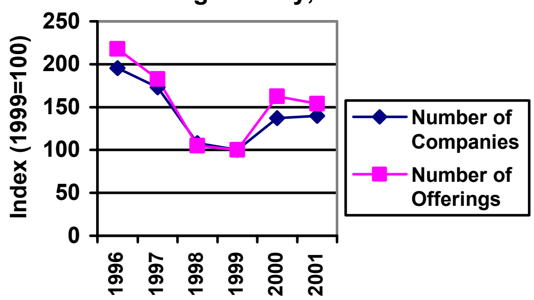
5.3.3 Exploration That is Financed by FTS and is Eligible for the ITCE

The FTS mechanism and the ITCE both fall within the purview of the *Income Tax Act*, which is administered by the Canada Customs and Revenue Agency (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 the CCRA (see

Appendix 1) 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 the 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. This agreement and the introduction of the provincial/territorial credits has prompted the CCRA to modify the tax forms used to collect information on FTS and more useful information will be available starting in 2003. Since the ITCE was only introduced in October 2000, the data available on sales, renunciations and tax credit eligible expenditures are limited, the years 2000 and 2001 being the only ones available and, as mentioned, are not as comprehensive as those that will be available starting in 2003.

Figure 5.9
Indices of Flow-Through Share Financing Activity, 1996-2001



Nevertheless, some preliminary conclusions can be drawn from the existing data. For instance, indices based on the number of companies planning FTS offerings and on the number of planned offerings both show a reversal in 2000 of the negative trend that had existed from 1997 to 1999 (**Figure 5.9**). Although not returning to the level of 1996, when, incidentally, exploration and deposit appraisal spending last peaked, the reversal recorded in 2000 coincides nicely with the introduction of the ITCE and would seem to indicate a renewal of interest in FTS. For 2001, both indices remained fairly stable but it has to be remembered that the data for that year are difficult to interpret as the economic outlook was very uncertain during the last quarter of that year when most financings in a given year are usually announced. It will be interesting to look at similar data for 2002 when it becomes available.

An important statistic in terms of evaluating the effectiveness of the ITCE is the total amount of expenses that are planned to be renounced to investors under that program per year. The CCRA estimates that ITCE eligible expenditures totalled $61 million in both 2000 and 2001. While the 2001 total is below the program's initial expectations, the 2000 total is impressive given the fact that companies had only about two months in which to plan their exploration and proceed with their flow-through issues due to the introduction of the ITCE late in the year (October 18). Overall, the $123 million that was recorded by the CCRA in 2000 and 2001 as ITCE eligible expenditures would seem to indicate that the program had some success in channelling resources into the grass-roots exploration sector. The steep learning curve, for both companies and investors, the struggling stock markets and the uncertain economic outlook following the September 11, 2001, terrorist attack are all factors that could have prevented the ITCE from fully achieving its objectives. It remains to be seen what the CCRA data will reveal for 2002 when it is released to NRCan in mid-2003.

5.3.4 Mix of Exploration Activities

An analysis of exploration and deposit appraisal spending over the period 1997-2002 reveals that the exploration phase typically represents about 70% of total spending for these two phases. The only exception was in 1999 when only 62% of all spending was dedicated to exploration rather than to deposit appraisal work. This lower percentage can probably be explained by continuing weak metal prices, mineral producers focussing their resources on proving reserves rather than discovering new orebodies, and diamond properties moving into more advanced stages.

Hence, there is no observable difference in the mix of exploration and deposit appraisal activities resulting from the introduction of the ITCE. However, as mentioned previously, there are differences in the distribution of junior/senior company spending where, since 2000, off-mine-site spending by junior companies has increased by 80% to account for 55% of all off-mine-site exploration spending. Over the same period, senior off-mine-site spending was decreasing both in absolute and percentage terms. The situation, since the introduction of the ITCE, can thus be described as one where junior company spending and off-mine-site spending by senior companies have both gained in importance after reaching a low in 1999.

5.3.5 Regional Distribution of Exploration Spending

As a general statement (based on the federal-provincial/territorial survey), it can be said that those provinces/territories that have introduced a tax credit (harmonized or not) to increase the level of incentive provided by the federal government have experienced improved levels of exploration work phase spending during the 2000-02 period. While it can show tremendous progress in terms of mineral development and mine production, the Northwest Territories suffered the largest decline in dollar terms among those jurisdictions that did not introduce new incentives. On the other hand, Nunavut is showing steadily increasing exploration expenditures while relying only on the incentives provided by FTS and the federal ITCE to encourage investment in that sector. These observations point to the conclusion that exploration is facilitated by the existence of tax credits and other incentives, but interesting discoveries remain the principal driver of exploration activity.

5.3.6 Distribution of Exploration Spending by Commodity

The distribution of exploration spending per commodity sought has not changed over the 1997-2002 period. Precious metals remain the most sought-after, followed by base metals and diamonds.

5.4 Cost-Effectiveness

The ITCE program is cost-effective to the extent that it causes exploration expenditures to increase by a multiplier that is significantly higher than one. That is, one dollar of tax expenditure must result in more than one dollar of new exploration spending. Also, this increase in expenditures should translate into a corresponding increase in exploration activity without any significant dissipation of value in terms of inflationary pressures on unit costs.

5.4.1 Incremental Exploration Activity Per Dollar of Tax Expenditure

Available data do not allow a quantitative evaluation of this criterion. There is no evidence of an overall increase in primary exploration spending in Canada. Nevertheless, it may be reasonable to assume that at the time of its introduction, the ITCE was a positive factor in the decision by mining companies to keep investing in primary exploration in Canada. This inference is supported by the indications that the proportion of expenditures engaged in mineral exploration in Canada relative to mineral exploration investment elsewhere in the world has increased significantly in 2000 and 2001.

In the absence of other identifiable contributing factors, the ITCE should be considered to be a significant factor in explaining the substantial increase in exploration spending by junior mining companies that took place in 2000 and 2001. However, there are indications that this increased spending by junior companies might have occurred at the expense of lower spending by senior companies with production income. A possible explanation is that senior companies might have relied to a greater extent on junior company spending to acquire new exploration data so as to take advantage indirectly of the ITCE.

5.4.2 Effects on Cost of Equity Financing

To ensure that the exploration expenses covered in a FTS agreement qualify for the ITCE and to derive the expected investors' tax benefits from the ITCE may require additional research and other administrative steps for the issuing company. To tailor FTS to specific tax credit target groups may require more offerings than would otherwise be the case. The extra costs entailed by these additional steps could not be evaluated in the context of this study.

5.4.3 Effects on Drilling Costs and Other Costs of Exploration Services

Providing investment assistance to investors is expected to create a greater availability of financing leading to increased exploration activity and increased demand for supplies and services to this industry. An undesired side effect of this increased demand could be an increase in the costs of exploration services, of which diamond drilling is the most important component. To date, capacity utilization rates do not appear to have reached critical levels and there has been no evidence of any unusual increase in diamond drilling and other costs.

5.4.4 Effects on Cost of Discovery

The costs of mineral discovery in Canada have been increasing over time and there are many reasons for this phenomenon. It would be difficult to argue that the introduction of an incentive that requires time and resources to understand, apply for and administer does not increase the cost of discovery, but this potential source of cost inflation is considered to be marginal. In any case, it is too early to quantify this potential effect because it will take years to track down the discoveries related to the ITCE program.

5.5 Ease of Administration/Compliance

Tax-based programs such as the ITCE are administered through existing government structures and, as such, they do not require the creation of a new bureaucratic apparatus. However, the ITCE program required the modification of tax legislation and the design, filing, compilation and analysis of numerous forms to verify that taxpayers claim only eligible expenses.

Renunciation rules and other rules applying to FTS are complex. Qualified professional advice is a prerequisite to help structure FTS agreements and apply compliance rules. But the introduction of the ITCE program created another level of complexity. This added complexity arose from the carving of a new restricted category of expenses eligible for ITCE out of the expenses eligible for the general FTS treatment. This resulted in delays for investors to pick up on the new program as they and their financial/accounting advisors had to spent time to familiarize themselves with the application rules of the program and learn how to fill out the prescribed forms properly. A side effect of this problem is that the CCRA is still in the process of sorting out the misallocation of expenses that occurred at the beginning of 2001.

Another source of complexity is that the expenses eligible for the ITCE receive different treatment depending on where the expenses are made and where the investor resides. Thus, companies and investors have to keep precise records of not only how the money invested is spent, but also where and when the expenses occurred to ensure that the expected tax relief is correctly applied. This requirement may be particularly burdensome in the case of investors in mutual funds, which typically invest in several mineral projects located in several jurisdictions.

6. Evaluation of the ITCE and Related Provincial/Territorial Tax Incentives – Provincial/Territorial Analysis

6.1 General Approach

For this section of the report, members of the working group agreed that participating provinces/territories would present an evaluation of their respective mineral exploration incentives and would provide their views on the effects of the ITCE on exploration activity within their jurisdictions.

6.2 Yukon

6.2.1 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 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, 2003. 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 1999 and 2000 taxation years: $3 218 344

The total dollar amount of claims for the 2001 taxation year is not yet available.

For reference, exploration expenditures for the Yukon are listed as:[1]

1999	$12.7 million
2000	$11.2 million
2001	$7.2 million (preliminary)
2002	$7.3 million (estimate)

6.2.2 Effect of YMETC on Yukon Exploration

The Yukon government has offered the YMETC for four years, despite a continued decline in 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.

[1] Source: Natural Resources Canada, Exploration and Deposit Appraisal Expenditures 1999-2002.

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.

6.2.3 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 of mining taxation in the territory.

6.3 Northwest Territories

6.3.1 Introduction

When the federal Minister of Finance announced the ITCE in October 2000, he also invited provincial governments to complement the federal tax credit with their own similar tax incentives. Currently, British Columbia, Ontario, Saskatchewan and Manitoba offer their own FTS tax credits to supplement the ITCE.

The Northwest Territories (NWT), on the other hand, does not currently have the financial resources to offer significant 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.

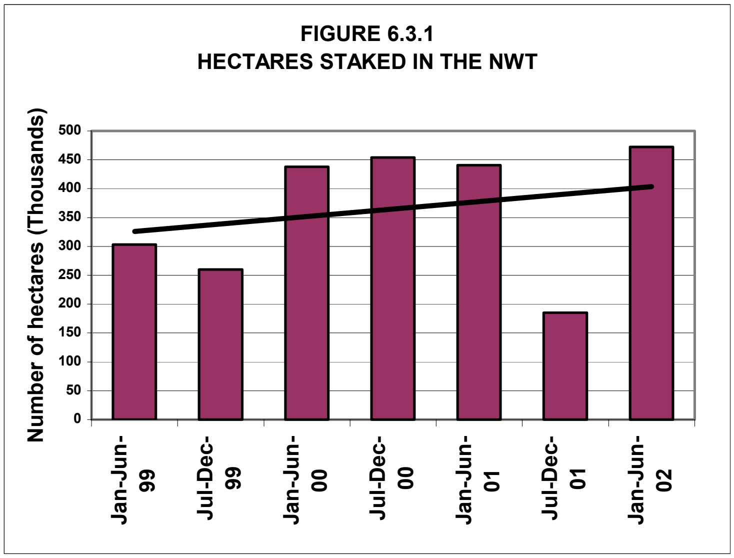
The impact of the ITCE on exploration activity in the NWT is examined in subsection 6.3.4.

6.3.2 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 recent discoveries in the Coronation Gulf area of Nunavut; and
- the improved gold price.

Figure 6.3.1 shows the increase in exploration activity in the NWT since 1999. The increase in hectares staked is also a positive indicator with respect to potential future grass-roots exploration spending. The dip in the graph 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.

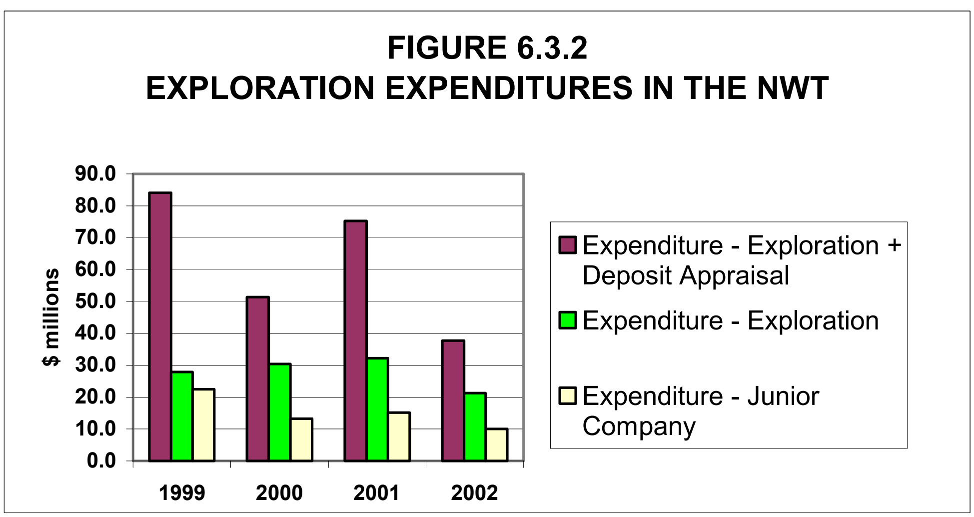


6.3.3 Exploration Expenditures

Exploration expenditures in the NWT from 1999 to 2002 (the latter being company spending intentions) are depicted in **Figure 6.3.2**. The increase in 2001 expenditures can be ascribed, again in part, to the introduction of the ITCE. The decline in expenditures in 2002 is due to a number of factors including:

- a marked reduction in deposit appraisal expenditures owing to the near-completion of the Diavik diamond mine, along with the temporary cessation of activities at the Snap Lake diamond project during final permitting; and
- negative sentiment in the diamond market in the period following the September 11 terrorist attacks.

However, diamond prices, in tandem with demand, are on the increase. Exploration expenditures are therefore expected to increase in 2003.



6.3.4 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 suggest that the ITCE had a positive impact 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, and given the limited scope available for the introduction of an NWT add-on incentive, the GNWT strongly supported the introduction of the ITCE.

6.4 British Columbia

6.4.1 British Columbia (BC) Mining FTS Tax Credit and Mining Exploration Tax Credit Programs

The BC Mining FTS Tax Credit (BC MFTS) and the BC Mining Exploration Tax Credit (METC) provide significant direct financial support for a wide range of grass-roots BC mineral exploration.

The BC MFTS was introduced in the July 30, 2001, Economic and Fiscal Update and is harmonized with the federal ITCE. The BC MFTS provides a 20% non-refundable tax credit on qualifying British Columbia flow-through mining expenditures incurred after July 30, 2001, and before January 1, 2004. The tax credit can be applied against BC income tax payable with any unused credit carried back three years or forward ten years. The combined impact of the federal and BC tax credit may reduce the after-tax cost of $1000 in eligible grass-roots exploration to $382.84.

The METC provides a 20% refundable tax credit for qualifying exploration expenditures incurred by companies or individuals after July 31, 1998, and before August 1, 2003. Amounts that are claimed under ITCE or BC MFTS cannot be claimed as qualifying exploration expenditures for METC.

FTS-financed exploration is not eligible for the METC, but underground programs and coal exploration can qualify.

Those programs are complemented by fiscal and policy measures designed to drastically improve the province's investment climate and revitalize its mining industry. Fiscal measures include significant reductions in BC personal and corporate income tax rates, the elimination of sales tax on machinery and equipment, and the elimination of the Corporation Capital Tax for taxation years commencing on or after September 1, 2002. Policy measures include legislation to streamline processes and encourage mineral exploration by clarifying rights and cutting red tape.

6.4.2 British Columbia's Evaluation of the ITCE and Harmonized Provincial Tax Credit

An analysis of recent actual and intended exploration expenditures, their trends and composition indicates that a significant rebound is occurring in BC exploration expenditure levels. Current estimates of the percentage increase in BC mineral exploration expenditures (which range from 50% to 100% higher than in 2001) are much larger than the percentage increases estimated for Canada's other major mining jurisdictions. This rebound is largely due to four complementary factors:

- the federal ITCE program;
- the province's harmonized BC Mining Flow-through Share Tax Credit program (BC MFTS);
- perceived changes in the province's investment climate; and
- stronger prices and/or markets for most metals and minerals and improved capital market conditions.

The nature of the factors and the absence of current data limit our ability to accurately weight the relative importance of the factors in the following brief discussion.

Preliminary exploration expenditure estimates indicate that junior companies' 2002 expenditures will be more than double the levels of 2001 (and possibly much higher than that), while that by seniors will decline. Informal reports indicate that, in anticipation of favourable provincial policy developments, exploration companies have been "taking positions" for over a year. Those companies and others are now exploring for a wide range of minerals and deposits types in all parts of the province. However, reports also indicate that future exploration programs will continue to be very sensitive to provincial government policy decisions.

Actual or expected commodity price improvements and favourable changes in capital markets have generally increased the supply of capital available for risky investments in mineral exploration. In the case of Canadian mineral exploration, enhanced FTS incentive programs have complemented those factors. In BC, this is particularly true for gold and, to a lesser extent, copper exploration. The province currently has several significant exploration programs under way that are targeting gold or copper-gold deposits. While flow-through funding is being used, the enhanced federal program is over a year old and US and offshore funding is also significant in several BC exploration programs. Thermal coal exploration (which can be eligible for the BC METC but is not eligible for the federal ITCE or BC MFTS) and development has benefited from North American energy opportunities and the expectation of supportive government policy developments.

The federal ITCE contributes to investor and industry confidence and can reduce the risk of Canadian exploration investments. BC exploration programs have benefited from this. The BC MFTS is completely harmonized with the federal ITCE and, as home to a large portion of Canada's affluent and sophisticated investors, it is likely that a significant portion of FTS-financed BC exploration qualifies for both programs. However, BC investors finance exploration in other provinces, including those with incentive programs, and it is probable that a large portion of BC exploration is financed by other provinces' residents (particularly those, such as in Alberta, that have a limited mining industry and lack incentive programs). There are no data with which to estimate the amount of BC exploration that has been financed by the ITCE and the province's MFTS program.

It will probably be more than a year before it is known how many BC mines were discovered as a result of the various BC exploration expenditures incurred since October 17, 2000 - regardless of how that exploration was financed. However, since current economic and market conditions remain very unsettled, sustained exploration effort is critical to the long-term health of the mining industry.

6.5 Saskatchewan

6.5.1 The Saskatchewan Mineral Exploration Tax Credit (SMETC) - Stimulating Grass-Roots Exploration

The mineral resource sector is a foundation of the Saskatchewan economy with minerals being the third leading value of GDP by industry behind the energy and agriculture sectors. Saskatchewan is the world's largest miner of both uranium and potash, providing about a third of world production for each of these commodities and is the third largest non-fuel mineral producer in Canada in terms of the value of mineral sales with 2001 sales reaching almost $2.4 billion. However, as in other parts of Canada, mineral exploration activity in Saskatchewan has declined significantly over the last three years. The Government of Saskatchewan recognizes that to maintain and cultivate this important sector of the Saskatchewan economy, mineral exploration is required to replace depleting reserves. To stimulate grass-roots mineral exploration, in March 2001, the Saskatchewan government introduced a new temporary, non-refundable 10% tax credit on the purchase by Saskatchewan taxpayers of FTS of eligible mineral exploration companies as one component of a multi-faceted strategy to increase investment in the mineral sector.

There is no cap on the maximum amount of tax credits issued to an individual investor and no limit on the maximum amount of the SMETC that can be issued as long as eligibility requirements are satisfied. For clarity and ease of industry and government administration, the Saskatchewan program adopted the eligibility requirements and definitions of the federal ITCE program, with the exception that the mineral exploration program must be carried out within Saskatchewan to qualify for the SMTEC. THE SMETC applies to eligible exploration expenses incurred on or after October 18, 2000, and before January 1, 2004.

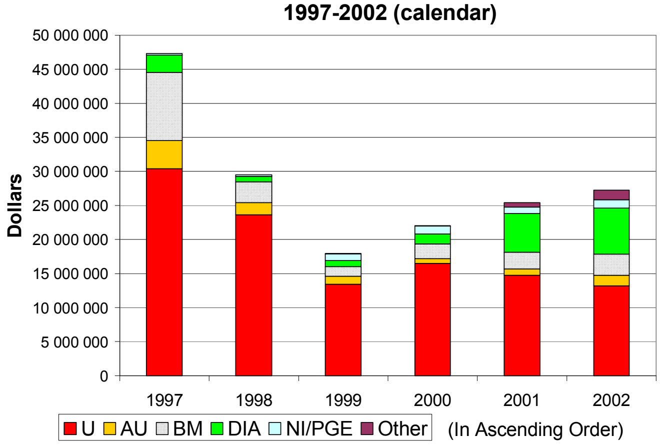
Applications for permission to issue SMETC are made to Saskatchewan Industry and Resources by the company issuing the FTS. The process again parallels the information requirements of the federal ITCE program and involves the company supplying Saskatchewan Industry and Resources with information that it has already supplied to the CCRA (T100 and T101 forms and related information) as well as certificates of planned and actual mineral exploration activity that outline the type of exploration work planned and/or carried out. Saskatchewan Industry and Resources then grants permission to the respective company to issue the tax credits to the individual investor (or partnership) on a supplied form.

Additional information is available at www.gov.sk.ca/enermine/about/semnew.htm. Copies of *The Mineral Exploration Tax Credit Regulations* are available free of charge at www.qp.gov.sk.ca.

6.5.2 Exploration Expenditures,[2] 1997-2002

Saskatchewan exploration expenditures have decreased from just over $47 million in 1997 to a projected $27 million in 2002, with a low of just $18 million in 1999. This trend is similar to the national trend of decreasing grass-roots exploration expenditures across Canada. Saskatchewan is capturing between 6 and 8% of annual Canadian exploration expenditures. Non-uranium exploration expenditures account for a significantly lower percentage of Saskatchewan expenditures as uranium continues to be the primary exploration target. However, diamonds have increasingly become an important target of exploration investment. Exploration expenditures by commodity from 1997 to 2002 are illustrated in **Figure 6.5.1**.

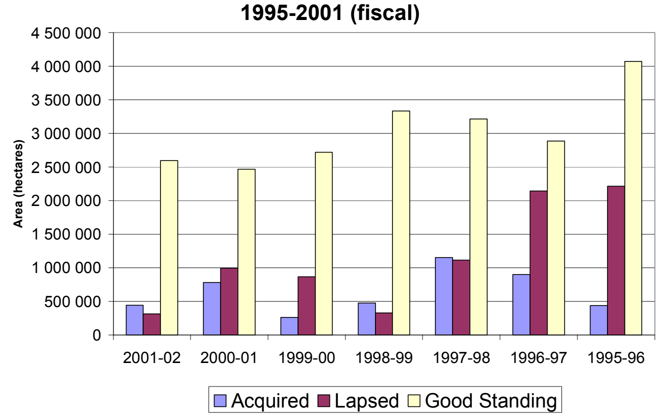
FIGURE 6.5.1
Saskatchewan Exploration Expenditures, 1997-2002 (calendar)



6.5.3 Mineral Tenure

Changes in mineral tenure activity are a reflection of the interest in mineral exploration of an area. **Figure 6.5.2** illustrates the mineral tenure activity in Saskatchewan over the past seven fiscal years. The decrease in the amount of Crown mineral lands under disposition from 1995 through 2001 confirms the general lower mineral exploration activity that is reflected in the federal-provincial/territorial survey of exploration expenditures. Of particular concern is the net loss of area of Crown mineral lands under disposition from 1994 through 2000. This trend appears to have bottomed out as in 2001 there was a minor net gain of Crown mineral lands acquired, a trend that has continued into 2002.

FIGURE 6.5.2
Saskatchewan Mineral Tenure Activity 1995-2001 (fiscal)



The overall decrease of Crown mineral lands under disposition underscored the need for a strategy to stimulate grass-roots mineral exploration activity.

6.5.4 Program Uptake

As the SMETC program is still in its infancy, results are very preliminary. Data are limited and it is difficult to complete a comprehensive analysis or to determine trends. The following observations, as summarized in **Table 6.5.1**, can be made:

[2] Exploration expenditure data are from the federal-provincial/territorial Annual Survey of Mineral Exploration, Deposit Appraisal and Mine Complex Development Expenditures.

Table 6.5.1: Saskatchewan Mineral Exploration Tax Credit Summary

Year	**2000**	**2001**
# of Placements*	n/a	n/a
Amount Raised	$1 050 249	1 599 388
Amount Renounced	$1 050 249	1 599 388
# Of Eligible SK Taxpayers Subscribing	7	74
% of FTS Subscription For Uranium	76.2	11.5
% of FTS Subscription For Diamonds	23.8	88.5
% of FTS Subscription For Other Mineral Commodities	0	0
SMETC Eligible To Be Claimed	$83 525	$71 128

**The number of individual placements is not indicated as it may allow information for individual companies to be determined.*

- The number of applications for the SMETC doubled from 2000 to 2001. The increase in program uptake may be a reflection of the increased awareness by the eligible companies of the program. It may also be a reflection that the program was only in effect for the last two months of 2000 compared to the full 2001 calendar year.
- While the amount raised in eligible FTS offerings increased, it did not increase by the same factor as the number of placements. This may reflect the difficult environment junior companies face in raising capital.
- The amount renounced in both 2000 and 2001 is 100% of the amount raised by the FTS offerings. This suggests that the juniors are passing along 100% of the tax credit to their investors and that the companies are absorbing operating costs not eligible under the ITCE or corresponding SMETC, including security-related fees involved in FTS offerings.
- The number of Saskatchewan taxpayers investing in FTS and eligible for the SMETC has increased tenfold from 2000 to 2001, indicating that there may be an increased awareness among Saskatchewan investors of the tax credit.
- While the commodity of interest for FTS offerings that have made application for the SMETC has shifted from uranium to diamonds from 2000 to 2001, there has been a notable void in any FTS offerings for other commodities such as gold, base metals or platinum group metals.

6.5.5 Analysis

The actual cost of the SMETC program to the Saskatchewan government treasury has been under $90 000 per year over the two-year period it has been available, which is less than what was originally forecast. With improved commodity prices and other favourable economic factors, it is anticipated that the uptake of the SMETC program over its final two-year period will increase modestly. Wider awareness of the program may also contribute to greater utilization.

Over the two-year period of the program's existence, in excess of $2.6 million in FTS have been raised by offerings that have applied for the benefit of the SMETC. The corresponding decrease in the provincial tax revenue was less than $155 000. Based on these figures, the return on investment is an impressive 1:17.

The true effectiveness of the program is difficult to determine as there is no way to measure how much would have been raised in the absence of the program. CCRA data indicate that there has been an overall increase in the amount of FTS offerings in Saskatchewan that corresponds with the introduction of the ITCE and SMETC.

The small investor base in Saskatchewan limits the ability of companies to raise substantial additional capital from within the province, and also limits the number of investors eligible to take advantage of the SMETC.

The administration of the program was absorbed by current government staff, resulting in no direct increased administrative costs to government.

Anecdotal evidence from companies who applied for the SMETC indicates that the availability of the tax credit made raising exploration capital through FTS offerings more attractive and increased the total investment made. The relatively higher proportion of Saskatchewan investors in the second year of the program would support this evidence.

As world commodity prices improve, FTS offerings and applications for SMETC related to exploration for these commodities are also expected to increase. Increased interest in exploration for these commodities has already been recorded by an increase in acquisition of Saskatchewan gold properties by junior companies in the same period.

Most FTS offerings are completed in the fourth quarter of the year. This will mean that not all funds raised by December 31, 2003, would realistically be spent by the end of the ITCE and SMETC program date of January 1, 2004.

6.6 Manitoba

On April 22, 2002, the Manitoba government introduced the Manitoba Mineral Exploration Tax Credit (MMETC) in order to encourage and promote exploration and development of mineral deposits in the province. The MMETC parallels and tops up the federal ITCE and builds upon existing provincial exploration incentives under the Mineral Exploration Assistance Program and The Manitoba Prospector's Assistance Program. However, the MMETC will more effectively target provincial incentives toward investment in the junior mineral exploration sector in Manitoba.

The MMETC is a non-refundable 10% personal income tax credit for resident investors in eligible FTS of qualifying mineral exploration companies. Earned credits will be applied against Manitoba income tax payable. There is no cap on the maximum eligible investment by an individual investor and no limit on the maximum amount of the tax credit. Eligible investments and qualifying exploration activity will be tied to federal eligibility, except that substantially all of the exploration activity must be undertaken in Manitoba and an eligible investor must file a tax return in Manitoba. Regulations are presently being drafted.

Since the Manitoba Mineral Exploration Tax Credit was introduced in 2002, it is too early to gauge its effectiveness in assisting junior exploration companies that are active in Manitoba. The Manitoba government continues to demonstrate its support of the minerals exploration sector through direct incentives like the Mineral Exploration Assistance Program and the Manitoba Prospector's Assistance Program.

6.7 Ontario

6.7.1 Ontario Focused FTS Tax Credit Program

In recent years, grass-roots exploration financing has dropped to very low levels and industry and government in Ontario have studied how to enhance the flow-through investment tool. As a result, Ontario included a flow-through tax enhancement in the spring 2000 provincial budget. The budget announced a 30% tax deduction for Ontario investors investing in companies carrying out Ontario exploration projects. With the announcement of the federal ITCE in October 2000, Ontario converted its deduction plan to a 5% refundable Ontario Focused Flow-Through Share Tax Credit (OFFTS) in an effort to harmonize tax provisions and simplify the tax process for the mineral exploration company investor. These and other provincial tax credit-enhanced FTS have been dubbed "Super Flow-Through" by the Prospectors and Developers Association of Canada.

6.7.2 Evaluation of the Ontario Focused Flow-through Share Tax Credit

6.7.2.1 Introduction

A provincial tax credit such as the OFFTS for investors was a new direction for Ontario in terms of tax stimulus for Ontario mineral development and exploration. The Ontario Ministry of Northern Development and Mines decided to study the effects of the new federal and provincial credits to ascertain their effects on investment patterns in the province. The study was also to provide some information to the Province that could be used to understand why the provincial credit was or was not used and to provide a basis for a decision on its continuation into the future. The following text summarizes the methodology and preliminary findings of this ongoing evaluation.

6.7.2.2 Study Parameters

An initial review of published exploration and financing information concluded that the Internet-based System for Electronic Document Analysis and Retrieval (SEDAR) would provide the most consistent information source for data collection about flow-through financing and exploration activity. SEDAR is a public information web site (www.sedar.com) that allows users to gain access to most Canadian public company and mutual fund information placed in the public domain.

The study has been divided into two phases as dictated by the flow of information and the use of the resulting data. The Data Acquisition Phase has reached its first milestone at the end of the first full calendar year of exploration and financing activity since the announcement of the harmonized federal and provincial tax credit programs in late 2000. Data have been compiled from SEDAR press releases for the period starting October 18, 2000, and ending December 31, 2001. The data acquired will form the basis of financial observations for that period. Data acquisition is ongoing and this report also includes information and observations for the period from January 1 to May 31, 2002.

A Mapping Phase will begin in 2002, once financial information has been consolidated for the October 2000 to December 2001 period. The generated map will locate mineral properties within Ontario that are being explored by companies who have raised flow-through capital during the period. No map has been prepared for this report.

6.7.2.3 Summary of Information Acquired

For the period ending January 15, 2002, the working table of companies for the data acquisition contains the following summary information:

- **1293** companies listed on SEDAR mining subdivisions have reported corporate activities through a press release;
- **828** companies (64%) state they continue to be involved in exploration as junior exploration companies;
- **500** junior exploration companies state that they are working in Canada (60% of exploration companies); and
- **202** companies have stated they have exploration assets in Ontario (40% of Canada). These companies have reported exploration, or acquisition, of over **500 Ontario mineral properties** as a principal or joint-venture owner during the period.

Table 6.7.1 summarizes the financing data recovered from the SEDAR review for the period from October 18, 2000, to December 31, 2001. Table 6.7.2 summarizes the financing data recovered for the period from January 1, 2002, to May 31, 2002.

Table 6.7.1 Ontario Flow-Through and Equity Financing - October 2001 to December 2001 Summary of Observations

Approximate number of companies describing exploration projects in Ontario through press	205		
Number of identified companies with announced financings	108		
Total number of financings identified	269		
Number of financings completed by date of review	208		
Number of financings not completed by date of review	48		
Number of financings cancelled by date of review*	13		
Total flow-through share financing amount			$ 73 525 319
Total common share financing amount			$ 41 190 050
Total financing by identified companies in review period**			$114 715 369
Number of identified company financings with FTS only	118		$ 23 229 509
Number of identified company financings with common shares only	91		$ 5 147 781
Number of identified company financings with a combination of	45	{FT	$ 50 295 810
flow-through and common shares		{Com	$ 36 042 269

* Only 2 of the identified companies (three cancelled financings) did not succeed during the period.

** Data acquisition period = October 18, 2000, to January 15, 2002.

Table 6.7.2 Ontario Flow-Through and Equity Financing - January 2002 to May 2002 Summary of Observations

Approximate number of companies describing exploration projects in Ontario through press releases (including previous period)	247		
Number of identified companies with announced financings	98		
Total number of financings identified	147		
Number of financings completed by date of review	56		
Number of financings not completed by date of review	89		
Number of financings cancelled by date of review*	2		
Total flow-through share financing amount			$ 16 739 610
Total common share financing amount			$ 53 121 594
Total financing by identified companies in review period**			$ 69 861 204
Number of identified company financings with FTS only	13		$ 4 796 200
Number of identified company financings with common shares only	77		$ 36 213 587
Number of identified company financings with a combination of	57	{FT	$ 11 943 410
flow-through and common shares		{Com	$ 16 908 007

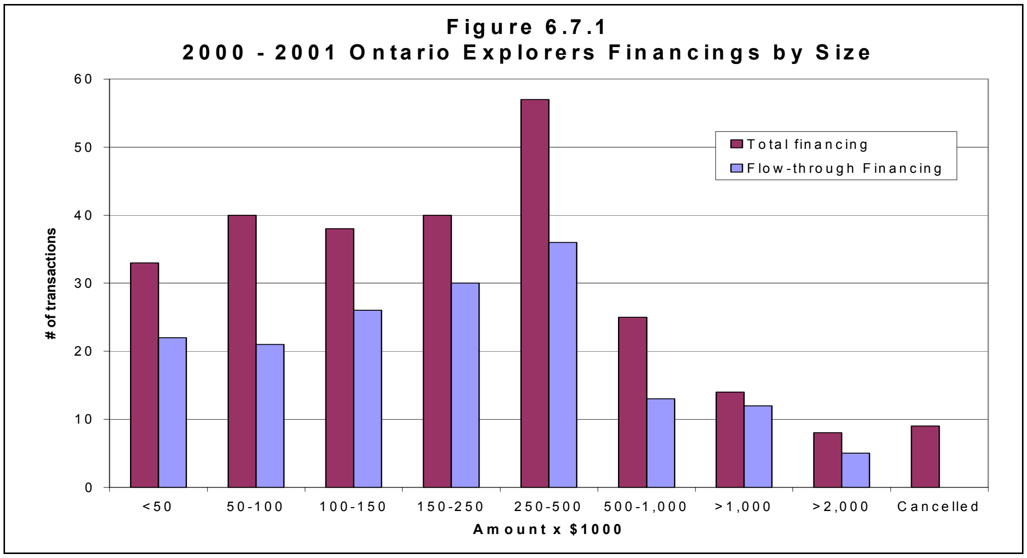
* Only 12 of the identified companies (two cancelled financings) did not succeed during the period.

** Data acquisition period = January 1, 2002, to May 31, 2002.

6.7.2.4 Amounts Obtained by Junior Exploration Companies Financing for Ontario Exploration

Of the 205 companies identifying mineral assets in the province of Ontario in the 2000-01 period, the only period of study to date that includes a 4th quarter "tax buying" season, only 108 (53%) were found to have announced a financing through SEDAR. This would indicate about half of the companies that could be exploring in Ontario are without funds or spending cash reserves. Eighty-three of these companies raised $74 million in flow-through capital. Five companies, two of which are producers, account for $26.9 million, or almost 37%, of total flow-through funds raised. Amounts raised by the other 78 companies are quite variable, ranging from $15 000 to $2 000 000.

Figure 6.7.1 compares total equity financings and flow-through financings over a range of financing sizes for the 2000-01 period. FTS represent a significant proportion of total financings within each selected size within the range (50-80%). Because FTS are not the instrument of choice for the seller (because of restrictive spending rules), it can be concluded that it is the investors' demand for FTS and attached ITCE and OFFTS benefits that are driving companies to select FTS offerings as a vehicle.



The most frequently secured amounts have a median value of approximately $200 000 and a statistical-mode value of $160 000 indicating that resulting exploration projects would be quite small **(see Table 6.7.3)**. The median and mode values for the financings recorded are more representative of the amounts obtained than the average of $450 000, which is strongly affected by several large amounts raised by a small group of companies. To provide a measure of comparison as to the value of a median-sized financing to an exploration company, $160 000 is approximately equal to expenditures incurred during a modest exploration program in an accessible area of the province. Such a program might consist of approximately 1500-2000 metres of core drilling, sampling and supervision lasting 30 to 45 project days.

Table 6.7.3 - Summary of Distribution of Financing Amounts

		Average	Median	Mode
2000-01	Flow-though	$443 500	$205 000	$155 000
	Total	$456 200	$207 700	$157 500
2002	Flow-though	$328 000	$160 000	$100 000
	Total	$481 800	$252 000	$100 000

Eighteen of 79 flow-through issuers attached flow-through warrants to their share offerings. If exercised, these shares will generate an additional $13.7 million, or 12% of the value of the announced financings during the period. Exercising these warrants may not be reported in a press release because of the small amounts exercised at any given time. The flow-through warrant may be a very useful tool to an investor purchasing shares for tax credit purposes as they can be exercised at a future time convenient to the purchaser and to the specific amount required for tax purposes. Warrants exercised during the effective ITCE period would receive the ITCE and the OFFTS as did their original purchase. For the issuer, the added tax appeal of the flow-through warrant may improve the odds of the warrants being exercised, particularly in the case where a significant share price increase, which would normally trigger this exercise, has not occurred during the warrant period. The exercise of warrants could reduce future financing costs.

6.7.2.5 Delivery of ITCE and OFFTS Credits to Investors Through the Securities Market in 2000-2001

The majority (90%) of FTS and other equity financings by Ontario explorers identified in the Ontario flow-through study state that they have been undertaken via private placement between individual purchasers and the issuing company. Few of the press releases recognize financings as being completed through mutual funds or other investment agencies, or by share offerings that allow investment to be managed or distributed to the general public such as a prospectus. Almost all private placement investments, including those for FTS have occurred in what securities regulators define as the “exempt market”. In this segment of the securities markets, regulatory exemptions allow companies to avoid full technical and financial reporting required when financings are done by prospectus (and the cost burdens associated with these). Exempt offerings permit sales of shares directly to sophisticated, knowledgeable or other specifically defined investors. The numbers of investors eligible under certain exemptions can be limited by regulation and the amounts of funds that can be raised may have lifetime caps. In addition, some eligible investors have minimum investment limits or must meet financial suitability tests.

Comments from Ontario explorers who have raised capital in the exempt markets since the inception of the ITCE and OFFTS identify opportunity, most particularly in the case of FTS, as a key element in accessing investors' money. This opportunity is generally framed by the investor's coming into the knowledge of his/her tax situation and the maximum deadline for seeking relief from it. An exploration company's time to find the investor and generate an approved agreement may range from several weeks to two or three months. The preparation time for a prospectus and the time required for due diligence and possible resubmission of information may be too long or be unpredictable with respect to a December 31 deadline and pose a risk for the company. A delay outside of the tax avoidance window for investors may send them elsewhere and provide no reward to the company for expenditure of working capital in preparing the more expensive instrument. Exempt private placements allow the flow-through issuer to "hit the tax window" more effectively, servicing the investor as originally promised by capitalizing on the use of the ITCE and OFFTS.

In addition to limitations on investors, the definition of purchasers in exempt market regulations also encourages investment "geographically" to a significant extent. Family or present and former employees and sophisticated investors, who would be intimate enough to be aware of a company's activities and financing initiatives within the severely limited promotion environment enforced in the exempt market, will by nature be in regular contact. In Ontario, only 55% of the companies exploring have corporate offices in the province. On this basis, a significant pool of exempt market investors living near company offices outside Ontario may not be able to avail themselves of a provincial incentive such as the OFFTS. Enhanced FTS investment will rely solely on the bottom line offered by the ITCE in these cases.

6.7.2.6 Interim Conclusions

Within the 20-month period of the Ontario study, 151 companies that have publicly identified Ontario exploration assets as part of their grass-roots exploration portfolio raised, or are raising, over $90 million of flow-through financing and over $94 million of non-flow-through “hard dollar” capital. Despite this level of activity, there has been very little time available with which to evaluate factors governing these funds and draw substantive or detailed conclusions about the overall importance of federal and provincial tax credits to exploration investment in Ontario. Investors, whom it was hoped would find the new credits hard to resist, have walked, not run back, to exploration in Ontario.

Access to flow-through financing from the company perspective has been challenged by their own general financial condition and those of the equities market. A lack of familiarity with the implications of recent changes to securities regulations, changes to the profile of their investors and, with some exceptions, a lack of interest from institutional investors and brokers to date are evidence that capital markets were unprepared to be the launching point for the time-limited credits.

Attraction to enhanced flow-through share incentives from an investor's perspective has also been hampered by a lack of flagship or marquee commodities they understand, the absence of investment from institutional investors and brokers who by their focus and analysis could create leadership in this part of the equities market, and by weakness in commodity prices in general. In addition, there would seem to be some lingering ill feelings about flow-through enhancements from the Mining Exploration Depletion Allowance years. Resolution of some of the flaws with respect to the treatment of flow-through investments made by the CCRA in the mid-1990s do not appear to have been successfully promoted to potential buyers.

Throughout the 2000-01 period of the Ontario study, which contained two year-end tax-buying seasons for investors, both the number of companies and the number of properties active in Ontario increased substantially. FTS obtained two thirds of the capital raised for the companies identified during this period. In 2002, with no similar tax-buying period included in the timeframe studied, FTS sales still account for one quarter of the financing obtained from investors. Over the 20 months of the study, 49% of the funds identified that could support exploration in Ontario came from sale of FTS. A significant proportion of companies raised only flow-through funds to support their exploration activities. As no similar study of flow-through financing exists for Ontario for previous years and few other factors affecting mineral investment appear to have changed during the study period, the relative increase in announced activity is taken as an indication that the ITCE and OFFTS tax credit have been successful to a noticeable degree.

With the exception of a sharp increase in palladium pricing in late 2000 and early 2001, which flow-through issuers exploring in Ontario took advantage of, there is little to explain the overall increase in activity in Ontario during the study to date other than renewed financial strength of the companies. While the financing levels hoped for by industry associations and governments have not met the expectations hoped for in late 2000, they have survived major economic and investor confidence crises that have affected financial markets, such as the economic downturn in the United States, the conservative response to terrorist attacks of September 11, 2001, and the collapses of Enron and other major corporations. Although the Ontario study cannot specifically quantify the impact of the ITCE or OFFTS tax credit, it seems clear that these instruments have protected and enhanced the financing base for grass-roots exploration to some degree during this period.

With specific regard to the OFFTS tax credit, several companies have made specific reference in press releases to using it in their placements of FTS. Still others have made reference to using the Ontario specific government incentive exemption in sales of flow-through to Ontario investors who will presumably pursue the credit for eligible exploration expenses from these financings. The majority of public information on flow-through financings is silent as to whether investors are being offered the Ontario credit or if it is being included in their agreements with exploration companies.

There is evidence to suggest that flow-through financing used in Ontario is raised elsewhere in Canada from non-Ontario investors. In these cases, issuers of flow-through and buyers are relying on the federal ITCE to enhance their investment opportunity and are foregoing not only an Ontario credit but also a provincially specific incentive they might obtain in their home province. This apparent "opting out" of the provincial credits would support the view that investors are still placing value on their selected asset rather than simply on obtaining maximum tax avoidance. This is a situation both levels of government should feel comfortable with – a federally sponsored credit attracting funds to grass-roots exploration across the country as it was designed to do and an Ontario credit that rewards local investment without the local incentive overcoming the results of an evaluation of the project of interest on its merit as a mining asset.

There are securities regulations in each of the major provincial jurisdictions where grass-roots explorers operate their businesses, which provide for ease of distribution of FTS to their investors. This guarantees a reasonable measure of success at the federal level for the ITCE and, to some degree, the OFFTS tax credit in Ontario. The securities rules under which these same companies have issued other forms of equity vary substantially from province to province. As a result, a company may tend to cultivate investors where it can best meet all its capital needs. Ontario investors may not receive the opportunity to invest in a flow-though financing where both the ITCE and the OFFTS could be used because the company and the Ontario investor are unaware of each other. This may be the case with as many as 55 companies, or approximately 30% of all companies exploring in Ontario.

6.8 Quebec

6.8.1 Quebec FTS System

The Quebec *Taxation Act* enables an individual in Quebec to claim a tax deduction up to 175% of his or her investment in FTS being used to finance surface mining exploration in Quebec.

To that end, the Quebec system provides for a basic deduction of 100% of the cost of FTS used to finance eligible exploration expenses. The individual in Quebec can also claim an additional deduction of 25% when the exploration expenses are incurred in Quebec by a corporation that is not mining any mineral resources. To this may be added an additional deduction of 50% for surface mining exploration, bringing the total deduction to 175% of the cost of the investment. These tax benefits apply to mineral and oil and gas exploration expenses incurred in Quebec.

When the share is sold, the Quebec tax system also provides for the deemed capital gains exemption, namely, the portion of the selling price between the share purchasing price and its adjusted cost base (ACB), which is deemed to be nil. In addition, the corporation may choose not to deduct its issuance expenses related to FTS, in which case the individual may claim them up to 15% of the investment cost for the same year, the excess amount being deductible over five years.

Quebec's tax benefits related to FTS have been extended until December 31, 2003, after which time the system will be completely replaced by the refundable tax credit for resources. Until December 31, 2003, a corporation may either choose to finance its exploration expenses by waiving the deduction of its eligible expenses and using FTS financing, or by not waiving its eligible expenses and claiming the refundable tax credit for resources.

It should be pointed out that the ITCE is not taxable in respect of Quebec income taxation. In other words, the investor does not need to cut back on his or her CEEs when claiming them in his/her Quebec income tax return.

For the 2002 taxation year, considering the federal and Quebec tax benefits, the net cost of an investment of $1000 in FTS amounts to some $224 when the individual in Quebec has reached the maximum marginal tax rate.

6.8.2 Refundable Tax Credit for Resources

The Government of Quebec announced the creation of a new tax assistance measure for exploration, specifically the Refundable Tax Credit for Resources. This measure was created within the framework of the *Taxation Act* and consists of direct tax assistance to corporations for eligible exploration expenses incurred beginning March 30, 2001.

The tax credit is given to eligible corporations that incur eligible 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 125% within the framework of the current FTS system.

The rate for the refundable credit is 20% of eligible expenses for producing companies (those mining a natural resource) and 40% of eligible expenses for junior companies. These rates increase to 25% and 45% when these expenses are incurred in Quebec's Near North and Far North. On August 20, 2002, the Quebec government increased the rates for the tax credit to 60% for mineral resources by adding a non-refundable portion to the existing refundable one. Thus, in the case of a mineral producer, the rate of the new non-refundable portion is 35% when eligible expenses are incurred in the Near or Far North and 40% when these expenses are incurred elsewhere in Quebec. For a junior company, the rate of the non-refundable portion of the tax credit is 15% for eligible expenses incurred in the Near or Far North and 20% when these expenses are incurred elsewhere in Quebec. This temporary improvement (the addition of a non-refundable component to the tax credit) will apply to eligible expenses incurred after August 20, 2002, and before January 1, 2008.

Corporations may claim the tax credit when filing their tax return, i.e., within six months of the end of their fiscal year. To that end, corporations must attach to their tax return a form prescribed for that purpose by the ministère du Revenu [Quebec Department of Revenue]. The tax credit could also be applied against a corporation's required monthly instalments with respect to income tax and capital tax.

A transition period is expected to ensure the switchover from the FTS system to the new refundable tax credit. Thus, until December 31, 2003, a corporation could either choose not to deduct its exploration expenses within the framework of flow-through financing or claim the refundable tax credit for exploration expenses incurred. After December 31, 2003, the tax benefits related to the FTS system will be revoked.

6.8.3 Analysis

Since the early 1980s, the FTS system has been not only an interesting tax shelter for investors, but also a determining financing method for junior exploration companies in Quebec. Moreover, flow-through financing has resulted in an average of nearly $17.5 million being raised annually over the last 10 years.

This method of financing remains highly appreciated by junior exploration companies, which have consistently expressed an interest in keeping it.

So far, no significant increase in the amount of money raised in Quebec via FTS has been registered since the introduction of the federal ITCE. However, this additional incentive to exploration can only contribute to an improvement of the FTS financing system over a long-term perspective.

Notwithstanding this and as noted in Section 6.8.2, a decision has been made to replace, by 2004, the Quebec tax benefits related to FTS by direct tax assistance to corporations, namely, the tax credit for resources.

In an effort to bolster administrative effectiveness and further encourage exploration in Quebec, the Quebec government elected to administer tax assistance intended for exploration as direct assistance to businesses rather than to grant a tax shelter to an investor who does not incur exploration expenses directly. This decision is in line with the government's policy to encourage businesses to undertake the economic activities that the government has decided to support. This measure is comparable in many ways to the tax assistance for R&D and film production.

We should point out that the refundable tax credit for resources has been in effect since March 30, 2001, which means that a corporation can benefit from this credit for eligible expenses incurred since March 30, 2001. With the increase in the tax credit rate mentioned in Section 6.8.2 above, the Quebec tax savings for a mining company can be as high as 87 cents for each dollar of eligible expenses incurred in Quebec.

7. Options for Improvement or Replacement

7.1 Introduction

Several suggestions have been received from the Prospectors and Developers Association of Canada (PDAC) and members of the study group, on behalf of governments participating in the study, on how the tax credit mechanism might be modified to enhance its attractiveness to mining companies and investors. There were no proposals made by either industry or governments to replace the program.

7.2 Industry Proposals

Industry associations are generally of the opinion that the program is working well, but not as well as everyone had hoped. It was expected that in 2001 around $300 million would be raised for exploration via FTS. Evidence suggests that the amount raised for this specific purpose was likely only half of the expected amount. Thus, the Prospectors and Developers Association of Canada (PDAC), the Association des prospecteurs du Québec (APQ) and the British Columbia & Yukon Chamber of Mines (BCYCM) are not recommending the replacement of the ITCE. Rather they propose four changes that they think would improve the success of the program. These proposals are as follows:

- extend the allowed spending period for the money raised in the final year of the program from December 31, 2003, to December 31, 2004;
- extend the "buy" period from December 31 to the end of February to coincide with the RRSP "buy" period potential investors are familiar with;
- designate between 10% and 15% of money raised to be eligible as Canadian Exploration Expenses to pay for financing costs such as prospectuses, offering memoranda, broker sponsorship fees, and listing and disclosure costs; and
- extend the ITCE privilege to "bona fide" mining companies acquiring FTS, instead of restricting this privilege to individual investors.

7.3 Working Group Suggestions

In addition to industry proposals, other suggestions were drafted by members of the working group, either individually or as a group, on the basis of the study findings and the specific issues raised by the program in the jurisdictions represented by the working group. These suggestions are discussed separately in Section 7.4.2.

7.4 Analysis

The proposals and suggestions presented below include preliminary comments and arguments that are meant to stimulate discussion and do not constitute the final position of the working group on these issues.

7.4.1 PDAC Proposals

- *Extend the allowed spending period for money raised in the final year of the program from December 31, 2003 to December 31, 2004.*

In its 1996 Budget, the federal government introduced a number of measures designed to improve the effectiveness of FTS-financed exploration. For mining, the most significant change introduced was a technical amendment to the *Income Tax Act* affecting the so-called "look-back" rule. The rule was modified to allow exploration expenditures renounced under the look-back rule to be incurred by the issuer up to a full year (rather than only 60 days) after the end of the calendar year in which the funds were raised. The extension of the "look-back" period allowed companies to conduct more efficient and more timely exploration activities.

According to CCRA numbers for the period 1996-2001, almost 40% of all renunciations by companies were made under the look-back rule, an indication that this rule is an essential component of the flow-through regime. The study group is of the opinion that the progressive reduction of the look-back period that is scheduled to take place during 2003 under the current ITCE rules may reduce the uptake on the program. This may also negatively affect the quality of exploration financed by FTS raised during the period.

Accordingly, there was overwhelming agreement that this is a suggestion that should be acted upon at an early stage to prevent the progressive reduction of the look-back period during 2003. The qualification should be made that if the program is extended in keeping with the recommendations of this committee, then the extension of the spending period should be for one year after the termination of the program (last offering of FTS linked to the tax credits).

- *Extend the "buy" period from December 31 to the end of February to coincide with the RRSP buy period that potential investors are familiar with.*

There was limited support for this measure among the study group. The general opinion seemed to be that this measure might not be particularly effective in raising new investment. Quarterly and monthly statistics concerning FTS financing activities provide little support for the notion that such activities are hampered by a lack of conformity with the RRSP investment period. Furthermore, from a social policy point of view, it may not be appropriate to match the investment season of a speculative investment vehicle such as FTS with that of RRSP funds, the purpose of which is to provide income security for retired people.

- *Designate between 10 and 15% of money raised to be eligible as Canadian Exploration Expenses to pay for financing costs.*

There was limited support for this measure. Although it would extend a lifeline to the smallest junior companies, it may work against the interest of investors. The measure would reduce the amount of exploration that could be undertaken with any parcel of investor's money, thereby reducing the chances of a discovery and the attractiveness of FTS as an investment. The working group is of the majority opinion that, if required, financing assistance for this category of costs should be sought outside the tax system.

- *Extend the ITCE privilege to "bona fide" mining companies acquiring FTS.*

There was some support for this measure on the basis that the current exclusion of established mining companies from participation to the ITCE could remove a major potential investor for junior mineral exploration companies. An extension of the program to established mineral producers could provide significant additional sources of funding for junior companies. An increased participation of established producers in the financing of junior companies could also be perceived by investors as an endorsement of the exploration activities of these companies.

On the other hand, established producers are already a significant source of financing for junior exploration companies. It could be argued that an extension of the program benefits to established producers may not significantly increase their investment in junior mining companies, but could serve to displace the conventional investment vehicles they are already using. Also, based on the experience of the late 1980s, the ability of companies to purchase FTS linked to ITCE could lead to complex tax sheltering investment structures and concomitant administration difficulties for the CCRA.

7.4.2 Working Group Suggestions Different From the PDAC Proposals

- *Extend the ITCE program and harmonized provincial tax credits for one or two years (to the end of 2004 or 2005).*

The system of harmonized federal-provincial/territorial tax credits is complex and has taken some time to be understood by the financial community. Now that the learning process is complete, the positive effects of the tax credit are starting to be felt as junior exploration spending and the amount of FTS financing both appear to be getting stronger in 2002. An extension of the ITCE for a one- to two-year period would allow junior exploration companies to reap the more concrete and durable benefits that were anticipated at program inception. It would provide a more stable financing environment for exploration projects when raising equity financing continues to be difficult.

On the other hand, the junior mining industry has managed to increase its share of exploration financing each year since the tax credit was introduced. It could be argued that the tax credit system has served its purpose and should be phased out as planned at its inception.

- *Extend the mandate of the working group so that it can continue evaluating the tax credits and further study the underlying factors affecting the success of the program.*

Data available to the study group were incomplete and did not allow the evaluation of a number of important aspects of the ITCE, notably in respect of cost-effectiveness. An extension of the mandate of the working group would be required to allow consideration of the more extensive and reliable data set that is scheduled to be available during 2003.

- *Include a coal deposit as a "mineral resource" eligible for the tax credits.*

The extension to coal deposits would allow Canadian mining/exploration companies to benefit from renewed interest in thermal coal to supply the North American markets and prevent situations such as the Californian energy crisis from recurring.

Junior companies are generally not interested in exploring for coal deposits since there is a significant regulatory burden in acquiring a coal mining lease. Also, coal is not a commodity that appeals to high-risk investors in the way that gold and diamonds do.

- *Allow larger "bulk samples" to be taken from diamond deposits where grade variability requires more extensive sampling to determine the "quality" of a deposit than would be the case in other types of mineral deposits.*

This measure would provide additional support to one of the most active parts of the mineral exploration industry in Canada.

However, it could be argued that the successes achieved by diamond exploration in Canada in recent years have ensured that adequate funding is available and that it is exploration for other commodities such as gold and base metals that requires further incentives.

- *Amend the legislation to provide for an exemption from deducting the provincial/territorial credit from the exploration expenses before calculating the ITCE.*

This suggestion has a precedent in the case of labour-sponsored funds and would simplify the calculation of benefits to the investor.

On the other hand, the provision in the federal *Income Tax Act* (ITA) relating to provincial/territorial assistance is not restricted to FTS or the mining sector and would create a distortion in the administration of the ITA.

- *Increase investor awareness of the tax credit through additional promotion and advertising.*

Despite the "awareness campaign" conducted in major financial centres in Canada by the PDAC, NRCan and the provinces/territories, there are claims that many potential investors are unaware of the benefits of the program and how it works.

However, it may be too late to conduct an effective awareness program if the December 31, 2003, termination date of the program is not revised.

- *Study the advisability of including certain new expense categories within the CEE definitions.*

Many exploration and mining companies are incurring, at the urging of various levels of government, environmental and social costs even before acquiring a property. To encourage corporate social responsibility and sustainable development, these costs should be allowed to qualify for the CEE deduction and tax credits.

On the other hand, the money spent on exploration would be reduced so that the chances of making a discovery and providing a return to the investor would also be reduced. A cap would have to be placed on these costs to preserve the investment value of FTS.

- *Study the possibility of increasing the level of federal incentives to the three territories and in the smaller provinces where administration of the tax system and/or small population bases effectively prevent these jurisdictions from adopting harmonized tax credits.*

Even if the territories and some of the smaller provinces were to provide a generous harmonized tax credit, their small investor base may not make it worthwhile for a company to structure an FTS issue so the residents of these provinces/territories could claim the harmonized tax credit. In the case of the territories, there is the added difficulty that the crown royalty revenues that could serve to finance the income tax credits are collected and administered by the federal government. A restructuring of the ITCE that would allow a special enhancement for exploration expenditures incurred in the territories and smaller provinces would address that specific issue.

However, this type of solution would introduce other challenges. Because investors from all provinces and territories could access the selectively enhanced ITCE, this measure could offset, or even reverse, the tax advantage that the provinces currently offering harmonized tax credits intended to accord to their own taxpayers. Ontario investors, for example, could obtain the same tax benefit (or even better) if they invest outside their home province instead of investing in an Ontario project. Moreover, territories and provinces benefiting from the enhanced ITCE would gain this advantage at no cost to their own treasury.

8. Conclusions and Interim Recommendations

8.1 Conclusions

The analysis of the ITCE and harmonized provincial tax credits was based on limited data, the ITCE having been introduced less than two years ago. In particular, very limited quantitative analysis could be performed to evaluate the program cost-effectiveness (or return on taxpayers' investment). A fuller evaluation would require an extension of the mandate of the working group to allow consideration of the more extensive and reliable data set that is scheduled to be available during the course of 2003.

Preliminary results indicate that the amount of financing raised that was eligible for the ITCE tax credit is in the order of $60 million per year. Overall FTS financings amount to approximately $250 million from the inception of the program in October 2000 to mid-2002.

These figures indicate that the ITCE uptake has fallen short of industry expectations, principally because of a longer-than-anticipated implementation period and the lagged introduction of harmonized provincial credits. It took several months for companies and investors to understand the technical rules of the program and to evaluate their effects. Harmonized provincial tax credits were introduced over a period of 18 months.

Nevertheless, the ITCE and harmonized provincial tax credits have provided a lifeline to junior mining exploration companies during a difficult period for raising exploration financing. The positive effects of the tax credit are starting to be felt as junior exploration spending and the amount of FTS financing both appear to be getting stronger in 2002. Unfortunately, the progressive collapse of the period in which spending can be undertaken during 2003 will mean that, without changes, the mechanism will not work well in its last year.

8.2 Interim Recommendations

The working group reached a consensus on the following recommendations:

- *The ITCE program and the harmonized provincial tax credits should be extended to December 31, 2004, with consideration given to a further year extension.*

- *The spending period for carrying out the exploration work should be extended until one full year after the program's proposed closing date.*

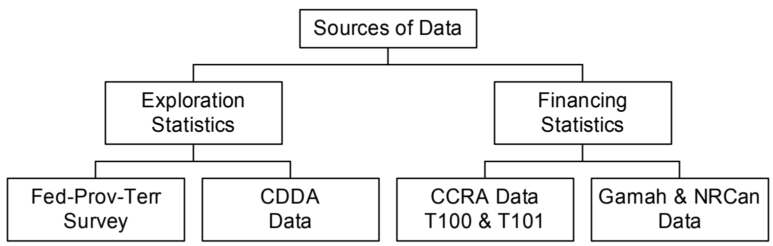
- *The mandate of the working group should be extended until the end of 2003 to allow for careful analysis of the other recommendations for improving the tax credit/FTS mechanism, and updating the evaluation of the effectiveness of the tax credits (as more extensive and reliable data become available).*

The non-inclusion of the other proposals reviewed by the working group does not constitute a rejection of these proposals. The working group believes that it would benefit from additional input from provinces/territories and industry on the proposals to allow the preparation of a revised edition of the report for the attention of the relevant federal and provincial/territorial departments.

Appendix 1 – Sources of Data

Introduction

Several sources of data have been used to evaluate the federal and provincial/territorial FTS incentive programs. One key source is to examine mineral exploration statistics while the other key source is to examine flow-through financing statistics.



Federal-Provincial/Territorial Survey of Mineral Exploration Statistics

Data on Canadian exploration and deposit appraisal activity are gathered by the federal-provincial/territorial Survey of Mineral Exploration, Deposit Appraisal and Mine Complex Development Expenditures. The survey is conducted twice a year. For example, for the 2000/01 survey period, a preliminary survey is conducted during the last quarter of 2000 and in January 2001, and a more detailed final survey is conducted in early 2001. This preliminary survey provides preliminary results on the 2000 exploration activity and would provide a forecast for 2001, based upon company spending intentions. The final survey provides more detailed project-specific information such as the commodities explored for, types of activities undertaken, and types of companies involved. These surveys include a full census of all companies involved in mineral exploration, deposit appraisal and mine complex development in Canada.

One limitation of the survey is that it does not ask companies the sources of their financing (e.g., amount obtained from flow-through financing, etc.). However, the report does give a detailed break-down of expenditures by senior and junior companies. A growth in junior company exploration levels would be a good indication of an increase in flow-through financing. Another limitation of the survey is that there is a time lag between the time the information was collected and the time the data are finalized and released.

Diamond Drilling Statistics

Diamond drilling is used to obtain samples for determining the existence, location, extent, grade and tonnage of mineral deposits. The majority of diamond drilling is conducted by independent companies that specialize in this type of work. Many of these diamond drilling companies are represented by the Canadian Diamond Drilling Association (CDDA). The CDDA collects drilling statistics on a quarterly basis from its members, which cover about 50 to 60% of total Canadian contract diamond drilling activity. Although incomplete, these data provide a reasonable and the most up-to-date indication of recent national mineral exploration and deposit appraisal trends.

While diamond drilling statistics are not a direct indication of flow-through financing, they are an important leading indicator for surface exploration activity, some of which is financed by FTS.

Limitations of this data set are that while drilling activity is the most important component of mineral exploration expenditures, it is not the only component. There are other activities involved in the exploration process, including geological mapping, geochemical surveys and geophysical surveys, as well as diamond drilling. Drilling statistics are not direct measurements of FTS financings, nor are they direct indications of the use of the ITCE.

Canada Customs and Revenue Agency T100 Information

Companies that issue FTS or prepare a selling instrument for selling FTS are required to fill out a T100 form. The form consists of three parts:

- Part I - Application for a selling instrument T100 identification number.
- Part II - Details of the FTS and flow-through warrants subscribed.
- Part III - Application for a T100 identification number on the exercise of flow-through warrants and details of the flow-through warrants exercised.

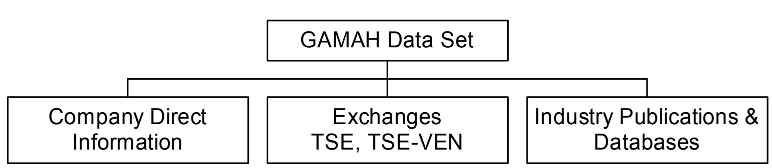
Part I of the T100 provides the CCRA with an estimate of what the maximum size of the planned FTS and warrant offerings will be for the mining company submitting the form. It is important to note that the amount of funding that is indicated on Part I of the form may not end up being the amount that will be subscribed to FTS investors. For example, a company may indicate that their maximum subscription will be $10 million, but this company may only raise $8 million from investors. Normally, a company will have a fairly good idea about how much it expects to raise through its flow-through subscription. The CCRA will not know what the actual amount raised until the company files Part II of the T100 form, which indicates the amounts that are subscribed. Therefore, a lag will exist between the time when a company first submits its Part I and after the subscription period when the company would submit Part II of the T100 form.

A second form, the T101 form, is submitted by a company to the CCRA to renounce its Canadian exploration expenditures (CEE) to its flow-through investors. This form will also indicate the amounts renounced under the ITCE. Modifications to the T-101 form will soon allow a breakdown of FTS and expenses eligible to the federal and provincial tax credits by province/territory where they were actually incurred.

The major limitation of the CCRA T100 and T101 forms information is the time delay involved in obtaining financing information, confirming it and inputting it in the Agency's database.

Gamah International Limited (Gamah)

Gamah publishes a summary of financings for mineral exploration on a monthly basis. It receives its data from several sources. These sources include press releases, faxes and e-mails that Gamah receives from companies on their financing activities. In addition to the information that they receive directly from companies, Gamah also collects information from stock exchanges (e.g., TSE and TSE-VEN) and from mining industry publications.



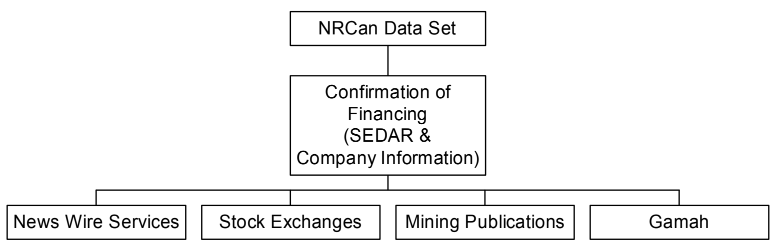
An important consideration in evaluating Gamah's data set is that the information that it contains is lagged by at least one month in terms of containing full details of the exchanges' information. Some information may be missed in that it may be necessary to probe deeper to find full reports of FTS financings (e.g., one may need to go directly to company and SEDAR web sites to find information on confirmations). Another consideration about the Gamah dataset is that there are no indications of where the financing money will be used, for what activities, or for what intended minerals.

Natural Resources Canada Data Set

Natural Resources Canada collects its own information on announcements of intended flow-through financings as a supplement to the Gamah data. The sources for this supplementary information include the following:

- newswire announcements (Canada News Wire, Bell Globemedia and Financial Post services);
- Canadian stock exchanges (TSE and TSE-VEN); and
- industry publications and web sites (InfoMine, Northern Miner).

This information on intended flow-through financings is later confirmed by examining company information from the SEDAR (System for Electronic Document Analysis and Retrieval of the Canadian Securities Administrators) and from individual company sources (e.g., company web sites).



Appendix 2 – Financing Difficulties and Investor Confidence

Background

In recent years, low metal prices have had an impact on the amounts dedicated to exploration by both senior and junior mining companies. In the case of the senior companies (producers), the resulting decline in profitability resulted in lower cash flows with less money being available to be directed to exploration projects. As international stock markets demanded higher-profile investments for their investors, large mining companies looked to mergers and acquisitions rather than discovery as a tool for rapid growth and stronger market capitalization. A spate of corporate consolidations focused on best production assets and current core mineral assets to create market-leading companies. Consolidation and redeployment of financial resources to exploration projects under these new organizations took second place to operations.

From 1999 to 2002, Canadian stock exchanges were also restructuring to reposition themselves with a higher profile to meet greater international competition. This period has also been marked by substantial regulatory change for the mining equity marketplace in Canada. Changes began with the 1999 merger of the Vancouver and Alberta stock exchanges and a portion of the Canadian Dealing Network to form the Canadian Venture Exchange (CDNX) and culminated with the acquisition of the CDNX by the Toronto Stock Exchange and its reorganization to become the TSX Venture Exchange, launched in early 2002. Throughout this period, the Canadian equity markets realigned their new company listing requirements and their ongoing listing maintenance standards to create a graduated market with the objective of providing successful companies with a pathway to a listing on the high-visibility Toronto Stock Exchange. During this re-alignment period, however, a considerable number of junior mining companies that were listed on the Toronto Stock Exchange were delisted or were moved to the TSX Venture Exchange, essentially being dropped back to the starting point for publicly traded companies in this new regime and potentially reducing their previous visibility.

During the three years preceding the introduction of the ITCE, junior mining companies experienced great difficulties in convincing investors to invest when there was no end in sight to declining commodity prices. In addition, a number of mining-related investment scandals in the late 1990s, including Bre-X, rocked the stock markets and put junior resource companies in general in a very negative light.

In response to Bre-X and other issues that were seen to negatively affect public confidence in investing, provincial regulatory agencies, such as the Ontario Securities Commission (OSC), the Investment Dealers Association and the stock exchanges, began reviewing the rules relating to investors and listed companies, such as the raising of funds and the disclosure of information. Many new or modified rules and requirements debated in the late 1990s began to come into effect in late 2000 and into 2001, making it one of the busiest periods for regulatory change for junior exploration companies in recent history. This occurred at the same time as the ITCE and several provincial flow-through tax credits came into effect with the result that the machinery available to take the best advantage of the new incentives was still shaking out. Several of these new policies and some possible impacts on financing with the super flow-through credits are briefly highlighted below.

In 2001, the first full year of availability for the ITCE and several provincial tax credits, the Vancouver-based CDNX Listed Companies Association (LCA) partially quantified the financial state of junior exploration companies on the CDNX. Their early conclusion indicated that many of the listed mining stocks were at risk of being delisted, lacking the capital required to meet ongoing listing maintenance requirements. Preliminary data from SEDAR filings provided to the LCA showed that companies were at a difficult starting point in their efforts to get back into exploration. Few companies appeared to have the resources to maintain their listings, let alone front the costs required to finance exploration in general and CEE constrained, flow-through financed exploration in particular. Poor working capital, or "hard dollar," positions meant many companies would have to first finance their way back to regulatory compliance before being able to invest in new exploration.

Preliminary CDNX Listed Company Association Findings:
- 792 companies were classified as mining, having a net positive cash position of $7.5 million;
- 371 had negative working capital, collectively $255 million
- *496 companies had $50 000 or less;*
- 250 companies had $250 000 or more; and
- only 55 companies had more than $1 000 000

National Instrument 43-101 – Standards of Disclosure for Mineral Projects

On December 20, 2000, the Ontario Minister of Finance approved National Instrument 43-101 – Standards of Disclosure for Mineral Projects. The National Instrument, the Companion Policy and Form 43-101F1 came into effect on February 1, 2001.

The completed NI 43-101 is the culmination of the review and research process undertaken by the Mining Standards Task Force, established in 1997 by the Ontario Securities Commission and the Toronto Stock Exchange. The Task Force mandate was to improve the disclosure framework for results of mineral exploration projects that had been previously reported using parameters established under National Policies 2-A and 22.

Two significant features of NI 43-101 are the changes to the guidelines for the reporting of mineral reserves and the definition of the roles and responsibilities of the “qualified person.”[1] The Canadian Institute of Mining, Metallurgy and Petroleum (CIM) has submitted new guidelines that are now accepted as the reference for reporting under NI 43-101.

One potential impact of this new disclosure rule that is cited informally by junior company executives is the perception that added cost for vetting all assets deemed material to a financing through a qualified person will accrue to the issuer. There is concern that these larger costs will occur as part of submitting a share offering or in the case that an exchange or a securities commission requires additional verification of information. The Instrument has been in place a very short time and no publicly available evaluation of higher costs associated with the advent of NI 43-101 is known to have been done. As part of a budgeting decision that assumes these costs will occur, it may be that companies are opting to try financing methods such as private placements that can avoid them, especially for smaller financings. In

[1] Under the National Instrument 43-101 a “qualified person” means:
(a) an individual who is an engineer or geo-scientist with at least five years of experience in mineral exploration, development or production activities and assessment, or any combination of these, including experience and technical responsibility appropriate to the particular mining project and who is a member in good standing of a professional association; and
(b) if such an individual is an employee, officer, director, associate or partner of a person or company the principal business of which is the provision of engineering or geo-scientific services.

the words of one commentator, "While no one has ascertained that new disclosure standards will cost more, no one has said they will cost less."

Regulation of Reporting on Mineral Projects by Mining Analysts

The Securities Industry Committee on Analyst Standards (SICAS) Committee was established by the Investment Dealers Association, the TSE and CDNX in September 1999 in response to concerns raised about the role analysts play in promoting stocks in the marketplace.

The SICAS Committee reviewed the practices and activities involved in securities research and reviewed the standards of conduct and supervision of analysts in Canada. The Draft Report, released in 2001, contained 28 recommendations regarding the conduct and supervision of analysts to preserve the integrity of the capital markets. Among the recommendations is the mandatory disclosure of conflicts in research reports, newsletters and media interviews. These conflicts could include analysts owning shares in a company they are writing reports about or being an officer, director, employee of, or advisor to a company.

Perhaps most important to small capital companies is that the report calls for the mandatory disclosure of the sources of information that the analyst uses and approval by qualified supervisory analysts of all research reports and recommendations in advance. Many analysts or their supervisors may view these conditions as newly added liabilities when providing research and recommendations for high-risk small capital explorers. They may decide in some cases that these are more costly to do than they are worth and thereby limit a junior company's exposure and profile in the marketplace.

Universal Market Integrity Rules

On April 20, 2001, The Toronto Stock Exchange released a discussion paper on proposed market integrity rules to be applied by all securities commissions and exchanges. TSE Regulation Services and the CDNX have developed market integrity rules based on the “framework” or core trading rules put forward in the CSA Proposal for Regulating Alternative Trading Systems. TSE Regulatory Services Inc. and CDNX will apply as market regulators for domestic equity markets and have proposed that the UMI rules apply to trading “of all types of securities traded on all exchanges and Automated Trading Systems.”

These integrity rules would apply to trading platforms outside of the current TSE/TSX framework. In the junior mining company context, one or more of these platforms might service companies that do not currently meet TSX/TSX Venture listing standards, such as viable companies who now reside on the Canadian Unlisted Board (“CUB,” a wholly owned subsidiary of CDNX) or who fail to maintain listing standards on the TSX/TSX Venture in the future. Canadian Trading and Quotation System Inc. is an example of an organization that proposes to create such a marketplace.

The Ontario Association of Unlisted Reporting Issuers estimates that before the Canadian Dealing Network (CDN) over-the-counter trade reporting and quotation system was absorbed into CDNX in late 2000, approximately 1100 companies reported to CDN, a number of which were mineral exploration companies. Some of these exploration companies were invited to list on Tier 3 of CDNX when CDNX took control. Trades in Ontario for the remaining exploration companies not invited to list on CDNX are currently reportable through a facility maintained by the Canadian Unlisted Board (CUB). CUB does not provide a stock quoting system or trading information, or facilitate access by the public or company to corporate information or investor interest. The lack of a visible means for an investor to bid or ask a stock price for shares in a CUB company means these companies are less able than under the former CDN regime to market FTS. Companies that might be relegated from TSX/TSX Venture to CUB in the future will be similarly affected.

OSC Rule 45-501, Exempt Distributions

In June 1999, the OSC proposed changing several rules concerning the ways in which small and medium capital enterprises (SME) raise capital. There were four exemptions, which have not been modified since 1980, being considered for replacement by two new exemptions. The four to be replaced were:

- *the private company exemption;*
- the $150 000 exemption;
- the seed capital exemption; and
- *the government incentive security exemption.*

The new proposed exemptions were:

- *the Closely Held Issuer Exemption; and*
- *the Accredited Investor Exemption.*

The new exemptions were intended to provide streamlining for small capital companies (e.g., most junior mining companies) that issue shares to raise capital, mainly through private placements. It will also raise the caps on these financings to higher limits (up to $3 000 000) than currently exist and, in some cases, widen the number of possible investors.

On April 6, 2001, the Ontario Securities Commission released a revised document entitled *Proposed Rule 45-501 – Exempt Distributions* via its web site, requesting comments. Industry associations such as the Prospectors and Developers Association of Canada responded, submitting that the proposal to eliminate the government incentive security exemption contained in Section 2.4 of the draft was of primary concern for the association's members. Under the proposed rule, only accredited investors (a very small percentage of potential investors) would have been permitted to acquire FTS on an exempt basis. The definition of accredited investor requires that the person has assets of cash and securities of $1 000 000 and a three-year pre-tax income history of $200 000 or more. The PDAC pointed out that, by removing the exemption, the OSC would be inhibiting the ability of exploration issuers to take full advantage of the new super FTS program implemented by the federal and Ontario governments as a policy measure. When the new Rule 45-501 came into effect in November 2001, the government incentive exemption was retained and two new proposed exemptions were instituted.

Although the opportunity to finance with FTS in relatively small amounts to individuals was protected, the replacement of the $150 000 rule with the Accredited Investor rule may potentially limit participation in the small capital marketplace by individual Ontario investors for normal equity, "hard dollar" financings. The Accredited Investor change places greater ease for making small investments in the hands of managed funds and other investment organizations. It remains to be seen whether these groups' investment risk strategies will parallel and replace investments made by the previously sophisticated $150 000 investor.

An evaluation of announced activity by the pool of junior exploration companies active on Canadian stock exchanges in 2000-01 indicates that the export of capital for exploration is another significant factor that federal and provincial governments need to include in their deliberations about the timing and duration of incentives like flow-through tax credits. Approximately 40% of listed companies indicate they are active in offshore projects. Although international access to good mineral prospects strengthens the portfolios of junior exploration companies and has provided growth to the sector in general, it has also attracted a body of strong technical and financial junior exploration professionals away from domestic projects. Investors with confidence in these professionals have followed.

At the World Mines Ministries Conference in March 2002, Professor James Otto of the Colorado School of Mines told participants that, in the 1980s, Australia, Canada and the

United States attracted more than 70% of worldwide exploration investment. By the end of the 1990s and in 2000, these same jurisdictions attracted only 41% of investment according to information gathered by the Prospectors and Developers Association of Canada and Gamah International. This out-migration of exploration capital has occurred after MEDA enhancements were cancelled and the ITCE and provincial flow-through credits were created within this new less geographically limiting international landscape.