September 2005

Taxation Issues for the Mining Industry

2005 Update

A Report by the Intergovernmental Working Group on the Mineral Industry

Mines Ministers' Conference 2005
St. Andrews, New Brunswick

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Executive Summary

Background

At their 2004 meeting in Iqaluit, mines ministers asked that the Intergovernmental Working Group on the Mineral Industry (IGWG) continue to provide analysis and advice to ministers on fiscal and taxation issues that remain of concern. Accordingly, the working group is reporting on the following outstanding issues:

- Financing mineral exploration through the use of flow-through shares;
- Modernizing the income tax definition of Canadian Exploration Expenses;
- Increasing exploration for base metals; and
- Restructuring of corporate income tax provisions for the resource industries.

Financing Mineral Exploration Through the Use of Flow-Through Shares and Tax Credits – Status Report

In October 2000, the federal government responded with the introduction of the Investment Tax Credit for Exploration (ITCE) to a broadly based campaign for a federal tax incentive to counter one of the most drastic declines in the history of Canadian mineral exploration. Initially announced for a three-year period, this 15% tax credit was extended twice, in the budgets of 2003 and 2004, to allow time for the measure to have a greater impact on exploration levels. The ability to raise money using the ITCE is now slated to expire at the end of 2005, although issuing corporations will have one further year in which to incur the exploration expenses.

In the last several years, the strong performances in terms of off-mine-site exploration spending, junior mining company spending, and flow-through-share funding suggest that the ITCE, related provincial tax credits and Quebec super deductions have helped revitalize the Canadian mineral exploration industry. Rising commodity prices and a favourable capital market were also critical factors in this recovery.

After three years where exploration expenditures had been close to their lowest point (in constant 2004 dollar terms) since 1969, a turnaround began in 2002 and continued in 2003, with spending for these two years reaching $573 million and $687 million, respectively. Then, expenditures rose by 59% in 2004 to reach $1091 million, marking the first year that spending had exceeded the $1 billion level since 1997. According to company spending intentions that were compiled in February 2005, exploration and deposit appraisal expenditures were expected to reach $1128 million in 2005.

During the recovery period, total flow-through-share financing grew from $110 million in 2001 to over $436 million in 2004. For the first quarter of 2005, over

$64 million was raised, which is a slightly higher level compared to the same period in 2004.

With the ITCE scheduled to lapse at the end of December 2005, it remains to be seen whether off-site mine exploration will remain strong with continued access to the normal flow-through-share regime. Other influences not related to flow-through shares will be the prevailing commodity prices and the phased-in corporate mining exploration tax credit. Five of the working group members, representing jurisdictions with the majority of mining exploration activity, supported a further extension of the ITCE.

It will also be interesting to see if the large sums invested in recent years in the early stages of the mineral development process will end up generating additional work at more advanced stages of activity. Going forward, it will be important for the Canadian mineral exploration sector to delineate substantial amounts of additional reserves to allow for the sustainability and growth of the industry, particularly for the base-metals sector.

Stimulating Exploration for Base Metals

Fuelled by China's vast appetite for minerals and metals, commodity markets appear poised for a period of sustained growth. The question is whether Canada will be in a position to reap significant benefits from this opportunity. Over the past 26 years, Canada has never been able to replenish the base-metal reserves it lost through production or declassification into sub-economic resources. As a result, base-metal reserves have dropped to such an extent that current production levels may not be sustained for long.

Although it is recognized that tax incentives alone will not bring about a reversal of this longstanding base-metal reserve decline, both industry and the provinces/territories believe that there is a positive role that taxation can play to address the issue. The Prospectors and Developers Association of Canada (PDAC) and provinces indicate that the preferred way to increase exploration for base metals is to facilitate the exploration of base-metal camps by junior mining companies. In their view, this can be achieved tax-wise in two major ways:

- by further extending the ITCE; and
- by allowing exploration close to existing mines to be CEE-eligible, thereby enabling them to be financed by flow-through shares.

However, based on the historical record, analysis suggests that extending the ITCE would mainly benefit gold and diamond exploration. For example, less than 20% of the $1 billion spent on exploration in 2004 was directed towards base-metal exploration. Unless fundamental economic trends change or other measures are introduced to increase the attractiveness of base-metal exploration, base-metal reserves will likely continue to decline.

The second proposal is now being considered by the federal government as part of a series of proposals to change the definition of Canadian Exploration Expenses.

Both PDAC and The Mining Association of Canada believe that industry would be encouraged to increase its search for new base-metal reserves if the high risk of deep drilling was recognized by higher tax incentives for drilling to depths of 300 metres or more in all areas, including in the vicinity of existing mines. This is where it is widely believed that new base-metal reserves are most likely to be found in the near future. The working group is of the opinion that this proposal warrants further investigation.

Reviewing the Definition of Canadian Exploration Expenses (CEE)

Further to technical discussions held at the end of 2004 with industry, the federal government is still considering industry proposals and reviewing supporting data. Many provinces are interested in enhancing the income tax treatment of environmental and community consultation costs, which have increased significantly in recent years. Both industry and the Province of Quebec made the case that a CEE treatment for the deep exploration drilling expenses incurred in the vicinity of existing mines would increase the attractiveness of base-metal exploration and would encourage increased industry efforts to replenish base-metal reserves.

Restructuring Corporate Income Tax Provisions for the Resource Industries

The transition period for the phase-in of the federal restructuring of the resource income tax provisions introduced in the 2003 budget has now passed its mid-point and the new set of tax measures will be fully implemented on January 1, 2007. At their 2004 meeting in Iqaluit, provincial and territorial ministers agreed to continue to consult with their respective Finance colleagues on the effect of the federal tax changes on their taxation regimes for mining to avoid any unintended change in taxes paid by the industry.

So far, Alberta, Ontario and Quebec have adopted measures to neutralize the effects of federal changes on provincial/territorial tax calculations. Other provinces and territories have not yet proposed any measures for adjustment, which is indicating that potential effects of federal changes on provincial/territorial taxation are not considered to be a matter that needs to be addressed at this time.

Following consultations with industry, on December 21, 2004, the federal government released a draft of proposed amendments to section 3900 of the Income Tax Regulations ("Regulation 3900"). The amendments to Regulation 3900 are intended to ensure, as announced in the 2003 budget, that a deduction for mining taxes imposed under a variety of provincial statutes will be phased in over the same five-year transition period that applies to other announced measures.

Several provinces have inquired about the proposed amendments to Regulation 3900 to verify if mining taxes paid under their specific mining tax structures are deductible or not by taxpayers. This issue, which the 2004 IGWG report noted as being a concern for industry, now appears to be resolved.

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Financing Mineral Exploration Through the Use of Flow-Through Shares and Tax Credits – Status Report

Introduction

In October 2000, the federal government responded to a broadly based campaign for a federal tax incentive with the introduction of the Investment Tax Credit for Exploration (ITCE) to counter one of the most drastic declines in the history of Canadian mineral exploration. Initially announced for a three-year period, this 15% tax credit was extended twice, in the budgets of 2003 and 2004, to allow time for the measure to have a greater impact on exploration levels. The ability to raise money using the ITCE is now slated to expire at the end of 2005, although issuing corporations will have one further year in which to incur the exploration expenses.

In addition to the ITCE, several provincial governments also launched similar credits and increased tax deductions. The combination of these provincial incentives with the federal ITCE amounted to a timely catalyst for the recovery in surface exploration activity and junior mining company spending that was also fuelled by improving metal prices and interesting mineral discoveries. As a result, today's Canadian mineral exploration context is quite different than the one that existed at the time the ITCE was introduced.

This new reality is demonstrated by the following analysis of mineral exploration trends and flow-through-share financing. While providing a continuation of the evaluation work that the sub-committee on taxation was tasked with by Canada's Mines Ministers at their 2001 Conference in Québec City, this analysis also sets the stage for debating the post-ITCE era. With the impending termination of the program, many in the industry and in mining communities are asking the federal government to reconsider and prolong the tax credit (see section on industry proposals). Concerns are also being raised about declining base-metal reserves and the role that the ITCE or some other measure could play in reversing this trend. As this issue appears to be on its way to becoming the next crisis to face the Canadian mining industry, a full section of this report has been dedicated to its treatment.

Exploration and Deposit Appraisal Spending

Statistics from the federal-provincial/territorial Survey of Mineral Exploration, Deposit Appraisal and Mine Complex Development Expenditures clearly show that Canada is currently enjoying strong levels of exploration and deposit appraisal activity.

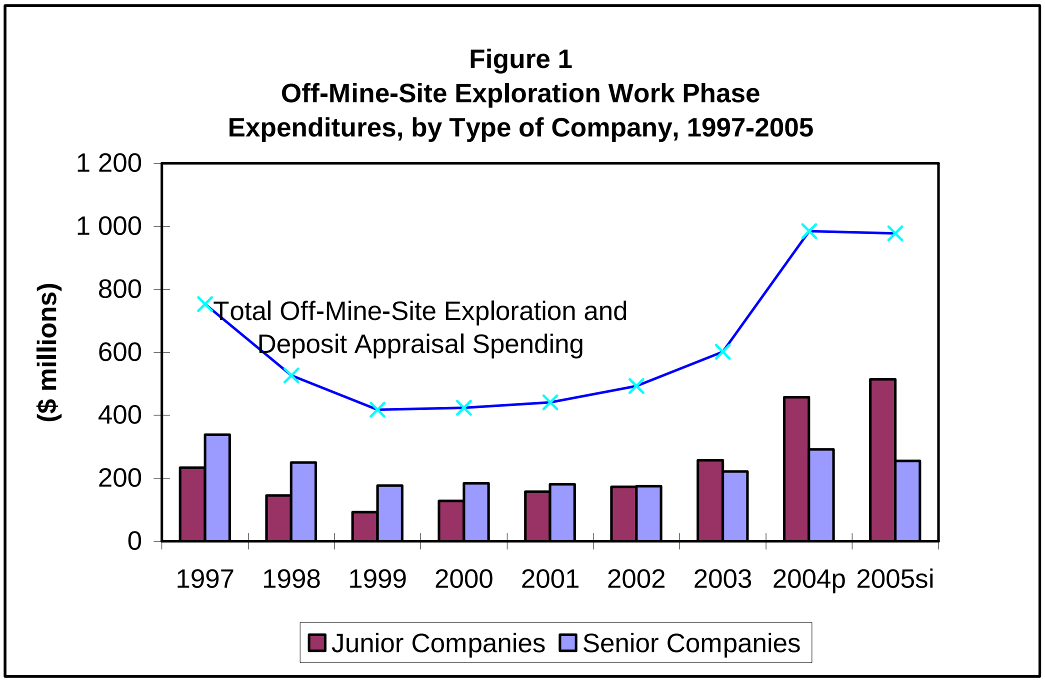
The exploration and deposit appraisal expenditure totals recorded in 1999 ($504 million), 2000 ($497 million) and 2001 ($513 million) were among the lowest on record since at least 1969. The turnaround began in 2002 and continued in 2003 with spending for these two years reaching $573 million and $687 million, respectively.

Expenditures rose substantially in 2004 to reach $1091 million, a 59% increase that revitalized the Canadian mineral exploration sector. It also marked the first year (in constant 2004 dollar terms) that spending had exceeded the $1 billion level since 1997.

According to company spending intentions that were compiled in February 2005, exploration and deposit appraisal expenditures are expected to reach $1128 million in 2005. Although this amount would represent only a small increase over the previous year's total, early results from a *revised spending intentions* survey, to be released in late summer 2005, indicate that the current spending intentions for 2005 will likely be surpassed.

Expenditures Targeted by the Tax Credits

In terms of spending by work phase, exploration that takes place away from mine sites (off-mine-site) is responsible for most of the exploration and deposit appraisal spending being incurred in Canada these days (**Figure 1**). For both 2004 and 2005, this type of spending, which is precisely the type of activity that is supported by the ITCE and other tax credits and deductions, is expected to account for over two-thirds of total expenditures. The remaining third is divided between the on-mine-site exploration, off-mine-site deposit appraisal and on-mine-site deposit appraisal expenditure categories. Of these three classes, the on-mine-site exploration and on-mine-site deposit appraisal are the weakest ones, raising concerns about the lack of on-mine-site work at a time when the reserves of some of Canada's most important metals are going down. This is particularly true in the case of base metals where Canada's reserves of copper, nickel, lead, zinc and molybdenum have been declining for about 20 years, along with a decline in the relative importance of base-metal exploration and deposit appraisal spending in the last nine years (since the survey was redesigned in 1997).



Junior Mining Company Spending

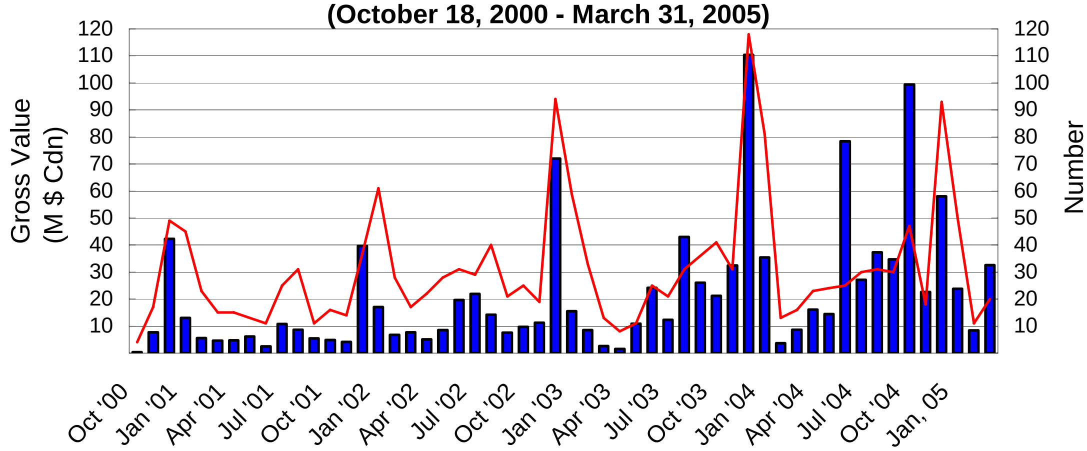
Incentives such as the ones examined in this report tend to favour junior mining companies who rely on the issuance of shares to finance their mineral exploration activities. It is thus noteworthy that the relative importance of junior company spending relative to senior company spending is perhaps the most outstanding feature of the current upward trend in overall spending. After falling below the 30% level in both 1998 and 1999, junior company expenditures gradually accounted for larger shares of total spending in the 2000-03 period. In 2004, junior spending jumped to $531 million and represented 49% of amalgamated junior and senior exploration and deposit appraisal expenditures. This proportion is expected to keep growing in 2005 with junior spending intentions amounting to 54% of the total for that year. In percentage terms, the anticipated $606 million in junior company spending for 2005 would even surpass the levels of 1987-88, which previously represented the best performance on record for the relative importance of junior mining companies in the Canadian exploration and deposit appraisal sector.

Exploration Financed by Flow-Through Shares

NRCan maintains a database of mining flow-through-share financings to track the success of the ITCE program since this tax credit can only be used in conjunction with the issuing of flow-through shares. This database consists of selected data on completed flow-through-share financings taken from information circulars that issuing mining companies release to their investors, to securities regulators, and to stock exchanges. These news releases are posted on the SEDAR web site.

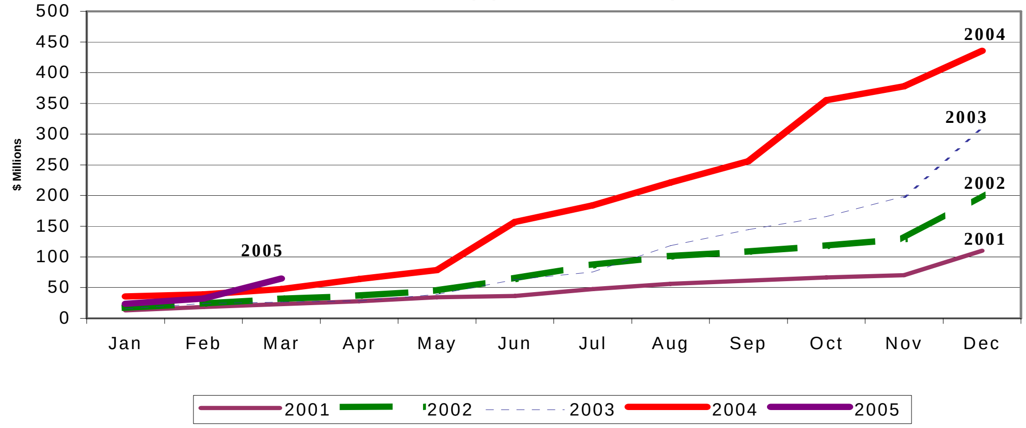
An analysis of the compiled data, from the inception of the ITCE in October 2000 to the end of March 2005, reveals that over $1171 million has been raised from 1680 separate flow-through-share issues (**Figure 2**). On a yearly basis, total flow-through-share financing grew from $110 million in 2001 to $202 million in 2002 and $309 million in 2003. This positive trend continued in 2004 as over $432 million was raised for mineral exploration through flow-through-share financing. For the first quarter of 2005, over $64 million has been raised through 81 financings. This is a slightly higher level compared to the same period in 2004 (**Figure 3**). While the amount of flow-through-share financings has risen dramatically, the number of share issues has only grown from 415 in 2002 to 427 in 2003 and 430 in 2004. The resulting larger average size of flow-through-share financing points to stronger industry fundamentals and increased investor interest in this type of share because of the additional tax benefits they provide.

Figure 2
Canadian Mining Flow-Through-Share New Issues
(October 18, 2000 - March 31, 2005)



Source: NRCan.

Figure 3
Rise in Flow-Through-Share Financings
2001-2005 (up to March 2005)



Summary and Outlook

The strong performances in terms of off-mine-site exploration spending, junior mining company spending and flow-through-share funding suggest that the ITCE, related provincial tax credits and Quebec super deductions have helped revitalize the Canadian mineral exploration industry. These incentives were geared towards off-mine-site surface exploration, and their connections to the flow-through-share mechanism helped ensure their acceptance by junior mining companies. Rising commodity prices and a favourable capital market were also critical factors in this recovery.

Still, the fact that these improvements have been concentrated in the early stages of the mineral development process should be of concern. With the ITCE scheduled to lapse at the end of December 2005, it remains to be seen whether off-mine-site exploration will remain strong. It will also be interesting to see if the large sums invested in recent years in the early stages of the mineral development process will end up generating additional work at more advanced stages of activity. Going forward, it will be important for the Canadian mineral exploration sector to delineate sufficient reserves to ensure the sustainability and growth of the industry, particularly for the base-metals sector.

Provincial/Territorial Views and Comments

Northwest Territories

ITCE

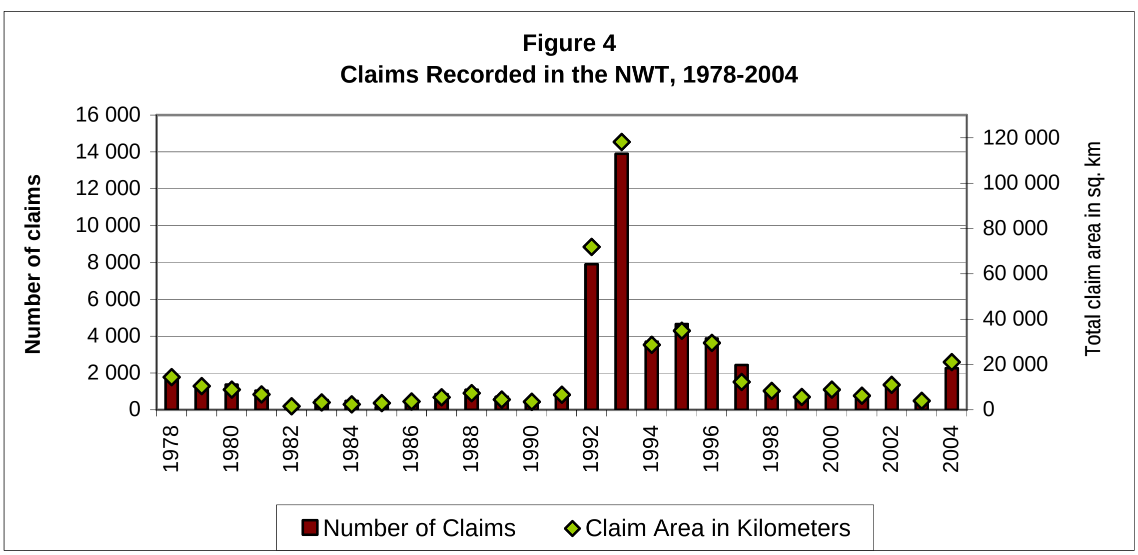
The Northwest Territories (NWT) does not currently have any tax incentives for exploration and therefore does not have any package that harmonizes with the federal government's ITCE program to attract mineral exploration investment in the NWT due to limited financial resources. The Government of the Northwest Territories (GNWT) has a limited ability to offer these types of incentives given that it does not collect the resource revenues from mineral exploitation. Further, the territorial tax base in the NWT is too small to generate a significant amount of investment.

The current program assisting/encouraging mineral exploration is the NWT Prospectors Grubstake Program. The Grubstake program is a grant rather than a tax incentive. Its purpose is to assist individual prospectors living in the NWT to conduct grassroots mineral exploration activities. Eligible applicants may apply for up to $8000 per annum. From 2000 to 2005, prospectors applied for nearly $800 000 and nearly $500 000 has been granted.

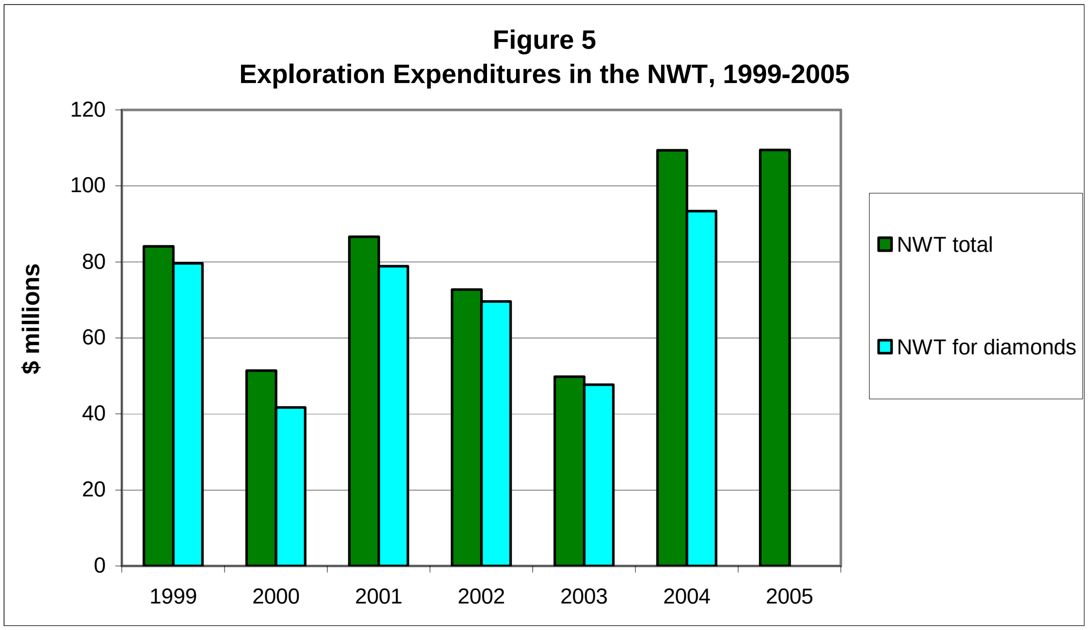
The net effectiveness of the ITCE on exploration expenditures in the NWT is complicated to estimate. However, it is reasonable to suggest that the ITCE had a positive impact on the NWT mining industry since the beginning of the program in 2000. This is because (1) a significant amount of exploration funding has been raised via flow-through shares (FST) across Canada; (2) mineral exploration expenditures in the NWT account for an important share of the total exploration expenditures in Canada in the past few years; and (3) it is evident that many mining companies who operated in the NWT did raise exploration funds from FST in the past few years. Therefore, the GNWT strongly supports another extension of the ITCE beyond 2005.

Claim Staking and Exploration Expenditures

Claim staking in the NWT in 2004 reached an eight-year high since 1997, probably due to the strong commodity market in general and the strong market for rough diamonds. **Figure 4** shows the trend of claim staking in the NWT since 1978. The record high in 1993 is attributable to the discovery of diamonds in the Lac de Gras area in 1991.



Exploration expenditures in the NWT in 2004 were $109.4 million, a twofold increase in the amount from 2003. Exploration expenditures have reached a six-year high since 1999 (see **Figure 5**). In 2005, companies intend to spend the same amount as in 2004. It is evident that diamonds are still the major factor attracting mining investment in the NWT. From 1999 to 2004, on average, 90% of the exploration funds were spent searching for diamonds.



British Columbia

The Ministry of Energy, Mines and Petroleum Resources (EMPR) supports a three-year extension to the ITCE proposed by the B.C. and Yukon Chamber of Mines (to December 31, 2008, with look-back provisions for expenditures in 2009). British Columbia supported program extensions in 2003 and 2004.

Rationale

Resurgent capital and minerals markets, the federal ITCE and British Columbia policies and programs (described in Attachment #2) have produced a strong recovery in B.C. mineral exploration expenditures:

Year	BC Mineral Exploration Expenditures (C$ millions)	Estimated BC METC and MFTS Tax Credits
1997	115.2	
1998	54.5	1.3
1999	41.3	3.1
2000	35.9	5.4
2001	29.1	5.7
2002	39.2	6.4
2003	62.5	8.7
2004	130.0 (prelim.)	Not Available
2005	150 - 200 (est.)	

However, British Columbia has not had a significant new grassroots discovery or major mine development decision and the sustainability of this recovery is of concern:

– Various economic indicators (e.g., weak G7 leading economic indicators, low GDP growth rates, weak money supply growth, unemployment rates, etc.) suggest that there is a significant risk of further weakness in the world economy; and
– Copper prices are particularly sensitive to economic conditions and several reputable forecasts postulate that copper prices have peaked and will decline to much lower levels by 2007. Copper is second only to coal in importance to the B.C. mining industry and a significant portion of B.C.'s mineral exploration programs target deposits with copper and other minerals (e.g., gold, molybdenum, poly-metallic, etc.).

The three-year ITCE extension would provide industry and investors with the confidence to fund the exploration necessary for a significant grassroots discovery to be made or support the exploration necessary to bring a major new metal mine to production.

The B.C. government will continue to provide a 20% tax credit for eligible flow-through-share-funded mineral exploration in British Columbia regardless of whether or not the federal ITCE program is extended:

– The B.C. Mining Flow-Through-Share tax credit program (BC MFTS) will be automatically extended if the ITCE is extended; and
– Grassroots mineral exploration will be automatically eligible for the B.C. Mining Exploration Tax Credit program if the ITCE is not extended.

However, since super-flow-through shares (combination of the federal ITCE and the BC MFTS) enjoy strong support by explorationists, investors and the financial community, the Ministry would prefer that the program be extended.

Saskatchewan

The ITCE and the Saskatchewan Mineral Exploration Tax Credit (SMETC) were initially put in place to spur exploration at a time when exploration spending and commodity prices were very low. Canada is now the world leader in mineral exploration, while expenditures and commodity prices have rebounded. These factors make it difficult to make a case for the extension of the ITCE or SMETC on the basis of the initial premises. Saskatchewan is currently enjoying record exploration levels, particularly with respect to uranium and diamonds, as Saskatchewan's potential to host world-class deposits is the main attraction for mineral exploration investment. The tax credit would be considered a bonus benefit to the investor; however, it is likely the investment would have been made on the basis of geological potential alone. Due to the cyclical nature of the industry, as well as market issues related to investor confidence, there is concern that programs such as the ITCE should only be in place during periods when the mineral industry cannot raise substantial funding for exploration.

The Province is currently reviewing its mineral exploration incentive programs, including the SMETC, to ensure they are effective in encouraging a diversified mineral sector in today's vibrant exploration climate.

Manitoba

Manitoba Position Concerning the Future of the METC and the ITCE

The ITCE was introduced as a temporary federal tax incentive in October 2000 to generate investment interest in a moribund Canadian minerals exploration sector. With the doubling of exploration expenditures and the almost fivefold increase in investment in flow-through-share financings since that time, it appears that the initial objectives of the program have been met.

Manitoba, with $1 billion in annual metal production, primarily from two vertically integrated base-metal facilities, believes that exploration levels now need to be maintained in an effort to replenish mineral resources that are constantly being exhausted and, in turn, to sustain local communities that are dependent on mining.

Manitoba's introduction of an exploration tax credit (METC) harmonized with the ITCE in 2002 demonstrated its recognition that additional exploration to extend ore reserves is the only long-term solution to sustaining the minerals industry in Manitoba. The present ITCE will expire at the end of 2005 and Manitoba fully supports an extension of the ITCE due to the declining metal reserves in the province and in Canada. Under the current legislative regime, extension of the federal ITCE will automatically result in the extension of the Manitoba METC.

If the federal credit is extended or reintroduced, Manitoba would consider the extension of the METC for possible announcement in the 2006 Budget.

Report on the METC

The Manitoba Mineral Exploration Tax Credit (METC) was announced in the provincial 2002 budget. The METC is a 10%, non-refundable personal income tax credit that is earned on eligible flow-through-share investments. While eligibility for the tax credit is harmonized with the federal ITCE, the incurred mineral exploration must be for a mineral resource located in Manitoba and the tax credit only applies against Manitoba income tax otherwise payable. Credits earned in a given year but unclaimed (due to an insufficient level of tax payable in that year) can be carried back 3 years and carried forward 10 years.

Canada Revenue Agency reports show that in 2002 almost $60 000 was claimed under the METC and approximately $350 000 was claimed in 2003. Translating these figures into estimates of investment by Manitobans in mineral exploration in an individual year is problematical due to the carry-back and carry-forward provisions of the credit.

Since introduction of the METC, Manitoba has seen a dramatic increase in off-site mineral exploration financed by flow-through shares, although not all shares qualify for the federal and Manitoba tax credits. In order to determine the impact of the METC, Manitoba has endeavoured to document flow-through-share financings and expenditures in the province principally via the review of company press releases and through dialogue with Manitoba explorers. In 2002, the year Manitoba introduced the credit, Manitoba estimates that just over $4 million, or 15%, of the almost $26 million spent on off-site mineral exploration was raised via flow-through-share financing for mineral exploration in the province. Natural Resources Canada estimates that over $30 million was spent on exploration in 2004 in Manitoba. Manitoba is aware of $19 million, or approximately 60% of total exploration expenditure estimates for 2004, that has been raised via flow-through-share financing for mineral exploration activity in the province. Manitoba estimates that just over $3 million of the $19 million (16%) raised via flow-through shares in 2004 will be eligible for the METC.

Although it is difficult to segregate the impact of the METC as a factor in increased grassroots exploration levels in the province, Manitoba believes that, along with strengthening commodity prices and increased investor interest in the junior sector, the METC has been a contributing factor. In addition, from discussions with Manitoba explorers, it appears that one effect of the METC has been to increase the ability of Manitoba-based junior exploration companies, or those companies with strong ties to Manitoba in terms of an investor base, to raise exploration funds locally.

Since the METC is harmonized with the federal ITCE, the present sunset date for the credit is January 1, 2006; flow-through shares must be acquired before that date although, under the look-back rule, eligible expenditures can be incurred under the end of 2006. Manitoba is presently reviewing the effectiveness of the credit and suitability of continuing an exploration tax credit tied to flow-through-share financings for mineral exploration in Manitoba.

Ontario

ITCE Wrap-Up

The federal ITCE program, together with the provincial focussed flow-through-share tax credit, has led to the highest levels of exploration activity since the previous flow-through-share program and this investment is generating economic activity in the remote regions of Ontario. The program helped Ontario out of the exploration downturn that occurred around 2000. There is a concern that if the ITCE program is terminated, exploration spending could drop significantly. The results from 2004 and the expected results from 2005 indicate that the program is very successful and the province will reap benefits well into the future as much of the data being captured in government databases will help in future exploration work.

Ontario is supportive of the flow-through tax credit programs for mineral exploration and will maintain the provincial program beyond 2005.

Flow-Through-Share Program in Ontario – IGWG Update 2005

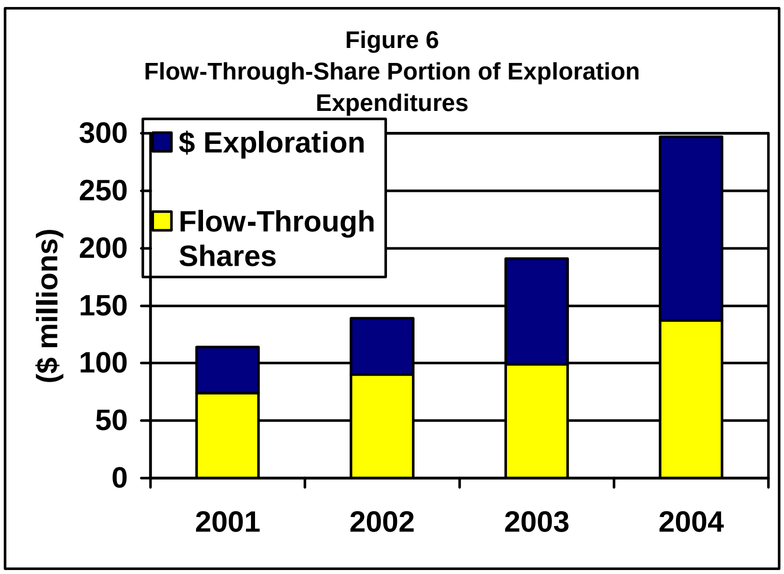


Figure 6
Flow-Through-Share Portion of Exploration Expenditures

Ontario exploration expenditures have climbed dramatically from $114 million in 2000 to more than $300 million in 2005. The amount of financing raised with flow-through shares for exploration has also risen from $19 million in 2000 to $137 million in 2004. In concert with other factors such as metal price increases and improved geological data, the flow-through-share program is playing a critical role in the dramatic increase in exploration expenditures. Its significance is also reflected in the increasingly important contribution of junior companies conducting exploration in Ontario. The percentage of total exploration expenditures by junior companies in Ontario has risen from 23% in 2000 to 39% in 2004. Another important trend is the increase in off-mine-site activity, which rose from $85 million in 2000 to $200 million in 2005. These trends reflect the increasing number of juniors issuing flow-through shares for general exploration.

	2000 (Oct.-Dec.)	2001	2002	2003	2004	2005
Ontario Total Exploration Expenditures						
Expenditures ($ millions of Current)	118	114	139	219	297	338
Percentage Change From Previous Year		-4	+22	+58	+36	+14
Ontario Flow-Through-Share Financing						
Value of Shares ($ millions)	19	48	72	99	137	

Sources: Natural Resources Canada; Ontario Ministry of Northern Development and Mines.

The first confirmed issue of super flow-through shares to be used for exploration in Ontario occurred in October 2000 and the value of flow-through shares issued in the last three months of 2000 reached $19 million. From 2001 to 2004, financing from flow-through shares increased from $48 million to $137 million. The number of companies issuing flow-through shares increased from 26 in 2000 to 67 in 2001, 94 in 2002, 104 in 2003, and 134 in 2004.

The average financing in 2004 exceeded $1 million, compared to about $800 000 in 2003, $578 000 in 2002 and $445 000 in 2001. Flow-through funds raised in 2004 are mainly being directed to exploration for gold near Timmins and Red Lake, diamonds in the Wawa and Temagami areas, and PGMs and nickel in Sudbury and Thunder Bay. A number of exploration projects funded under the flow-through-share programs have moved on to the advanced exploration stage.

The Ontario Ministry of Finance is reporting that about $3 million was claimed under the Ontario Focused Flow-Through Share tax credit program in 2003. However, the amount raised by exploration companies could not be confirmed from the taxation data. The $3 million is a rough estimate because the carry-back and carry-forward parts of the credit mean that the credit does not have to be claimed the same year in which the shares were issued.

Quebec

Preliminary data indicate that exploration and deposit appraisal expenditures in Quebec reached $204 million in 2004. This represents a rise of 52% since 2003 and a fourth consecutive annual increase. The stepped-up search for precious and base metals, as well as diamonds, accounts for this strong increase in spending in 2004.

Over 60% of exploration expenditures were incurred by junior companies, which are known to rely almost completely on the frequent issuance of shares to finance their activities. Flow-through money raised throughout the country is still an important component of mineral exploration funding. Funding that is not flow-through is strongly encouraged by the Quebec refundable tax credit for resources, a measure to which the government commits considerable sums.

The participation of funders supported by the public sector (Société d'investissement dans la diversification de l'exploration [SIDEX], Sodemex, Fonds de solidarité FTQ, etc.) must also be mentioned.

In 2004, 60% of the funding raised by larger Quebec junior exploration companies that are active exclusively (or almost exclusively) in that province was flow-through funding. The Quebec exploration industry is heavily dependent on the extension of the flow-through-share program. For this reason, in March 2004, Quebec's basic flow-through-share system was made permanent. Moreover, the Quebec government maintains a 150% deductibility for surface exploration investments.

Despite the significant increase in exploration expenditures, the overall state of reserves continues its declining trend. From 1995 to 2004, copper reserves were reduced by about 80% and zinc reserves by 60%. Gold and silver reserves fell by 55% and 30%, respectively. Given that years of effort are still required in order to reverse the downward trend in mine reserves and restore them to a sufficient level, Quebec considers that the Investment Tax Credit for Exploration in Canada (ITCE), an important feature of the flow-through-share regime, should be extended for at least three more years.

Yukon

Exploration Financed by Flow-Through Shares and the ITCE

In 2004, the Yukon made a commitment to extend the 25% Yukon Mineral Exploration Tax Credit (YMETC) to 2007. YMETC is a refundable corporate and personal income tax credit of 25% of eligible mineral exploration expenditures incurred by eligible individuals and corporations conducting off-mine-site exploration in the Yukon. Eligible mineral expenses within this program include:

- Prospecting;
- Geological, geophysical or geochemical surveys;
- Drilling by rotary, diamond, percussion or other methods; and/or
- Trenching, test pits, and preliminary sampling.

As the following table shows, the uptake of the tax credit has been virtually 100% of exploration expenditures since 2001, i.e., every dollar of expenditure has been refunded the 25% tax credit. Financial evidence and further confirmations in recent interviews with companies strongly suggest that junior exploration companies plan their activities in the Yukon with the tax credit in mind.

Yukon Mineral Exploration Tax Credit – Uptake 2001-2004

	Actual 2001	*Actual 2002*	*Actual 2003*	*Forecast 2004*
Personal Tax	86 374	113 278	50 564	200 000
Corporate Tax	1 863 830	1 533 421	3 150 397	5 300 000
Total YMETC	1 950 204	1 646 699	3 200 961	5 500 000
Estimated Eligible Exploration Expenditures	8 042 077	6 586 796	12 803 844	22 000 000
Actual Exploration Expenditures	7 400 000	7 600 000	12 500 000	22 000 000

Source: Yukon Mineral Development Branch, using data provided by the Canada Revenue Agency.

The data also conclude that resident Yukoners only account for 6-8% of investment in mining exploration over the past four years. The balance has come from outside of the territory. Recent studies clearly indicate that this outside investment is linked to the ability of companies to raise flow-through financing and, therefore, the continuation of ITCE funding from the federal government is critical to mining investment in the Yukon.

The YMETC program is not designed to harmonize with the federal government's ITCE program to attract mineral exploration investment in the Yukon due to the limited investment market available to companies resident within the territory. Further, the territorial tax base in the Yukon is too small to generate a significant amount of investment. In fact, with current levels of exploration investment approaching an estimated $40 million in 2005, the YMETC is approaching the estimated total corporate tax base of $10 million. This further suggests that the Yukon is at or near its maximum point in its ability to provide a tax incentive to the mining sector in relationship to the overall current territorial corporate tax base.

The Yukon also provides other incentives to stimulate mineral exploration. The Yukon Mineral Incentives Program (YMIP) is designed to promote and enhance mineral prospecting exploration and development activities in the Yukon. The program's function is to provide a portion of the risk capital required to locate and explore mineral deposits.

The YMIP contains three modules:

1. Grassroots – Prospecting:
   Qualified prospectors may apply for a contribution of up to $10 000 per year to cover basic operation expenses while searching for new mineral occurrences in the Yukon. 100% of approved expenses are reimbursed.

2. Grassroots – Grubstake:
   Companies or individuals providing prospectors with a grubstake (basic operating expenses while searching for new mineral discoveries in the Yukon) may apply for a contribution up to $10 000 per person, per year. Seventy-five percent (75%) of approved expenses are reimbursed.

3. Focused – Regional:
Individuals, partnerships, or junior companies undertaking basic exploration work directed at appraising the potential of an under-evaluated occurrence or target may apply for a contribution up to $20 000 per year. The intent of this funding is to allow prospectors to evaluate new occurrences following discovery and to prepare them for option for sale. Fifty percent (50%) of approved expenses are reimbursed.

The Yukon provides a significant yearly investment into YMIP to support exploration investment and stimulate grassroots activities by prospectors. From a return on investment perspective, this program has been very positive for the Yukon.

The net effectiveness of the ITCE on exploration expenditures in the Yukon has not been estimated and is complicated to estimate. But, from personal interviews, and in a recent independent study on tax incentives conducted by the Yukon, industry continues to stress the extreme importance of continuation of the ITCE program by the federal government. It is clear to the Yukon that the ITCE plays an important role and has had a positive impact on its mining industry and continues to contribute to the rejuvenation of the hard-rock mining sector in the territory. As a significant portion of current exploration activity is spent on exploration for base metals, the Yukon believes that the ITCE program is serving to contribute to dealing with the problem of declining base-metal reserves in Canada.

Therefore, the Yukon strongly supports a three-year extension to the ITCE proposed by the PDAC, MAC, the B.C. and Yukon Chamber of Mines, and the Yukon Chamber of Mines (to December 31, 2008, with look-back provisions for expenditures in 2009). In the Yukon's view, a minimum period of a three-year extension of the ITCE is required to provide industry and investors with the confidence to fund the exploration necessary to advance known base-metal discoveries and stimulate potential new grassroots discoveries. The mining industry in the Yukon is just starting to rebound and the ITCE is an essential component to maintain exploration levels and provide the necessary support to the exploration sector to bring major metal mines into production in the Yukon.

Industry Proposal to Extend the ITCE

In its brief to the Mines Ministers' Conference 2005, the Prospectors and Developers Association of Canada (PDAC) recommends that mines ministers work together to adopt an effective strategy that will enable this country and its rural, northern and Aboriginal communities to derive the fullest economic benefits possible from its mineral endowment. According to the PDAC, the strategy will need to stimulate both grassroots exploration to find new reserves and "brownfields" exploration to extend known deposits or find new ones in the vicinity of existing mines and communities. In order to achieve these objectives, the PDAC believes that the strategy will need to include two fundamental components: 1) exploration incentives for the near term; and 2) geoscience initiatives for the longer term.

Specifically, the PDAC is recommending the extension of the Investment Tax Credit for Exploration as a means to maintain strong levels of exploration investment in Canada and to replenish reserves for the range of mineral commodities required. The PDAC is asking that the ITCE be extended in a series of rolling three-year phases, supplemented with annual reviews of the program's benefits.

The PDAC believes that the ITCE was highly successful in its objectives, serving as a temporary measure that enabled Canadian exploration companies to raise money to finance their exploration activities during a very severe stock market downturn. Indeed, it acted as a lifeline for many companies.

The PDAC believes that Canada now faces a different set of conditions and challenges that necessitates the continuation of the ITCE program by the federal government.

These conditions and challenges include: Canada's serious decline in reserves, particularly base metals; an almost unprecedented global demand by emerging markets for this country's mineral commodities over the next two to three decades; and the lack of discoveries and reserves that resulted from the severe downturn in exploration investment in Canada from 1997 to 2002.

The PDAC argues that the ITCE program is ideally suited to address these challenges for the following reasons:

- The program keeps exploration investment in Canada, thereby increasing the possibility of new discoveries of mineral deposits.
- It has a positive impact, particularly in northern and rural regions of the country. This northern economic activity is especially important for Aboriginal peoples who are participating more and more in the mining industry, both in terms of employment, holding interests in successful projects, and supplying goods and services.
- The program focuses particularly on the junior exploration sector, the foundation of the exploration industry. This is an important consideration because major companies are tending to explore outside Canada in their search for large ore deposits.
- The program covers the full range of commodities. Canada stands to benefit from any discovery, but will derive particular advantages from the discovery of base metals.
- Given that the reserves of a range of commodities need to be replenished, the ITCE program is ideally suited for the task.
- The effectiveness of the program is already known and has been demonstrated. It is also an efficient program that offers considerable advantages at a relatively low cost. The 2004 federal budget, for example, included an estimate of $10 million as the reduction in tax revenues associated with a one-year extension of the ITCE.

Stimulating Exploration for Base Metals

Statement of Issue

Canada's reserves of base metals have been declining for more than 20 years. The most recent available data (December 31, 2003) show that, since 1980, Canada's reserves of copper, nickel, lead, zinc and molybdenum are declining more or less steadily at annual rates varying between 5% and 18%. This phenomenon transcends commodity price cycles and appears impervious to substantive government efforts to revitalize mineral exploration by way of tax-based exploration incentives. Unless this trend is stopped or reversed, base-metal production and related employment will continue to decline.

In particular, this situation is causing a direct threat to the long-term (even medium-term) viability of many base-metal smelters, most of which were built inland to service local and regional mines. As these smelters become increasingly reliant upon imported sources of raw materials and recyclables to maintain metal production, the resulting increases in transportation costs become a heavy burden that thwarts efforts to achieve the productivity gains that are needed to remain competitive.

When such operations cease, the consequences on the local population and regional economy can be extensive. Several remote communities depend on mining and metal smelting as a principal source of economic activity.

The decline in reserves occurred because the rate of discovery of new ore reserves has not kept up with the rate of depletion both by production of current reserves and by reclassification of current reserves into non-economic resources. The reasons as to why the rate of discovery failed to match the rate of depletion could relate to insufficient exploration and/or unproductive exploration. It is beyond the mandate of the working group to identify the exact causes and circumstances of insufficient or unproductive exploration. However, the question as to whether enhanced tax-based exploration incentives have helped solve the declining reserves problem while they were in place is quite relevant in the context of current industry wants. This is because industry is asking for an extension of the ITCE beyond its scheduled termination date of December 31, 2005, as a necessary (if not sufficient) component of a strategy to bring base-metal reserves back to levels that will ensure the long-term viability of mining-dependent communities.

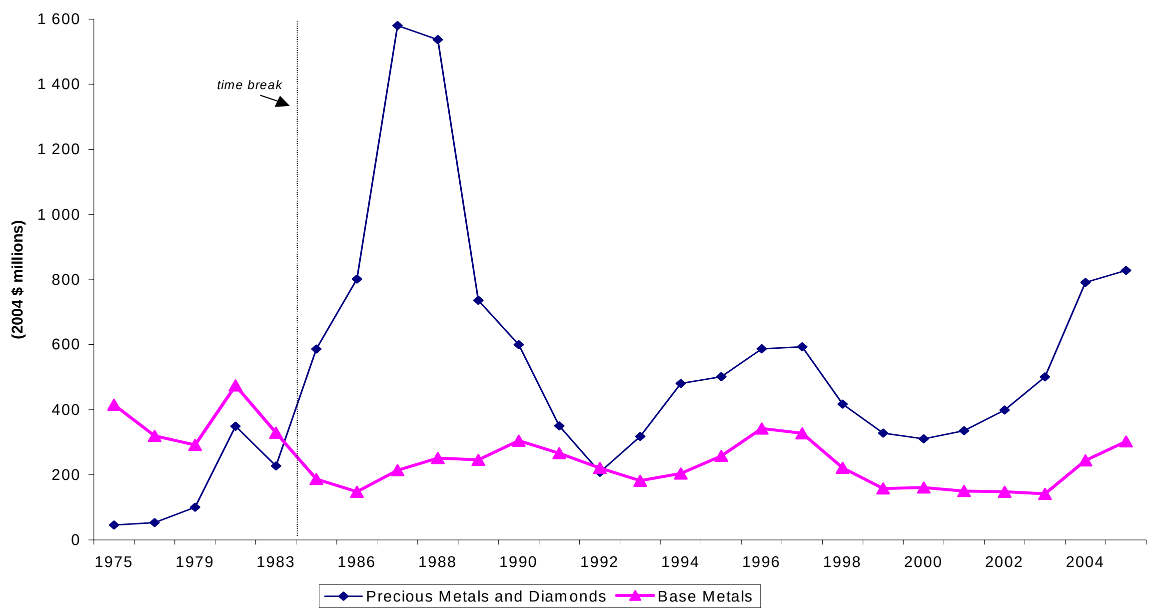
Industry Proposal for Extending the ITCE

Historically, since 1980, enhanced flow-through-share (FTS) tax incentives for exploration have been in place in two distinct periods: from 1983 to the end of February 1990 (first in the form of the Mining Exploration Depletion Allowance, then superseded by the Canada Exploration Incentive Program), and from the end of 2000 to the end of 2005 (in the form of the ITCE and its provincial counterparts).

Based on Canada's experience with FTS incentives, is there evidence, generally speaking, that such incentives have helped replenishing base-metal reserves?

In answering this question, one has to keep in mind that exploration spending does not necessarily produce immediate effects on ore reserves. There is normally a time lag of several years between initial discoveries and firmed-up ore reserves. This time lag can vary. To avoid this problem, the working group undertook the simpler task of determining if levels of exploration spending for base metals have fared significantly better with, than without, special FTS incentives during the period of investigation.

Figure 7
Exploration and Deposit Appraisal Expenditures in Canada, by Commodity Sought
(Constant 2004 dollars)



Source: Natural Resources Canada, based on the Survey of Mineral Exploration, Deposit Appraisal and Mine Complex Development Expenditures.

Figure 7 shows the evolution of exploration spending for base metals and for precious metals and diamonds during the 1975 to 2005 period. A careful analysis of these trends has revealed the following facts:

- Since the value of base-metal production in Canada vastly exceeds the value of precious metal and diamond production, one would expect that, in order to sustain a larger production base and replenish reserves, more efforts and financial resources would need to be directed at exploring for base metals than for precious metals and diamonds. However, this has not been the case since 1985 when exploration spending for precious metals and diamonds exceeded exploration spending for base metals for the first time. This situation has prevailed both with and without exploration incentives in place.
- From 1975 to 1983, exploration spending for base metals routinely exceeded $300 million per year in real dollar terms. But from 1985 to 2005, exploration

spending for base metals has exceeded (and just barely so) $300 million only in four years (1990, 1996, 1997 and, tentatively, 2005).

– Four of the five top exploration years for base metals occurred when no extra incentives were provided for FTS. In contrast, all five best exploration years for precious metals and diamonds occurred when exploration incentives were in place.
– When exploration incentives were in place, exploration expenses for precious metals and diamonds have been 90% *higher* than in the absence of such incentives. In contrast, during periods when exploration incentives were in place, exploration expenses for base metals have been 18% *lower* than in periods of no incentives.

Based on this evidence, it appears that exploration spending for precious metals and diamonds in Canada has been far more responsive to tax incentives than exploration spending for base metals. Several factors are at play to explain these results. Firstly, FTS incentives appeal and are directed to junior exploration companies that have been traditionally searching principally for precious metals and diamonds. Junior exploration companies also obtain their financing principally from individual investors who are traditionally more attracted to precious metals and diamonds than to base metals. In addition, the capital costs of developing a base-metal mine in Canada are generally far greater than for a gold mine. They are consequently more difficult for a junior company to finance. Finally, the economic fundamentals of the two markets may be significantly different, the precious metal market being the most speculative in nature (therefore appealing more to FTS investors). In contrast, the base-metal market appears to be the most affected by a secular downward trend in real prices.

There may be some recent signs of a change in the exploration strategies of senior companies that see junior companies more involved in base-metal exploration. A few junior companies have entered into option agreements with senior companies wherein the junior partner will earn a significant interest in a senior company property in exchange for the junior company contributing the exploration funds (e.g., Noranda Inc.-Slam Exploration Ltd.-Government of New Brunswick in the Bathurst area, Noranda Inc.-Alexis Minerals Corp. in the Rouyn-Noranda area, Falconbridge-First Nickel in northeastern Ontario, and INCO Ltd.-FNX Mining Company Inc. in the Sudbury area). The driving force of such deals appears to be the ability of junior companies to secure exploration funds at more advantageous terms than senior companies because of their access to FTS tax incentives. It remains to be seen how such alliances develop.

This recent development notwithstanding, historical evidence does not provide a solid case for extending the ITCE <u>if the rationale for an extension of the program is to stimulate exploration for base metals</u>. Because the ITCE applies to all metals, diamonds, and certain industrial minerals at the same rate, its extension would likely stimulate mainly exploration spending for precious metals and diamonds. Unless there are fundamental changes in the economics of base-metal markets, or unless other measures are introduced that change the relative attractiveness of exploration investment in favour of base metals, Canadian base-metal reserves will likely continue to decline.

A New Proposal for Deep Drilling Incentives

Most of the mines in Canada were found by the discovery of mineralization at surface, or close to surface, which was then followed down to depths of 1000 metres or so. It is widely acknowledged that substantial potential for new base-metal discoveries exists (particularly in the vicinity of existing mines), but are buried at depths greater than usually probed by traditional exploration techniques.

New geophysical techniques are now able to yield information about the rock properties below 300 metres, and diamond drilling can produce cored samples of the rocks down to a depth of 2000 metres or more. However, these techniques are expensive. Diamond drilling to depths of less than 300 metres may cost as little as $75 per metre, whereas diamond drilling to a depth of 1500 or 2000 metres could be in the order of $250 or more per metre. Few companies can afford to drill many holes to these great depths, and those that can are discouraged by the high risk of failure because of the lack of knowledge of the geological conditions at these depths.

In recognition of the need for new avenues to stimulate base-metal exploration, the Canadian Mining Industry Federation and the Prospectors and Developers Association of Canada, in their brief to the Mines Ministers' Conference 2005, are recommending the introduction of a non-refundable 20% deep drilling investment tax credit applicable against corporate income taxes payable by the taxpayer. This new tax credit could apply to exploratory drilling carried out below 300 metres with the objective of discovering deep ore deposits or extending the reserve life of existing mines at depth. For this particular category of expenses, it is understood that this new credit would replace the existing 10% federal corporate income tax credit that has been available (at increasing phase-in rates) to mine operators since 2003 for all mineral exploration and mine development expenses incurred in Canada. Presumably, this tax credit would not be transferable to outside investors by way of flow-through shares. A change to the definition of CEE would be required to allow deep drilling from existing mine workings to be eligible for the proposed tax credit.

While posing some administrative challenges (notably, the definition of fair and workable criteria for inclusion into a new category of expenses), this proposed approach has the merit of being directly relevant to the base-metal reserve issue and warrants careful review.

Provincial/Territorial Views

Saskatchewan

Saskatchewan recognizes the concern of Canada's declining base-metal reserves and is interested in increasing exploration in the province's undeveloped, high mineral potential areas. The Province is currently developing a revised exploration strategy to encourage a more diversified mineral exploration and production sector, specifically base metals and gold.

The Province, however, does not recommend a commodity-targeted tax credit as an option to achieve these goals. This type of program would likely be difficult to administer and there are many instances where a company exploring for one mineral commodity has found another. The Province is investigating a program that includes supporting additional geoscience activity (regional geochemical and airborne surveys, mapping crews) in favourable base-metal terrains as a more effective way to spur exploration for base metals.

Ontario

The decline in base-metal reserves is a problem in Ontario as it is elsewhere in Canada, and Ontario smelters and refineries are short of feed from within the province. Exploration expenditures for base metals in Ontario have climbed from $26 million (19%) in 2002 to an estimated $68 million (21%) in 2005. The increase in exploration for base metals is largely the result of the flow-through-share program and increasing metal prices. This has also led to expansion at base-metal mines in the Sudbury area and to the discovery of new prospects such as the McFaulds Lake project in the James Bay lowlands.

Other initiatives can be undertaken that benefit base-metal operations. The Northern Ontario Heritage Fund is investing $3.5 million in the **Deep Mining Capability Research,** a project that is conducting research into deep mining capabilities to address the challenges of mining below 2000 metres – particularly for base-metal mines. The consortium is made up of private, public and academic partners. Another possibility for assisting base-metal exploration is to orient geological survey mapping projects for areas with potential for base-metal deposits.

Quebec

The fact that the current rate of discovery is well below that needed to ensure renewal of known reserves of base and precious metals leads the province to look for complementary measures that would be supportive of a suggested three-year extension of the ITCE and the permanent provincial income tax incentives related to flow-through shares. In that connection, the Province strongly supports a specific revision of the Canadian Exploration Expenses (CEE) definition.

In Quebec, in addition to significant tax advantages associated with CEE for mining companies throughout the country, mining companies that have eligible CEE in Quebec can take advantage of the Tax Credit for Resources. This tax credit is a direct assistance mechanism, part of which is refundable (35% of the costs incurred by companies that are not mining a mineral resource and 15% of the costs incurred by companies engaged in mining) and part of which is non-refundable (companies engaged in mining in the province can deduct an additional maximum of 30%, which may be applied against their income tax and corporations capital tax). Therefore, certain revisions of the definition of the CEE could have a significant impact on exploration activities.

Exploration undertaken from within the infrastructure of a producing mine is not considered CEE, whether the purpose is to search for the extension of mineralized zones currently being mined or to discover new mineralized zones that are distinct and separate from the resources being mined, although operators have often made the case that exploration effort to extend the reserve base involves searching for "unknown" resources and such exploration may be undertaken from within the area of a current mine. This work incurs costs that may never be recouped from future production.

Mineral potential in mature mining regions is located at increasing depths, and mines therefore offer a unique and favourable access to exploration and discovery of new mineral resources at depth. Under the current definition of CEE, income tax treatment of exploration in the vicinity of mines from existing mining infrastructure is less advantageous to industry than surface work in particular. Income tax treatment does not distinguish between exploration to search for the extension of known mineralized zones and exploration to uncover new mineralized zones located at great distances from existing mines and at great depths.

To encourage exploration and new discoveries at depth in the vicinity of existing mines, Quebec considers that the definition of CEE should be revised to ensure the eligibility of exploration work undertaken from existing mining infrastructure if it is located:

– outside the area covered by a mining claim;
– inside the area covered by a mining claim, but in a new zone or lithology, or a structure that is separate and distinct from that of the zone of mineralization currently being mined and that does not constitute an extension of that zone; or
– at a significant distance away from mineralization zones currently being mined.

Yukon

A New Proposal for Deep Drilling Incentives

The Yukon recognizes the concern of Canada's declining base-metal reserves and is interested in ensuring that the industry continues to have the ability to invest in exploration of undeveloped, high-mineral-potential areas.

Mineral exploration is rebounding in the Yukon. All of the 82 known major mineral deposits are base-metal discoveries, and industry has shown a renewed interest in advancing exploration of these properties to increase known reserves and to advance pre-feasibility efforts. Exploration levels have been steadily improving since 2002. Exploration expenditures have increased from a low of $6.5 million in 2002 to an estimated $40 million for 2005, and it is forecasted that similar or higher levels of exploration activity will be occurring in 2006.

Currently, within the Yukon, there are four companies indicating intent to advance base-metal deposits to the development stage in the short to medium term.

Development expenditures have increased from zero in 2004 to an estimated \$13-\$15 million in 2005, and it is expected that these will increase significantly in 2006 with potential development work at the Minto (Sherwood Mining Corp./Minto Explorations Inc.), Wolverine (Yukon Zinc Corp.), Red Mountain (Tintina Mines Ltd.) and Carmacks Copper (Western Silver Corp.) projects.

Of concern is that the Yukon landscape remains relatively unexplored despite increased exploration spending. Overall, only 2.5% of the Yukon is currently staked for hard-rock mine exploration and placer activity, with hard-rock exploration consistently accounting for approximately 85-90% of overall claims activity. Claims in good standing for hard-rock mine exploration have decreased by 24.3% from 61 882 to 49 772 claims, with a total area decrease from 1 299 522 to 1 045 210 hectares. To a lesser extent, the Yukon has also experienced a decrease of 3.8% in claims in good standing for the placer sector, with 16 054 claims in good standing covering 149 141 hectares in 2004.

Junior exploration companies conduct over 90% of exploration activity in the Yukon. With rising commodity prices and an improved ability to raise financing, the juniors have increased exploration activity for base metals. The Yukon is a prime target for base-metal deposits, but continued activity remains highly dependent on the ability of these companies to continue to attract investment. As previously noted, this is highly dependent upon the continuation of the federal ITCE program.

Other suggestions for incentives have included the introduction of a non-refundable 20% deep drilling investment tax credit applicable against corporate income taxes payable by the taxpayer. Even though any incentive improves Canadian competitiveness, current exploration drilling efforts in the Yukon are mainly focusing on expanding reserves of known deposits by drilling relatively shallow targets. Therefore, in the Yukon, a tax credit stimulating deep drilling would not serve to stimulate a significant increase in exploration drilling for base metals. The continuation of the 10% federal corporate income tax credit for all mineral exploration and mine development expenses continues to be better suited in “frontier” terrains as is the case in the Yukon, where mine development continues to be based mainly on near-surface deposits. Therefore, recognizing the need for incentives to be applied to stimulate deep drilling in more mature exploration regions within Canada, the Yukon would prefer that jurisdictions be given an opportunity to select which tax credit would be most suitable to their needs.

Finally, the Yukon emphasizes the fact that tax incentives alone will not bring along a reversal of the base-metal reserve decline. None of the 82 major known mineral deposits in the Yukon contribute to the national reserve base since these reserves are not considered as economic deposits. Even though feasibility efforts are under way in several major projects, tax incentives alone will not change this situation in northern remote areas. Key to project economics in north-of-60 jurisdictions such as the Yukon is improvement to infrastructure, such as the provision of access roads to mine sites, reasonable energy costs, and port access to international markets.

Recent studies conducted by the Yukon concluded that industry would prefer governments to help provide infrastructure, which would serve to improve project economics and help advance projects to move towards feasibility and eventual development. Furthermore, many of the identified major deposits are located at significant distances from existing road networks, and port options are extremely limited. Thus, many potential projects will continue to remain undeveloped until infrastructure is put in place that provides the required access through either the construction of improved road networks, railway development, or expansion of port facilities. The Yukon has a limited ability to finance the required infrastructure and will require Canada's support in infrastructure improvements in order to advance the development of known major base-metal deposits, some of which are world-class in nature.

Summary and Conclusion

Although it is recognized that tax incentives alone will not bring about a reversal of the longstanding base-metal reserve decline, both industry and the provinces/territories believe that there is a positive role that taxation can play to address the issue. The Prospectors and Developers Association of Canada and provinces indicate that the preferred way to increase exploration for base metals is to facilitate the exploration of base-metal camps by junior mining companies. In their views, this can be achieved tax-wise in two main ways:

- by further extending the ITCE; and
- by allowing exploration close to existing mines to be CEE eligible, thereby enabling them to be financed by flow-through shares.

However, based on the historical record, analysis suggests that extending the ITCE would mainly benefit gold and diamond exploration. Unless fundamental economic trends change or unless other measures are introduced to increase the attractiveness of base-metal exploration, base-metal reserves will likely continue to decline.

Industry associations also believe that junior exploration companies and producing companies would be encouraged in finding new base-metal reserves if the high risk of deep drilling was recognized by more generous tax incentives for drilling to depths of 300 metres or more in all areas, including in the vicinity of existing mines. This is where it is widely believed that new base-metal reserves are most likely to be found in the near future. The working group is of the opinion that this proposal warrants further investigation.

The Yukon noted that the provision of new infrastructure would improve the project economics for existing, identified, base-metal deposits that remain undeveloped. Improved road networks, railway development and expansion of port facilities would help advance projects towards greater feasibility and mine development.

Reviewing the Definition of Canadian Exploration Expenses

Background and Update

In September 2004, officials from Finance Canada, the Canada Revenue Agency (CRA) and NRCan held technical discussions with industry representatives on issues related to the definition of Canadian Exploration Expenses (CEE). Progress has been made in clarifying current administrative practices, to further define the nature of industry concerns, and to articulate industry requests.

Industry Priorities

In light of those discussions and on the basis of the latest industry submissions, a short restatement of industry issues follows, by category of costs:

1. **Extension of ore reserves on existing mine property**
   Industry is asking for CEE tax treatment for exploration expenses that are incurred for the purposes of extending reserves at existing mining properties.

   The rationale for this request is twofold:

   - This type of expense is no different in nature than exploration expenses incurred outside the boundaries of existing mines; and
   - It would provide additional incentives (tax credits) and a new source of financing (flow-through shares) to look for base-metal deposits in the vicinity of existing mines.

   Currently, unless it can be demonstrated that on-site exploration expenses cannot be related to an actual or potential extension of an existing mine, such expenses are treated either as a Canadian Development Expense (CDE) or operating expenses, depending on the circumstances and details of expenses. The policy rationale for the current tax treatment is that mining operators will naturally seek to find additional reserves to extend the life of existing assets, even without additional incentive. Also, the existence of infrastructure, underground workings and facilities that can be used in support of the exploration program may confer a cost advantage to on-property exploration relative to grassroots exploration.

   There may be circumstances, however, where on-property exploration may be as costly and risky as grassroots exploration. This is notably the case when exploration targets are a long distance away from existing workings or at great depth. The Mining Association of Canada is proposing that exploration expenses be treated as CEE if they meet certain (still undetermined) criteria of distance from existing workings. The Prospectors and Developers Association of Canada is proposing that reclassification of on-property exploration into CEE be restricted to exploration programs seeking extension of base-metal reserves, in addition to applying certain distance criteria.

2. **Feasibility studies**
   As income tax rules are currently administered, certain costs incurred in the preparation of feasibility studies are deductible as CEE while certain others are deductible as operating expenses or as capital expenditures, as the case may be. Costs incurred to determine the location, extent and physical/chemical characteristics of minerals are normally deductible as CEE, but costs related to the financing, transportation and marketing arrangements of an eventual mining project are typically deducted as operating expenses.

   Industry argues that such costs are necessary to evaluate whether the mineral resources under evaluation constitute economically exploitable ore reserves or not, and is therefore requesting that all costs relating to feasibility studies be deductible as CEE. At issue is what is meant by the expression "expenditure incurred to determine . . . the quality of a mineral resource," which is part of the income tax definition of a CEE. Feasibility study costs constitute a major component (9%) of exploration budgets.

3. **Aboriginal and community consultations**
   Industry is concerned that, under current tax rules, there is uncertainty about the income tax status of Aboriginal and community consultation costs. Discussions with industry have revealed that such costs are probably deductible as CEE if they are undertaken in the course of carrying out an exploration program.

   So far, it does not appear that consultation costs have given rise to disputes between taxpayers and the tax administration authorities. Nevertheless, industry remains concerned that such disputes may arise in the future due to the emergence of consultation costs as a significant element of exploration costs.

4. **Environmental baseline studies**
   Environmental baseline studies are undertaken to provide baseline data against which changes in the environment arising from the exploration activity are measured. Since they are not usually required under the exploration permit and they do not specifically meet the purpose test for CEE, such studies are not normally deductible as CEE. Industry is requesting that environmental baseline studies be treated as CEE since they are an integral part of any exploration program and are incurred in accordance to industry best practices, which should be encouraged by governments.

5. **Environmental impact assessments**
   In recent years, environmental impact assessments have caught the attention of tax administration authorities because of the emerging importance of their costs, notably in the case of the large nickel and diamond projects developed in northern regions. The National Diamond Strategy is recommending that environmental impact assessment costs incurred in the course of exploring for minerals or bringing a mine into production be treated as CEE for income tax purposes.

   Currently, environmental impact assessment costs may be treated as CEE if incurred *for the purpose of* exploring for a mineral deposit or bringing a new mine into production. These costs meet the purpose test for CEE if, particularly, they are incurred in the course of the mine development phase as a condition for maintaining a mining licence in good standing. However, some provincial regulations may require environmental impact assessment as a prerequisite for obtaining a mining licence, in which case the associated cost would be treated less favourably as CDE. At issue, therefore, is the possibility of obtaining two different income tax classifications for the same type of expenses, depending on how the particular provincial mining regulations are structured.

6. **Capital assets used in exploration**
   Industry wants to clarify that certain tangible property attached to or permanently embedded in a mine be classified as CEE instead of depreciable assets. To some extent, tax administration authorities, in certain circumstances, effectively accord such tax treatment after verification of facts. The CRA requested that mining associations provide a list of specific tangible properties for consideration as to their inclusion as CEE. The Mining Association of Canada provided a list at the end of December 2004.

Provincial/Territorial Views

British Columbia

Position

As in 2003 and 2004, the Ministry of Energy, Mines and Petroleum Resources (EMPR) supports the further review and analysis of the implications of policies that:

- Classify expenditures for consultations and environmental studies undertaken until the completion of pre-production development as CEE;
- Allow for the renunciation of those expenditures under FTS agreements;
- Allow for those consultation and environmental expenditures that are FTS financed to also be eligible for the federal ITCE; and, as an alternative,
- Amend an existing tax category, or create a new tax category, to provide appropriate tax recognition for environmental baseline studies and community and First Nation consultations.

Rationale

The following is further to the analysis and discussion that was prepared by British Columbia on:

- Pages 23 and 24 of the report "Taxation Issues for the Mining Industry: 2004 Update" for the 2004 Mines Ministers' Conference; and
- Pages 35 to 37 of the report "Taxation Issues Relating to Exploration and the Restructuring of Resource Taxation" for the 2003 Mines Ministers' Conference.

Environmental study and community and Aboriginal consultation practices, requirements and costs continue to evolve in response to court decisions, industry and government initiatives, and community expectations. Recent British Columbia developments include the Supreme Court's November 2004 decisions on the Taku River Tlingit and Haida appeals, which provide further guidance on the consultation and accommodation responsibilities of the Province, industry and First Nations. Among the key results of those decisions are that consultation and accommodation should reflect the strength of the First Nation interest, that accommodation does not necessarily entail a First Nation veto on resource development, and the consultation and accommodation undertaken for the Tulsequah Chief project was sufficient.

The B.C. & Yukon Chamber of Mines released the first draft of its "Mining and Aboriginal Community Engagement: A Guidebook for Minerals Exploration and Mining" publication (ACE Guidebook) in January 2005. The Guidebook has been well received by the B.C. mining industry and other industries and non-government organizations in British Columbia, Canada and the rest of the world.

British Columbia continues to work on the development of a consistent set of policies for the tax treatment of consultation expenditures by its resource industries. Progress is slowed by the complexity of the issues and their possible implications for other industries such as forestry, tourism, and oil and gas.

Saskatchewan

The Department of Industry and Resources supports the modernization of the definition of CEE, recognizing that costs such as environmental baseline studies and community and Aboriginal consultations are occurring prior to development and have become a significant obligation to the industry. The Department is reviewing the proposed changes to a modernized definition and will continue to consult with industry and the Department of Finance to determine areas of preference.

Ontario

With respect to the mining industry's recommendations for changes to the CEE, Ontario notes that there is an increase in the number of companies conducting community consultation and it is becoming an important part of the cost of doing business. Travel for community consultation to the more remote regions of the province is particularly expensive.

Quebec

In addition to exploration expenses incurred in the vicinity of existing mines, other types of expenses are also being put forward by the industry to be recognized as CEE, including expenses incurred in consulting communities and Aboriginals, as well as expenses incurred in basic environmental impact studies.

Companies involved in exploration activities in Quebec are strongly encouraged to maintain relations with Aboriginal and other communities living in or using the regions they are exploring, whether or not they have any recognized rights in the area in question. To acknowledge the communities' needs and their participation in the economic and social spin-offs of the project, such consultations should take place throughout the *exploration/appraisal/development* process in order to ensure that community members are well informed about what the company is doing and to prepare them for the activities that could lead to the establishment of a mine. Costs incurred in touring communities, guided visits, rental of meeting rooms, travel, legal advice, translation, etc., can amount to considerable sums, which are actually part of the costs of exploration.

In a context in which costs tend to rise over time, Quebec favours classifying as CEE a set of reasonable types of expenditures commonly incurred in consulting Aboriginal and other communities.

Finally, with regard to basic environmental impact studies, regulations governing the quality of the environment provide that no one may carry out an activity if it seems likely that this will result in a change in the quality of the environment without first obtaining from the minister a certificate of authorization. Companies wishing to engage in exploration activities at a site must often sample and analyze water, soil, vegetation and wildlife, and then produce the required expert report.

Quebec therefore favours recognizing as CEE all categories of expenditures normally incurred in conducting a basic study of the environmental impacts of an exploration project.

Yukon

Reviewing the Definition of Canadian Exploration Expenses

As in 2004, the Yukon supports that changes be made to the definition of eligible Canadian Exploration Expenses (CEE) to reflect modern-day demands on exploration and mining companies. In particular, the Yukon would like to see clarification on the eligibility of Aboriginal and community consultations within CEE. The Yukon would also support that costs incurred by the mining sector for feasibility studies, environmental baseline studies, and environmental impact assessment be included within CEE.

In the Yukon, mining companies incur significant costs in conducting Aboriginal and community consultation. Companies involved in exploration activities in the Yukon are strongly encouraged to maintain relations with First Nations governments and communities living in or using the regions they are exploring or proposing to develop, whether or not they have any recognized rights in the area in question. Furthermore, to enhance an awareness and understanding of mineral industry activities, companies often initiate consultations in the early stages of exploration and then continue them through to the development phase, throughout the mine life, and also throughout mine closure. In most instances, companies may now be engaged in consultation for over 20 years to support even shorter mine-life projects and, for major projects, these types of costs can be incurred for much longer periods of time. Furthermore, effective communication and consultation processes can clearly help to facilitate project-permitting processes as they assist to establish community and First Nations government support for mine projects. Even though disputes on these costs have not occurred between taxpayers and taxation authorities, it is desirable to have certainty on the eligibility of these costs for CEE.

Northern regions are characterized with pristine landscapes and one of the last relatively undisturbed frontiers within Canada. The mining industry has significantly improved its reputation to support and implement responsible development in such regions. This has increased costs for the industry, particularly with respect to conducting environmental baseline studies and proceeding through environmental impact assessment processes. These activities are clearly an integral part of mine development in the 21st century, and applying these activities to the CEE definition will clearly assist the industry in supporting the additional costs resulting from the adoption of best management and responsible development practices.

Furthermore, in jurisdictions such as the Yukon, the emergence of junior companies as financiers for mine development further emphasizes the need for feasibility study costs to be recognized within the CEE definition as a necessary cost these firms have to incur to evaluate projects. Information requirements by financial exchanges, investors, and the financial sector as a whole have increased significantly over the past decade. Limited financial and human resources stresses the ability of junior companies to prepare comprehensive feasibility assessments of projects that will meet the scrutiny of the financial sector. It is therefore important that feasibility study costs be included within the CEE definition.

Finally, the Yukon supports the industry request to have clarification that certain tangible property attached to, or permanently embedded in, a mine be classified as CEE instead of depreciable assets.

RESTRUCTURING CORPORATE INCOME TAX PROVISIONS FOR THE RESOURCE INDUSTRIES

Background

On November 3, 2003, Royal Assent was given to *An Act to Amend the Income Tax Act (Natural Resources)* ("Bill C-48"). Bill C-48 implemented a series of improvements to the income taxation of resource income announced in the 2003 budget. It reduced the corporate income tax rate applicable to resource income from 28% to the general corporate rate of 21%. The reduction in the tax rate is being phased in over a five-year period ending in 2007. Bill C-48 also phases out the resource allowance deduction and phases in a deduction for Crown resource royalties and mining taxes over the same five-year period.

The transition period for the phase-in of the federal restructuring of the resource income tax provisions has now passed its mid-point and the new set of tax measures will be fully implemented on January 1, 2007. At their 2004 meeting in Iqaluit, provincial and territorial ministers agreed to continue to consult with their respective Finance colleagues on the effect of the federal tax changes on their taxation regimes for mining to avoid any unintended change in taxes paid by the industry.

Following consultations with industry, on December 21, 2004, the federal government released a draft of proposed amendments to section 3900 of the Income Tax Regulations ("Regulation 3900"). The amendments to Regulation 3900 are intended to ensure, as announced in the 2003 budget, that a deduction for mining taxes imposed under a variety of provincial statutes will be phased in over the same five-year period.

In addition to extending the application of Regulation 3900, the proposed amendments remove a prorating formula test that reduces the deduction for mining taxes to the extent that a taxpayer's mining income, as determined for federal income tax purposes, is less than the taxpayer's mining income as determined for provincial/territorial mining tax purposes.

The amendments also expand the deduction for mining taxes to include a deduction for provincial/territorial taxes on certain non-Crown mining royalties. The extension of the deduction for taxes imposed on non-Crown mining royalties is limited to taxes on royalties that are contingent on production or computed by reference to the value of production from mining operations in the province/territory.

It is anticipated that Regulation 3900 will be published in the *Canada Gazette, Part 1* by year-end.

Status on Provincial/Territorial Actions

So far, Alberta, Ontario and Quebec have adopted specific measures to neutralize the effect of federal tax restructuring on the amount of income tax to be paid to these provinces by mining companies. Alberta and Quebec have decided to keep their current resource provisions unchanged until the end of the transition period, at which time they will both eliminate the resource allowance and allow full deductibility (subject to possible adjustments in the case of Quebec).

The 2004 Ontario Budget announced that the Province would maintain the Ontario resource allowance and the rules restricting the deduction of Crown royalties, although the federal government is phasing out these provisions. The legislation implementing the Ontario announcement has been passed and the required Ontario regulations are being finalized.

The 2005 budget proposes that the Ontario provisions be amended to clarify that income computed for Ontario purposes must be used in determining Ontario resource profits. This amendment, which would be effective for taxation years beginning after May 6, 1997, would prevent corporations from obtaining a double benefit as a result of claiming both an Ontario incentive deduction and an additional resource allowance on that incentive.

However, no other province or territory has yet proposed any measures for adjustment, which indicates that potential effects of federal changes on provincial/territorial taxation are not considered to be a matter that needs to be addressed at this time. As mentioned in the IGWG report of 2004, provincial taxes paid by mining companies operating in British Columbia are not affected by the federal changes since provincial tax rules already disallow the resource allowance and provide a deduction for actual mining tax payments.

Several provinces have inquired about the proposed amendments to Regulation 3900 to verify if mining taxes paid under their specific mining tax structures are deductible or not by taxpayers. This issue, which the 2004 IGWG report noted as being a concern for industry, now appears to be resolved.

The Department of Resources, Wildlife and Economic Development of the Northwest Territories has conducted a study of the effects of federal resource taxation reform on typical mining operations in different provinces and territories.