Tax memo

Canadian tax updates

pwc

August 14, 2012 legislative proposals: Alert for mining companies

Discusses the August 14, 2012, draft legislative proposals that affect the Canadian mining industry.

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On August 14, 2012, the Department of Finance released for consultation draft legislative proposals that implement measures included in the March 29, 2012 federal budget. Comments on the proposals are due by September 13, 2012.

This *Tax Memo* summarizes the draft legislative proposals that affect the Canadian mining industry. In particular, it focuses on the phase-out of the investment tax credit (ITC) in respect of eligible Canadian exploration expenses (CEE).

Canadian exploration expenses

Current rules

Currently, a taxable Canadian corporations can claim non-refundable ITCs equal to 10% of its "pre-production mining expenditure," which is an expenditure incurred after 2002 that is:

- referred to as a "grass-roots" exploration expense[1] or as a "development expense";[2]
- in respect of a mineral deposit from which the principal minerals to be extracted are diamonds, base metals, precious metals or industrial minerals that, when refined, result in a base or precious metal; and
- not renounced to a flow-through shareholder.

2012 budget: Phase-out of ITCs

The 2012 federal budget proposes different ITC phase-out rules for grass-roots exploration expenses and for development expenses.

Grass-roots exploration expenses

Grass-roots exploration expenses are incurred by a taxable Canadian corporation for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada that is a mineral deposit from which the principal minerals to be extracted are diamonds, base metals, precious metals or industrial minerals that, when refined, result in a base or precious metal.

1. Grass-roots exploration expenses are described in paragraph (f) of the definition of CEE in subsection 66.1(6) of the *Income Tax Act* (the Act).
2. Development expenses are described in paragraph (g) of the definition of CEE in subsection 66.1(6) of the Act.

The ITCs in respect of grass-roots exploration expenses will be phased out as follows:

		Grass-roots exploration expenses ITC rate
Expenditure incurred	Before 2013	10%
	In 2013	5%
	After 2013	0%

Development expenses

Development expenses are incurred by a taxable Canadian corporation:

- for the purpose of bringing a new mine in a mineral resource in Canada into production, in reasonable commercial quantities; and
- before the new mine comes into production in such quantities, that is a mineral deposit from which the principal minerals to be extracted are diamonds, base metals, precious metals or industrial minerals that, when refined, result in a base or precious metal.

Generally, the ITCs in respect of development expenses will be phased out as follows:

		Development expenses ITC rate
Expenditure incurred	Before 2014	10%
	In 2014	7%
	In 2015	4%
	After 2015	0%

Development expenses: Exception for 2014 and 2015

ITCs can continue to be claimed at the 10% rate in 2014 and 2015 if the expenditure was incurred:

a) under a written agreement entered into by the corporation before March 29, 2012;
b) as part of the development of a new mine and the construction of the mine was started by (or on behalf of) the corporation before March 29, 2012; or
c) as part of the development of a new mine and the engineering and design work for the construction of the mine, as evidenced in writing, was started by (or on behalf of) the corporation before March 29, 2012.

The terms "construction" and "engineering and design work" have not been defined for purposes of determining (b) and (c) above. However, neither term encompasses obtaining permits or regulatory approvals, conducting environmental assessments, community consultations or impact benefit studies, and similar activities.

PwC observations

The federal government's phase-out of the ITC for pre-production mining expenditures was not surprising in a period of government austerity. For grass-roots exploration expenses, the phase-out is straightforward and rapid, with a 10% ITC available in 2012 and a 5% ITC available for 2013.

For development expenses, an attempt has been made to grandfather mining projects that have reached certain stages of development on March 29, 2012, the date the changes were announced. However, companies may face some challenges in interpreting the proposed grandfathering rules:

- **Written agreement** – As mentioned, development expenses in respect of which a company has already made a written commitment to spend before March 29, 2012, will remain eligible for the 10% ITC for 2014 and 2015. This assumes the company has outsourced the expenses that qualify as pre-production mining expenditures and so has a written agreement with an external consulting firm. This exception may be difficult to apply for a company that uses its own employees to bring a mine into production.

- **New mines** – The grandfathering rules apply only to the development of a new mine.[3] Whether a development project is a "new mine" is a complex question of fact, particularly if it is on property that was previously mined.

- **Construction** – The term "construction" is not defined. More often than not, mining companies issue a press release when construction of a mine is commenced. This is usually after the

3. This mirrors the requirement in paragraph (g) of the definition of CEE in subsection 66.1(6) of the Act that, to qualify as CEE under that paragraph, the expense must be incurred for the purpose of bringing a new mine into production in reasonable commercial quantities.

relevant government authority approves the company's environmental impact assessment and closure plan. We expect that this will be the date most often used in determining whether the project is grandfathered. However, given the complexity of both the approval process and the projects themselves, determining the exact date for the commencement of construction could be difficult.

- **Engineering and design work** – The phrase "engineering and design work" is not defined. If mining companies hire an external engineering firm to assist with the design of the mine, it should be relatively straightforward to determine when the work commenced, as evidenced by a contract between the company and the engineering firm. However, if the mining company undertakes some of the engineering and design work itself, it may be difficult to demonstrate that the work commenced before March 29, 2012, because there may be no supporting written evidence, except for the work product produced.

- **Exclusions** – In determining whether construction of a mine, or engineering and design work for the construction of a mine, commenced before March 29, 2012, activities to be excluded include obtaining permits or regulatory approvals and conducting environmental assessments, community consultations or impact benefit studies. The purpose of this exclusion is unclear.

  Often, construction of a mine cannot start until the provincial government issues its approvals. However, a company could start construction before community and First Nations consultations are complete. Does this mean construction will not be considered to have started before March 29, 2012, if at that date consultations are continuing? Notably, expenses incurred in respect of these activities have not been excluded by the legislative proposals from pre-production mining expenditures that are eligible for the ITC.

Atlantic ITC

The 2012 federal budget also phases out of the 10% Atlantic ITC, as indicated in the following table:

		Atlantic ITC rate
Expenditure incurred	Before 2014	10%
	In 2014	5%
	In 2015	
	After 2015	0%

To qualify, the property must be a prescribed building or machinery or equipment acquired by the taxpayer primarily for use in oil, gas and mining activities in the Atlantic Provinces, the Gaspe Peninsula and associated offshore regions.

Exception to phase-out

Projects will continue to be eligible for the 10% Atlantic ITC for assets acquired before 2017 if:

- there is a discrete expansion of a project beyond the capacity level that was attained before March 29, 2012; and
- the expansion in capacity was the taxpayer's demonstrated intention immediately before March 29, 2012.

For more help

For more information about the implications of the 2012 federal budget changes, please contact your PwC adviser or any of the individuals listed below.

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