Prospectors & Developers Association of Canada
l'Association canadienne des prospecteurs et entrepreneurs

PDAC recommendations to ensure that mineral exploration companies survive and contribute to Canada's economic recovery

19 December 2008

Response to the impact of the financial crisis on the mineral industry

This document summarizes several policy recommendations and proposals being advanced by the PDAC in support of the mineral exploration sector. The proposals are being developed as possible temporary initiatives and longer term solutions to reduce the impact of the current financial crisis on the mineral industry in Canada. **Our objective is to ensure that exploration companies survive and are positioned to support our economic recovery.**

As the 'research and development' branch of the mining sector, exploration companies do not have production revenue and, therefore, must rely on investors who are prepared to support high risk activities. The global financial crisis and the steep drop in commodity prices are having dramatic and negative effects on our sector. **Reduced investment in companies will lead to fewer drilling programs in 2009 and will impact negatively on regional employment and income, particularly in rural, northern and Aboriginal communities**.

Recommendations to reduce the impact of the financial crisis on exploration companies:

Tax incentives:

1. a. encourage investment in Canadian projects by **temporarily increasing** the **Mineral Exploration Tax Credit** (METC) for exploration financed using flow-through shares from the current **15%** rate to **30%** for the next **two years**; and,

b. To ensure longer term investment in Canada, **make the current 15% METC a permanent feature** of the federal income tax system.

Infrastructure:

2. Create jobs and retain expertise in Canada's world renowned mineral exploration sector by **increasing the investment in the Geo-mapping for Energy and Minerals** (GEM) infrastructure program to **$50 million annually for 2009 and 2010** and accelerating its progress through the involvement of the **mineral exploration industry** and employment of **geology students and recent graduates**.

Company costs:

3. Improve an exploration company's ability to retain employees by allowing a portion (e.g. **15% to 20%**) of **overhead costs** (i.e. costs associated with financing, salaries, legal and accounting expenses) to qualify for renunciation as Canadian Exploration Expense (CEE) under flow-through share arrangements.

We believe these recommendations will have an overall positive impact on the economy without a significant cost to government. However, the proposals offered above may not be sufficient to counter the effects of the global financial crisis; variations on these proposals, improvements to existing programs, or additional measures may be necessary.

Aboriginal participation in the mineral exploration sector

The PDAC has developed a series of initiatives and recommendations to promote Aboriginal – industry partnerships and to improve the regulatory environment in Canada. An effective economic stimulus package should include measures that address the financial situation faced by the mineral sector and contribute to increased Aboriginal participation and community benefit. Following is a brief summary of recommendations to promote Aboriginal – industry partnerships and to improve the regulatory environment in Canada:

- Clarify consultation protocols and permitting requirements
- Implement recommendations in the McCrank Report on the northern regulatory improvement initiative
- Expedite the resolution of outstanding land claims
- Implement government resource revenue sharing
- Support training, education and business development opportunities with Aboriginal people with a focus on training for and experience in the mineral exploration and mining sector. Implementation of the GEM program provides an excellent opportunity to involve Aboriginal people in the early stages of exploration and mining.
- Support information sharing initiatives that promote partnerships and good relations between Aboriginal people and the mineral sector.

Longer Term: Maintaining a Vibrant Exploration Sector

A vibrant mineral sector in Canada creates jobs, sustains communities, fosters new business opportunities and raises tax revenues that allow government to meet social needs. In the past few years, the federal government has responded positively to our sector's recommendations through changes to tax policies and investments in specific programs. Examples include the creation and extension of the Mineral Exploration Tax Credit (METC) and the expansion of the Geo-mapping for Energy and Minerals program. In addition to making the METC permanent, the PDAC recommends the following policy initiatives as longer term measures that are intended to support a strong investment climate for the mineral industry in Canada.

Recommendations to support a continuing strong investment climate for the mineral industry in Canada:

4. **Clarify CEE definition with respect to former Mine Sites:** the federal government, as part of a long-term strategy for mineral exploration, should clarify that the Canadian

Exploration Expense definition includes the costs of carrying out exploration at former mine sites that have not operated for at least 5 years.

5. **Provide Flow-Through Share Treatment for QETs:** allow specified costs related to the activities of a Qualified Environmental Trust (QET) to be eligible expenses that can be financed using flow-through shares**.**

Current situation: The Financial Crisis and Exploration Companies

- Exploration companies do not have production revenue and must rely on investors who are prepared to support high risk activities
- Slowing global growth is significantly reducing commodity demand
- The steep drop in commodity prices and market instability are having dramatic and negative effects on mineral exploration companies' share prices and on their ability to raise money for grassroots exploration programs
- Without sufficient investor support, exploration companies face a reduction in or cancellation of programs in 2009 and 2010, with a resulting impact on service companies, and other businesses and individuals, particularly those in rural, northern and Aboriginal communities
- The situation is urgent as a loss of companies and qualified workers will severely limit Canada's long-term ability to restore its leadership position in the global exploration and mining industry

About the PDAC

The Prospectors and Developers Association of Canada is a national organization with over 7,000 members representing the range of companies and individuals in mineral exploration and development. Our corporate members include senior producing companies and junior companies (small and medium enterprises). Our individual members include prospectors, geoscientists, geological consultants, company executives, and junior exploration and senior mining company representatives. Our members also include people in the financial, legal, and academic communities, students, and those who supply services and equipment to the mineral industry.

135 King Street East, Toronto, Ontario, Canada M5C 1G6
Website: pdac.ca; email: info@pdac.ca
Telephone 1 416 362 1969; Fax 1 416 362 0101

APPENDIX A

Initiatives to reduce the impact of the financial crisis on exploration companies

Tax incentives

Recommendation 1 (a): encourage investment in Canadian projects by temporarily increasing the Mineral Exploration Tax Credit (METC) for exploration financed using flow-through shares from the current 15% rate to 30% for the next two years; and,

Recommendation 1 (b): To ensure longer term investment in Canada, make the current 15% METC a permanent feature of the federal income tax system.

1 (a) Benefits of a temporary Two-Year Increase in the METC Rate from 15% to 30%

- Without sufficient investor support, exploration companies face a reduction in or cancellation of programs in 2009, with a resulting impact on service companies and neighbouring communities, including those in remote and northern areas of Canada.
- Currently, potential investors are concerned that, even with the 15% METC, future market prices of flow-through shares do not justify the investment.
- Increasing the credit rate to 30% for two years during a critical survival period would help to address investor reluctance and thus allow the junior mining industry to maintain a reasonable level of exploration activity during this period of depressed commodity prices. For a high-income investor in Ontario, for example, it would reduce the after-tax cost per dollar of investment by about 9 cents
- The after-tax cost would be further reduced if the provinces were to reinforce the proposed federal initiative by increasing their tax credit rates as well.

1 (b) Benefits of making the 15% METC a permanent feature of the income tax system

- Mineral exploration companies are generally small and medium enterprises (SMEs). They are not currently paying corporate income taxes since they are in a growth phase and may not yet have producing mines. These companies depend heavily on new equity investors. Flow-through share financing is vital to their growth. The METC is critical for financing grassroots exploration expenditures.
- Investor uncertainty about the future of the METC impairs the ability of companies to effectively plan multi-year exploration program financing. It limits the ability of flow-through limited partnerships to market the investments in an orderly and timely manner to new investors. Making this program permanent would increase investor certainty, and provide a more rational time-frame for planning and executing exploration programs.
- Mineral exploration companies are comparable to small high tech or start-up innovation companies that must also finance their high risk speculative expenditure. High tech companies currently receive significant direct federal and provincial income tax support, even when they are not yet taxable, through the refundable Scientific Research and Experimental Development (SR&ED) tax credit.

- The METC is the cornerstone of the current system of harmonized provincial exploration tax credit programs. By making the METC permanent, it is more likely that the major mining provinces will also continue to provide additional incentives to supplement the federal credit.

Background

- Without sufficient investor support, exploration companies face a reduction in or cancellation of programs in 2009, with a resulting impact on service companies and neighbouring communities, including those in remote and northern areas of Canada

- The 15% federal METC is the centerpiece in the current system of federal and provincial exploration tax incentive programs designed to assist flow-through share financing. Almost all major mining provinces in Canada provide additional incentives to supplement the federal credit including Quebec, Ontario, British Columbia, Manitoba and Saskatchewan.
- In the February 28, 2008 federal budget, the METC was extended by one year to March 31, 2009.
- During the 2008 election campaign the Conservative Party platform indicated that the credit would be extended (a period of time was not mentioned).
- The PDAC's 2008 Mines Ministers submission recommended that the METC should become a permanent feature of the federal income tax system.
- The steep drop in commodity prices and market instability are having dramatic negative effects on mineral exploration companies' share prices and on their ability to raise money for grassroots exploration programs. Even a 15% METC is insufficient to attract adequate levels of new exploration financing

<u>**Initiatives to reduce the impact of the financial crisis on exploration companies**</u>

Infrastructure

Recommendation 2: Create jobs and retain expertise in Canada's world renowned mineral exploration sector by increasing the investment in the Geo-mapping for Energy and Minerals (GEM) infrastructure program to $50 million annually for 2009 and 2010 and accelerating its progress through the involvement of the mineral exploration industry and employment of geology students and recent graduates.

Benefits

- This proposal recommends that an additional investment in geo-mapping be made during 2009 and 2010 and that mineral exploration companies and geology students and recent graduates become directly involved in carrying-out some of the planned geo-mapping work during the current economic downturn.
- In the past, geo-mapping has largely been undertaken by the public sector; however, there is expertise and capacity available in the private sector that could assist with meeting program objectives.
- We are concerned that a significant reduction in exploration as a result of low commodity prices and investment will lead to a loss of this expertise and capacity, thereby making the sector's recovery more difficult. Retaining this private sector expertise through involvement in GEM would benefit both the program and the industry.
- The involvement of the private sector should also permit a more rapid achievement of geo-mapping objectives than would be the case if the program was undertaken solely by government. The work done would complement and accelerate any work that would normally be carried out directly or under contract by governments.
- Implementation of the GEM program provides an excellent opportunity to involve Aboriginal people in the early stages of exploration and mining.

Background

- The PDAC has long advocated the expansion of the federal government's geoscience and mapping activities.
- The PDAC was very pleased with the Prime Minister's recent announcement of $100 million to map the North (the Geo-mapping for Energy and Minerals or GEM Program).
- Investment in geoscience research directly benefits both governments and the mineral sector by advancing knowledge and encouraging new exploration activity. A high-quality and easily accessible geoscience database (i.e. geological data and maps) is a key competitive advantage internationally.

Initiatives to reduce the impact of the financial crisis on exploration companies

Company costs

Recommendation 3: Improve an exploration company's ability to retain employees by allowing a portion (e.g. 15% to 20%) of overhead costs (i.e. costs associated with financing, salaries, legal and accounting expenses) to qualify for renunciation as Canadian Exploration Expense (CEE) under flow-through share arrangements.

Benefits

- It is proposed that a portion (e.g.15% to 20%), of the overhead expenditures (i.e. costs associated with financing, salaries, legal and accounting expenses) incurred by exploration companies in carrying out their offering be treated as a Canadian Exploration Expense.
- Many overhead costs are associated with issuing requirements established by provincial law or the rules of stock exchanges. They are a relatively fixed charge associated with share issuance. Allowing a proportion of such costs to be treated as CEE and, therefore, eligible for flow-through share treatment will allow companies to retain employees.
- Not all overhead costs are associated with share issuance. In principle, the specific costs associated with share issuance could be separated out. However, such an approach raises difficult definitional questions and uncertainty regarding eligibility.
- The 15% to 20% proposal substitutes a simple administrative rule which, in turn, provides greater certainty to both issuer and purchaser regarding eligible costs. There is a precedent for this under provincial grant systems which support mineral exploration (e.g. Manitoba). These grant programs usually have a ceiling on the amount of eligible overhead expenses. Historically, federal grant programs designed to encourage resource exploration have also included allowances for certain overhead costs.

Background

- The Income Tax Act places various restrictions on amounts that can be renounced as Canadian Exploration Expenses (CEE) and be financed through the METC.
- Overhead expenses – legal, regulatory, salaries and financial costs, etc - are excluded from the CEE definition and thus cannot be financed using flow through shares. Although overhead expenses are deductible, the typical junior mining company is not in a tax-paying position and thus is unable to use these deductions for many years.
- Overhead expenses are essentially a fixed cost associated with flow-through share issuance. In the current environment of depressed share prices, the fixed overhead charges severely restrict the funds available to junior mining companies for exploration activity.
- The cost of simply maintaining a stock exchange listing is approximately $250,000 or more per annum, and it is virtually impossible for mining exploration companies that are not listed on a stock exchange to raise financing to continue their exploration activities.
- Partnerships which raise money by selling units to new investors may also have overhead expenses. These partnerships often purchase flow through shares on behalf of their unit holders.

<u>Longer Term: Maintaining a Vibrant Exploration Sector</u>

Recommendation 4: Clarify CEE definition with respect to former Mine Sites

The PDAC recommends that the federal government, as part of a long-term strategy for mineral exploration, clarify that the Canadian Exploration Expense definition includes the costs of carrying out exploration at former mine sites that have not operated for at least 5 years. The PDAC recommends providing a specific quantifiable test that would permit CEE to include eligible costs of exploring in the vicinity of old mines that have not been operating for at least 5 years.

Benefits

- An objective test would eliminate uncertainty in the application of the existing law, and encourage the discovery of new resources that could help maintain existing mining communities and revive ones that have low levels of activity.

- Treating costs associated with these activities as CEE will promote mineral exploration in Canada in areas that might otherwise be overlooked because of uncertainty about the tax treatment of the expenditures incurred.

- The change to a 5 year rule will also reduce the administrative and compliance burdens for both CRA and PDAC members while enhancing the fairness of Canada's tax regime in treatment of similar geological opportunities.

- The change will reduce uncertainties about the tax treatment of exploration costs which is particularly important when the costs have been financed through the sale of flow-through shares.

Background

- PDAC members greatly appreciated the initiative led by the Canada Revenue Agency to provide more detailed Guidelines for the industry in the interpretation of the Canadian Exploration Expense (CEE) definition. This initiative was completed last year and will provide additional important certainty to both CRA and the industry about the treatment of various types of expenditures such as those for community consultations and land access.

- There remains some concern about the income tax treatment of costs where new exploration activity takes place in the vicinity of a previously existing mine.

- The tax treatment of on-site exploration expenses applies irrespective of whether the related mine is in operation or is inactive, unless the taxpayer can demonstrate to the CRA that the closed mine has lost all the essential characteristics of a mine. The CRA determination involves evaluating the property-specific facts against the essential characteristics established by jurisprudence.

- The tax treatment is applied in the same way unless it can be demonstrated to the CRA that the proposed exploration expenses are related to a potential new mine whose exploitation will not materially benefit from existing facilities and workings.

- The process of reaching these decisions can involve many subjective factors. CRA often must seek guidance from officials from Natural Resources Canada and provincial mining departments to help make these determinations as well as refer to any relevant jurisprudence.

- There would be greater certainty if a specific quantifiable test were used: one such test that industry has discussed is a simple 5 year period during which a mine has not produced. This test would be easier for CRA to administer and is consistent with provisions in certain provinces.

- The IGWG for the Mineral Industry studied the issue and submitted a report to MMC in September 2007. Most provinces recognized the need for a change but there was no unanimity on the exact nature of the new approach.

- PDAC suggests that treating exploration activities as CEE when incurred in the vicinity of a mine where there has been no production for 5 years is fully consistent with the policy intent of the CEE definition since these costs are being incurred to determine the existence, location, extent or quality of a mineral deposit.

- The precedent for such a test in the CEE definition tied to a specific time period already exists. For example, an oil or gas well that has not produced for 24 months is classified as a CEE cost rather than a CDE cost. The introduction of this time limit test rule for these types of wells helped improved the administration and compliance for the CEE definition for both CRA and the oil and gas industry.

Recommendation 5: Provide Flow-Through Share Treatment for QETs

The PDAC recommends that the federal government allow specified costs related to the activities of a Qualified Environmental Trust (QET) to be eligible expenses that can be financed using flow-through shares**.**

The PDAC recommends that, as a minimum first step, the federal government should permit eligible site remediation costs incurred on orphan and abandoned mines to qualify as a CEE expenditure that could be financed using flow-through shares (FTS). These remediation expenditures are conceptually very similar to "preproduction mining expenditures" except that they are required to stabilize a mine site and restore it to an environmental acceptable condition for future generations.

The PDAC also suggests that the federal and provincial governments should consider whether the existing flow-through share mechanism could be utilized to develop suitable rules to permit deductions for contributions to QETs that cannot be utilized at the corporate level.

Benefits

- The benefit to governments of allowing FTS treatment for expenditures incurred at abandoned sites is that the costs of the program would be offset by the reduction and/or transfer of the government's financial or environmental liabilities at abandoned sites to the private sector.

- There will also be benefits from increased economic activity and tax revenues from increased exploration and reclamation and from economic development and investment from potential discoveries, particularly in remote northern communities.

- This proposal assists with addressing several major issues affecting the Canadian mining industry including: declining mineral reserves, the clean-up of abandoned sites and the difficulty for juniors to finance reclamation security.

Background

- In the 1994 Budget the federal government established tax rules with the objective of permitting mining companies to make deductible contributions to prescribed trusts (now called Qualified Environmental Trusts) related to mining properties. The purpose of these trusts is to set aside funds to ensure the rehabilitation of mine sites when they cease production. In the 1997 Budget the rules were broadened to include similar trust funds for waste disposal sites and quarries for the extraction of aggregates and similar materials. QETs exist at the provincial level in BC, Ontario, Quebec and Saskatchewan.

- A QET is controlled by an independent trustee and dedicated to a specific site. With concurrence of regulators, funds in a QET can be used to fund reclamation work as security requirements decrease with completion of progressive reclamation.

- QETs are restricted in their investment activities. The trusts may not borrow or invest in anything other than certain types of secure assets. The investment income which is earned in the trust on the funds on deposit is taxable both to the trust and the beneficiary which is the contributing company. However the beneficiary receives a refundable tax credit for the tax paid in the trust.

- Contributions that are required to be made to the trust are deductible. Companies that are in production or have a revenue stream can benefit from the deduction. However for junior companies (small to medium sized) who are undertaking advanced exploration or mine start up, the deduction is not useful or may not be useable for many years.

- The current rules for QET are expensive and it is complicated to effectively use the existing QET tax deduction. Thus, QETs are being under-utilized despite the potential benefits they could provide for government, the environment and industry.

- The outstanding liability to governments in Canada for remediation of over 10,000 abandoned mine sites is estimated at over $3 billion and growing. Governments are being asked to find creative and financially responsible solutions to such environmental problems and to protect Canadians from future environmental liabilities.

- Providing flow through share treatment to contributions to Qualified Environmental Trusts (QET) is a creative means to engage the private sector in innovative and cost effective solutions to help government remediate abandoned and environmentally degraded mine sites and to unlock value from brown sites.

- We believe that junior companies, which are major contributors to economic activity and discoveries in the mining sector, should have the same ability as larger producing companies to take advantage of the tax write-off provisions of QET.

- Some abandoned and closed mine properties may have significant potential for mine development and junior companies are particularly well suited to take on the exploration challenges offered by such sites and the proposed implementation of FTS for QETs would remove an important barrier. Implementing FTS for QETs would also reduce risk for governments by increasing the funding available for high quality reclamation security, and encourage sustainable economic development, progressive reclamation and innovative solutions to environmental remediation problems.

- FTS for QETs is an environmental initiative that would reduce risks to governments and help to keep the Canadian junior exploration and mining sector competitive. It could be implemented quickly using existing and known provisions of the Income Tax Act and produce immediate results benefiting the government, mining companies and the public image of the industry.

- The existing QET tax provisions could be more effectively utilized by junior companies if FTS could be used to fund QET reclamation security. Support and interest for the FTS for QETs proposal has been received from industry associations as well as, some Provincial/Territorial governments.