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Oil and gas taxation in Canada

Framework for investment in the Canadian oil and gas sector

Summarizes the main features of how Canadian oil and gas operations are taxed by the federal government and primarily the provincial governments of Alberta, British Columbia and Saskatchewan.

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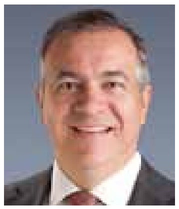
Foreword



Oil and gas taxation in Canada has been prepared by the Canadian Energy Tax Group of PricewaterhouseCoopers (PwC), a specialty practice that serves the unique tax needs of the oil and gas industry.

This publication summarizes the main features of how Canadian oil and gas operations are taxed by the Canadian federal government and primarily the provincial governments of Alberta, British Columbia and Saskatchewan (the "Western producing provinces"). The commentary is based on legislation and proposals in effect on August 10, 2012, and, when appropriate, includes references to draft legislation as of the time of writing.

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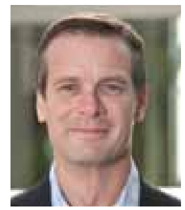
Domenico Baruffaldi
Leader, Canadian Energy Tax Group
August 2012

This publication is available in simplified Chinese.

PwC's energy practice



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Contents

Basic framework of the Canadian system

Income from Canadian oil and gas operations is taxed under a three-tier system:

Tier 1	A federal income tax, levied on the "taxable income" of an oil and gas operation.
Tier 2	Provincial income taxes, based on the same or similar taxable income.
Tier 3	Provincial taxes, lease rentals or royalties ("Crown charges"), levied on the ownership of Canadian resource property or on production of oil and gas from wells or oil sands projects situated in the particular jurisdiction.

Under the *Income Tax Act,* the federal government levies income tax on a corporation's taxable income. For federal tax purposes, a corporation resident in Canada is required to account for income from all sources, both within and outside Canada.

Provincial governments levy corporate income tax only on income reasonably attributable to permanent establishments that exist in the particular province. Provincial income is determined by a formula based on gross revenues and on salaries and wages paid in each jurisdiction.

In this publication, for purposes of illustrating how the Canadian federal and provincial tax system works, it is assumed that a Canadian-resident corporation carries on only an oil and gas business.

Canada and the United States – Key differences

The Canadian and U.S. corporate income tax systems have substantial similarities. In both cases, taxes at prescribed rates are levied on taxable income. However, for the oil and gas industry, the three key differences between the two systems are the treatment of:

- levies imposed by a provincial government on oil and gas production (including natural gas liquids) from wells or oil sands projects situated in the province;
- depreciation for tax purposes; and
- expenditures incurred in exploring and drilling wells, mining oil sands, and on the acquisition of oil and gas or oil sands properties.

Rate of tax

The net federal rate on oil and gas income is computed as follows:

(December 31 year ends)	**2009**	**2010**	**2011**	**2012**
Basic federal rate	38%			
Less: Abatement	(10%)			
General federal rate	28%			
General rate reduction	(9%)	(10%)	(11.5%)	(13%)
Net federal income tax rate	**19%**	**18%**	**16.5%**	**15%**

The 10% federal abatement

The 10% abatement of federal tax is designed to give the provinces and territories room to impose corporate income taxes.

The abatement is available only in respect of taxable income allocated to a Canadian province or territory. Income earned in a foreign jurisdiction is subject to the full basic rate of federal tax.

Oil and gas operations are like all others, in that income taxes imposed by one jurisdiction in Canada (whether federal, provincial or territorial) are not deductible in another. Since 2007, Crown charges imposed on, or in respect of, the production of oil and gas in Canada have been fully deductible in computing income for federal tax purposes. Previously, to compensate for the non-deductible portion of Crown charges, a taxpayer was entitled to a "resource allowance" deduction. This deduction was phased out gradually and was entirely eliminated in 2007. The provincial income tax systems also provide for the full deduction of crown charges, except for Ontario, where a resource allowance system is used.

Investment tax credits (ITCs)

A 10% investment tax credit (ITC) can be claimed on the cost of qualified property acquired for use in the Atlantic Provinces, the Gaspé region of Quebec and prescribed offshore regions. The 2012 federal budget phases out the 10% credit for certain oil and gas and mining activities, for assets acquired after March 28, 2012. The rate depends on the year of acquisition: 10% if before 2014, 5% if in 2014 or 2015 and nil if after 2015. Transitional relief will apply in certain cases.

Also, ITCs continue to be available for expenditures on qualified scientific research and experimental development (SR&ED) incurred anywhere in Canada. In certain cases, the SR&ED ITC can be claimed on salary or wages incurred outside Canada that are an integral part and solely in support of SR&ED carried on in Canada that is related to the taxpayer's business.

ITCs for SR&ED are calculated by multiplying the amount of qualified expenditures in respect of SR&ED by a specified percentage. The applicable ITC rate is 35% for Canadian-Controlled Private Corporation's (CCPCs) and 20% (to be reduced to 15% for taxation years ending after 2013 by the March 29, 2012 federal budget) for other corporate taxpayers, as explained in the SR&ED section of this publication (see page 13).

Unused investment tax credits can be carried forward twenty taxation years and carried back three.

Federal income tax

Loss carryover

In computing taxable income, non-capital losses can be carried forward:

- twenty taxation years for those that arose in taxation years ending after December 31, 2005;
- ten taxation years for those that arose in taxation years ending after March 22, 2004, and before January 1, 2006; and
- seven taxation years for those that arose in taxation years ending before March 23, 2004.

Non-capital losses can be carried back three taxation years. Net capital losses can be carried back three taxation years and carried forward indefinitely.

When control of a company is acquired, all net capital loss carryovers are lost and the subsequent deduction of pre-acquisition-of-control non-capital loss carryovers becomes restricted. In addition, a tax year end is deemed to occur immediately before the change of control. Generally speaking, pre-acquisition-of-control non-capital losses are allowed as a deduction against income from the same business in which the losses were incurred, or a similar business, but only if that loss business is carried on after the acquisition of control with a view to profit.

A company's pre-acquisition-of-control net capital losses and non-capital losses will be affected as follows if the value of certain assets has eroded relative to their cost for tax purposes:

- if the undepreciated capital cost of depreciable properties exceeds the fair market value, the excess will increase the non-capital losses via additional capital cost allowance claims; and
- if the adjusted cost base of capital property (e.g., non-depreciable capital property, depreciable property and accounts receivable) exceeds the fair market value, the excess is deducted from the adjusted cost base and treated as a capital loss.

Capital cost allowance (CCA)

Capital cost allowances (CCAs) are discretionary deductions allowed to a taxpayer in computing income for tax purposes in lieu of depreciation calculated for book purposes on depreciable property. For conventional oil and gas production, depreciable property includes the tangible equipment used to facilitate the production of oil or gas, and comprises mainly wellhead equipment, flow lines, gathering systems, batteries, compressors, dehydrators and gas plants for the extraction of excess hydrocarbons from "wet" gas and sulphur from "sour" gas.

The costs of tangible property that is "available for use" are accumulated by classes. For each undepreciated capital cost (UCC) class, a specified CCA rate may be applied to the balance of UCC at the end of a taxation year on a declining balance basis. The rate is the maximum amount of CCA that can be claimed. A taxpayer can claim less, or even nothing at all, for a taxation year. In a short taxation year, the claim is restricted to the fraction that the number of days in the tax year is of 365 days.

The following table shows the main classes of depreciable property relevant to the oil and gas industry:

		CCA rate
Class 1	Pipelines that are not part of gathering systems acquired before February 23, 2005 (see also Class 49)	**4%**
Class 7	Vessels primarily designed for drilling oil. Pipeline pumping and compression equipment acquired after February 22, 2005	**15%**
Class 8	Tangible equipment not otherwise included in another class	**20%**
Class 41	Oil and gas well equipment and gas plant equipment	**25%**
Class 43.1	Alternative energy assets	**30%**
Class 43.2	Specified clean energy generation equipment acquired before 2020	**50%**
Class 49	Pipelines that are not part of the gathering systems acquired after February 22, 2005 (see also Class 1)	**8%**
Class 50	Computers and systems software	**55%**

Oil and gas well equipment generally includes production tubing, wellhead equipment, flow lines, gathering systems, dehydrators and compressors. It excludes well casing, the cost of which will be either a Canadian development expense or Canadian exploration expense, depending on the characterization of the well being drilled.

As part of the federal government's clean air initiative, the CCA rate for carbon dioxide pipelines acquired after February 25, 2008, increased from 4% to 8% (by including these assets in Class 49) and for ancillary pumping and compression equipment from 4% to 15% (by including these assets in Class 7).

Also, for clean energy generation and conservation equipment acquired after March 28, 2012, the 2012 federal budget enhances Class 43.2 as follows:

- the restriction that heat energy generated from waste-fuel thermal energy equipment must be used in an industrial process or a greenhouse has been removed;
- district energy system equipment is expanded to include those that distribute thermal energy primarily generated by waste-fuelled thermal energy equipment; and
- the list of eligible waste used in waste-fuelled thermal energy equipment or a cogeneration system is expanded to include the residue of plants.

In addition, equipment using eligible waste fuels will no longer be eligible under Class 43.1 or Class 43.2 if the applicable environmental laws and regulations of Canada or of a province, territory, municipality, or a public or regulatory body are not complied with at the time the equipment first becomes available for use.

Canadian oil and gas property expense (COGPE)

Canadian oil and gas property expense (COGPE) encompasses the acquisition cost of oil and gas Canadian resource properties, including:

- oil and gas rights;
- oil and gas wells;
- royalty interests; and
- oil sands rights acquired after March 21, 2011.

These costs are pooled in a fashion similar to costs in respect of depreciable property and are deducted, on a discretionary basis, at a maximum rate of 10% per year (declining balance). In a short tax year, the claim is restricted to the fraction that the number of days in the tax year is of 365 days.

The following key rules apply to COGPE:

- All intangible proceeds of disposition of oil and gas Canadian resource properties are credited to the COGPE pool (referred to as "cumulative COGPE"), while proceeds of disposition of depreciable property are credited to the appropriate UCC pool.
- If, at the end of a taxation year, the balance of cumulative COGPE is in a credit position (i.e., because the proceeds of disposition in the year exceed the balance of available costs), the entire credit balance is applied to reduce the balance of cumulative Canadian development expense.
- If all of the oil and gas Canadian resource properties of a taxpayer are sold, any remaining balance of cumulative COGPE continues to be deductible at a maximum rate of 10% per year (declining balance).

Canadian development expense (CDE)

Canadian development expense (CDE) comprises intangible drilling and completion expenses that are not otherwise a Canadian exploration expense. They are accumulated in the CDE pool and deducted at a maximum rate of 30% per year (declining balance). The claim is discretionary. In a short tax year, the claim is restricted to the fraction that the number of days in the tax year is of 365 days.

As indicated above, a credit balance of cumulative COGPE in a year reduces the balance of cumulative CDE to which the 30% rate is applied.

If the balance of cumulative CDE at the end of a taxation year is in a credit position, the entire balance is included in the taxpayer's income.

Canadian exploration expense (CEE)

Canadian exploration expense (CEE) comprises, in general terms:

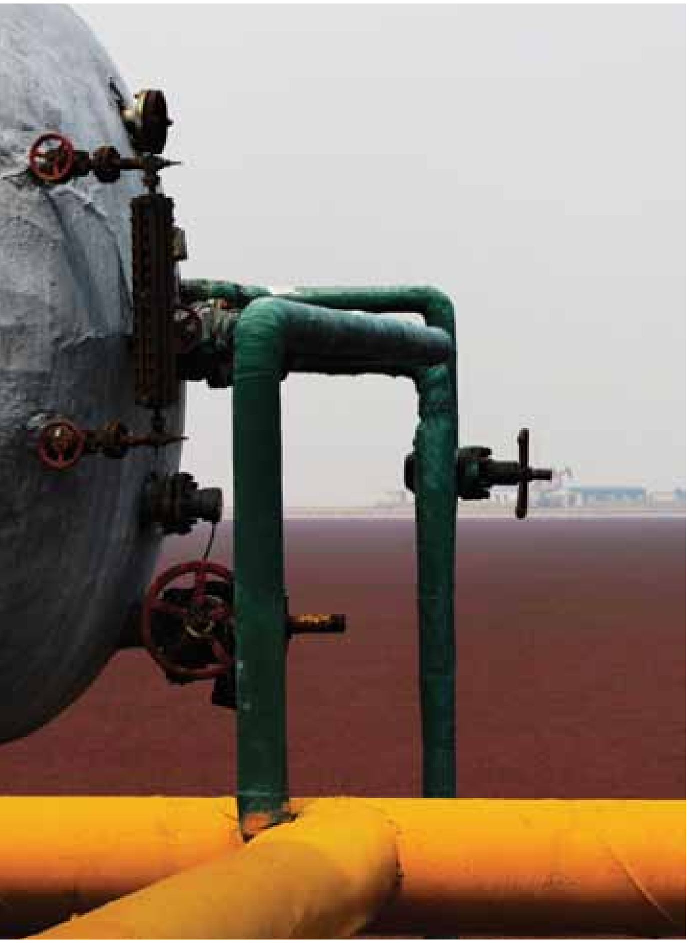
- geological, geophysical, and geochemical costs;
- dry-hole costs, if the wells are abandoned in the year or within six months of the end of the year; and
- drilling and completion costs in respect of the first discovery well in a natural underground reservoir.

These costs are accumulated in the CEE pool, the balance of which is 100% deductible on a discretionary basis.

Drilling and completion costs in respect of a well previously included in CDE may be transferred to CEE if the well, other than for testing purposes:

- never produced before being abandoned; or
- did not produce within 24 months of completion.

A principal business corporation (i.e., a corporation the principal business of which includes, among other things, the carrying on of an oil and gas business) cannot create or increase a loss by claiming CEE.



Foreign resource expense (FRE)

Foreign resource expense (FRE) includes the acquisition cost of foreign resource properties and any drilling or exploration expense incurred by the taxpayer in respect of exploring or drilling for petroleum or natural gas outside Canada. FRE is separated into pools by country.

A taxpayer can deduct the lesser of:

- its foreign resource income from a country; and
- 30% of the cumulative FRE (CFRE) in respect of that country.

In aggregate, the taxpayer will be allowed to claim the lesser of 30% of its total CFRE for all countries and its total foreign resource income from all countries for the year. In any case, the taxpayer can claim up to 10% of its total FRE (pro-rated for short taxation years), regardless of the amount of foreign resource income, and thereby offset income from other sources.

Successor corporation rules

Canadian income tax provisions reflect an underlying policy that income tax relief should be available in respect of all exploration and development expenditures. This includes, in defined circumstances, those incurred by previous taxpayers (as long as a deduction is claimed only once in respect of any particular expense). To this end, the so-called "successor corporation" rules of the *Income Tax Act* contain complex provisions. Under those provisions, in specified circumstances the unclaimed exploration and development expense balances (i.e., COGPE, CDE, CEE and FRE) of a particular taxpayer may be "inherited" by another corporation (the "successor corporation").

A successor corporation becomes entitled to deduct an amount in respect of the predecessor's unclaimed exploration and development balances, if it:

- has acquired "all or substantially all" (usually interpreted as being 90% or more) of the transferor's (the "predecessor's") Canadian resource properties; and
- jointly elected with the predecessor in a prescribed manner.

These deductions, however, can be applied only to reduce the aggregate income the successor corporation earned that is reasonably attributable to production from properties acquired from the predecessor corporation.

Acquisition of control of a corporation will also result in the corporation's exploration and development pools becoming successor pools that are subject to the same restrictions.

The successor rules are extremely complex and can apply in different ways to:

- a liquidation or statutory amalgamation of wholly owned subsidiaries; and
- statutory amalgamations of sister corporations.

Flow-through shares

Structuring an oil and gas venture through conventional share financing limits the deductibility of the expenses of the venture to the income generated in the corporation. Given the uncertainty inherent in an oil and gas venture, it is possible that the corporation may not have sufficient income to fully use otherwise deductible CEE and CDE.

Flow-through shares are shares issued by a principal business corporation, pursuant to an agreement under which the issuing corporation agrees to incur certain qualifying CEE and/or CDE in an amount equal to the consideration given by the subscriber for the shares. The corporation "renounces" to the subscribing taxpayer an amount in respect of the CEE and/or CDE incurred by the issuing corporation during a qualifying period of 24 months from the date of the agreement. The renounced CEE and/or CDE are thereby deemed to be those of the shareholder and not of the corporation.

As a result, the shareholder can deduct these expenses as if they had been incurred directly. The advantage of flow-through shares is that the shareholder has the opportunity to deduct expenses that may not be used by the issuing corporation in the foreseeable future.

Flow-through shares are deemed to have a nil cost base. Therefore, when sold, the entire proceeds of disposition normally will be treated as a capital gain.

Special rules allow a qualifying corporation to renounce eligible exploration and development expenses up to a year in advance of their being incurred, in certain circumstances. A special tax is payable by the issuing corporation if the qualifying expenses are not fully incurred by the end of February following the year for which the expenses are renounced to the subscribing shareholder.

In limited circumstances, costs that are otherwise CDE may be renounced as CEE to a subscribing shareholder of flow-through shares.

The following expenses are not eligible for flow-through renunciation:

- Canadian exploration and development overhead expense (CEDOE);
- costs related to certain purchased seismic information; and
- COGPE.

In general, CEDOE includes overhead expenses that are capitalized as CEE or CDE but are not directly incurred in exploration and development activity.

Canadian renewable and conservation expense (CRCE)

Canadian renewable and conservation expense (CRCE) encompasses intangible costs associated with the development of projects for which the equipment is eligible for Class 43.1 or Class 43.2 CCA treatment. In general, these classes include equipment used to produce energy or electricity by use of alternative sources, such as solar, tidal and biomass. The policy reason behind these provisions is to provide consistent treatment for different types of energy investments and to expand domestic and international markets for renewable energy products and expertise. CRCE also provides investors in renewable energy and energy conservation projects with faster deductions for certain types of expenses that would normally be treated as capital. CRCE encourages investment in the pre-production stage of these projects.

CRCE is similar in concept to CEE in that:

- the full amount of CRCE is fully deductible in any taxation year and can be carried forward indefinitely; and
- CRCE can be renounced to shareholders that have entered a flow-through share agreement.

The 2012 federal budget proposes to expand the eligibility of assets that qualify for inclusion in Class 43.2, which in turn may expand the scope of projects that qualify for CRCE. See page 3 for details of proposed changes to Class 43.1 and Class 43.2.

Provincial income tax

Allocation of taxable income

Taxable income of corporations that have a permanent establishment in more than one province is allocated based on the gross revenues and on total salaries and wages attributed to those establishments.

The definition of a permanent establishment includes, among other things, an office, a branch and an oil well.

The major oil and gas producing provinces are Alberta, British Columbia and Saskatchewan. Only Alberta requires the filing of a tax return separate from the federal one.

Alberta

The basic Alberta corporate tax rate is 10%. The small business tax rate is 3%, applicable to a CCPC's active business income. The small business threshold is $500,000.

Alberta's income tax statute is separate from its federal counterpart, but adopts a substantial portion of the federal provisions. However, a number of provisions are specific to Alberta, as follows:

- Although the Alberta and federal CCA classes and rates are the same, a corporation can choose to deduct different amounts for federal and Alberta income tax.
- Capital taxes that are payable by corporations in other provinces are non-deductible for purposes of Alberta corporate income tax, but are deductible (within limits) for federal purposes. See page 12 for capital taxes.
- For years before 2007, a royalty tax deduction could be claimed, equivalent to the excess crown royalties disallowed for federal income tax purposes over the 25% federal resource allowance. This deduction cannot reduce Alberta income tax below zero. Unused deductions from years before 2007 can be carried forward to the subsequent seven taxation years, but expire on December 31, 2013.

For eligible expenditures incurred by qualifying corporations after December 31, 2008, Alberta allows a SR&ED tax credit of 10% on up to $4 million of eligible expenditures incurred, for a maximum annual credit of $400,000. The credit is calculated using the definition of eligible expenditures in the federal SR&ED tax credit program. It is refundable to all taxpayers, regardless of size or industry.

Alberta's 2012 budget eliminates, for taxation years ending after March 31, 2012, the requirement to deduct the prior year's federal SR&ED tax credit from eligible expenditures when calculating the province's SR&ED tax credit. This will simplify the Alberta calculation and align it with that of other provinces.

British Columbia

The basic British Columbia corporate tax rate has been 10% since January 1, 2011. British Columbia's 2012 budget temporarily increases the rate to 11% on April 1, 2014, if the province's fiscal situation worsens. The small business tax rate of 2.5% applies on the first $500,000 of a CCPC's active business income.

Qualifying corporations are entitled to a 10% tax credit on their SR&ED expenditures. This tax credit is also available to active members of partnerships, to the extent of their proportionate share of the partnership's SR&ED qualified expenditures incurred in the province. (An active member of a partnership includes a qualifying corporation that is otherwise engaged in a business similar to that carried on by the partnership, but excludes a limited or passive partner.)

This tax credit is refundable to qualifying corporations that are CCPCs at the rate of 10% of the lesser of eligible B.C. SR&ED expenditures and the federal expenditure limit (i.e., $3 million or less). It is scheduled to expire on September 1, 2014.

Saskatchewan

The basic Saskatchewan corporate tax rate is 12%. The small business rate of 2% applies on the first $500,000 of a CCPC's active business income. The small business rate decreased to 2% from 4.5% on July 1, 2011.

Saskatchewan, like British Columbia, adopts the federal income base that is used to calculate federal taxable income. For years before 2007, a tax credit mechanism (the Saskatchewan Royalty Tax Rebate Program) applied.

Effective January 1, 2007, much as in other provinces, the elimination of the federal resource allowance and full deductibility of the provincial royalties and taxes, made the Royalty Tax Rebate unnecessary. However, any outstanding Royalty Tax Rebate that arose before January 1, 2007, can still be carried forward for the next seven years.

The province has changed the treatment of SR&ED tax credits for SR&ED expenses incurred after March 31, 2012:

<table>
<tr><th colspan="3"></th><th colspan="2">Qualifying corporation</th></tr>
<tr><th colspan="3"></th><th>CCPC</th><th>Non-CCPC</th></tr>
<tr><td rowspan="4">SR&ED expenditures incurred</td><td colspan="2">Before March 19, 2009</td><td colspan="2">15% non-refundable[1]</td></tr>
<tr><td colspan="2">After March 18, 2009 and before April 1, 2012</td><td colspan="2">15% refundable</td></tr>
<tr><td rowspan="2">After March 31, 2012</td><td>Up to threshold ($3 million or less)</td><td>15% refundable</td><td rowspan="2">15% non-refundable[1]</td></tr>
<tr><td>Above theshold</td><td>15% non-refundable[1]</td></tr>
</table>

1. Non-refundable credits can be carried back three years and forward ten.

Taxation of oil sands operations

Oil sands production refers to the extraction of crude bitumen, a highly viscous hydrocarbon mixture, from oil sands. In its natural state, bitumen cannot be recovered by using conventional oil production methods. The two most common methods of extracting bitumen from oil sands are open-pit mining and *in situ* (in place) extraction.

Although for the most part oil sands production is taxed similarly to conventional production, several key differences are important to note.

The acquisition costs of leases acquired before March 22, 2011, receive different tax treatment for oil sands than for conventional oil and gas. An oil sands deposit is a mineral resource. As such, the cost of acquiring the mineral lease, regardless of the method of extraction used (i.e., open-pit mining or *in situ*), is included in the cumulative CDE pool. Conventional oil and gas and coalbed methane accumulations are considered "petroleum and natural gas and related hydrocarbons." Consequently, the cost of acquiring this property is included in the cumulative COGPE pool. As discussed earlier, the CDE pool is deductible at 30% (declining balance) while the COGPE pool is deductible at 10% (also declining balance).

The cost of acquiring oil sands leases after March 21, 2011, is now included in the cumulative COGPE pool.

Another difference is in the treatment of intangible costs to bring the well or mine into production. Generally, intangible costs incurred to bring a new mine in a mineral resource into production in reasonable commercial quantities are included in CEE. In contrast, intangible costs incurred in bringing an oil or gas well into production are generally included in CDE (unless the costs qualify as CEE, as explained on page 3).

Complex legislation has phased out the CEE treatment for intangible costs incurred to bring a new oil sands mine into production. However, the following transitional relief was provided:

- CEE classifications continue to be available for qualifying intangible costs incurred:
  - before March 22, 2011; or
  - before 2015 for completion of a specified oil sands mine project for which a designated asset was acquired or under construction before March 22, 2011; and
- for qualifying intangible costs that are not covered by these two exceptions, CEE treatment is being phased out as follows:

	2011	2012	2013	2014	2015	2016
Allowable percentage of CEE	100%		80%	60%	30%	0%

The portion that does not qualify as CEE would be treated as CDE.

The CCA claim for mines is more generous than for oil and gas wells. While equipment expenditures for mines and for oil and gas wells are included in Class 41, mining equipment expenditures are eligible for an accelerated CCA claim in addition to the general 25% rate applied to the UCC balance at the end of the year. A taxpayer can claim an additional amount in respect of eligible mining equipment costs, not exceeding the lesser of:

- income from the mine for the year before the deduction for exploration and development expenses and the additional CCA; and
- the remaining UCC in the separate prescribed class at the end of the year before the additional claim.

Eligible costs are those incurred in respect of new projects or a major expansion of existing projects. A major expansion is defined as an expansion that increases the greatest designed capacity of the mine by at least 25%. If the conditions for a major expansion are not met, the accelerated CCA may be available for a certain portion of qualifying expenditures, if these expenditures exceed 5% of the gross revenue from the mine for the year.

An important change involving mining and *in situ* projects made in 1997 was partially curtailed in 2007. In 1996, the federal government extended the accelerated CCA regime to include *in situ* projects, thereby treating all types of oil sands projects on the same basis. However, for *in situ* wells to be treated as a mine, the Minister of National Revenue, in consultation with the Minister of Natural Resources, must make a determination that the wells constitute one project and therefore one mine. This determination generally must be made to support any accelerated CCA claims made in respect of an *in situ* project.

The half-year rule does not apply for purposes of the accelerated CCA claim, and it is possible to obtain an immediate 100% write-off for qualifying expenditures.

As of March 2007, the federal government phased out accelerated CCA for both mining and *in situ* oil sands projects. However, the following transitional relief was provided:

- accelerated CCA continues to be available for otherwise qualifying assets that were acquired:
  - before March 19, 2007; or
  - before 2012 and are part of a project phase on which major construction began before March 19, 2007; and
- for qualifying assets that are not covered by these two exceptions, accelerated CCA is being phased out as follows:

	2010	2011	2012	2013	2014	2015
Allowable percentage of accelerated CCA	100%	90%	80%	60%	30%	0%

Oil sands projects normally take more than three years to complete. Under ordinary "available for use" rules, mentioned in the CCA section of this publication (page 2), this would mean that the taxpayer would not be entitled to claim CCA until the assets are fully constructed. To enable taxpayers to claim CCA earlier, the *Income Tax Act* provides two rules that allow portions of the asset costs to be treated as "available for use" in the third and subsequent years. The first is the two-year "rolling start" rule, for which no election is required. The second is the "long-term project" rule, for which an election is required in the third year of the project. A detailed review of these complex rules is beyond the scope of this publication.

Partnerships and joint ventures

Partnership structures

The oil and gas industry has historically used partnerships in their corporate structures for various reasons. Partnerships are recognized as separate legal entities both for commercial and tax purposes. Partnerships can have different fiscal period ends than their partners. The partners may be individuals or corporations.

Partnerships are not taxpayers. However, their income or loss that is allocated to the partners is included in the income or loss of the partners for both accounting and tax purposes.

Under previous rules, corporate partners were able to defer the taxation of partnership income by adopting a misaligned fiscal period for the partnership. This deferral is no longer available for taxation years ending after March 22, 2011.

The new measures require corporate partners that have a substantial interest in a partnership to accrue the portion of partnership income (but not losses) earned in the "stub period" between the end of the partnership's fiscal period and the end of the corporate partner's taxation year. In some cases, this can result in the inclusion of a significant amount of partnership income (for up to 24 months) in the first taxation year of a corporate partner that ends after March 22, 2011.

Transitional relief allows stub-period income for the first affected fiscal period to be recognized over a 5-year period. However, certain transactions may eliminate the availability of this transitional rule.

New rules that apply specifically to multi-tiered partnerships include a requirement that they adopt a common fiscal period. The rules for tiered partnerships present some particular issues that should be discussed with your tax adviser.

Joint venture arrangements

Joint ventures are common in the oil and gas industry and typically are structured well-by-well or property-by-property, unlike in other industries. As a result, the fiscal period ends of the joint venture and its participants would be the same.

A revision in Canada Revenue Agency (CRA) policy affects any joint venture with a different fiscal period than its participants: joint venture arrangements can no longer report income using a separate fiscal period. Corporate participants must report their actual share of joint venture income or loss up to the end of their own year-end for tax years ending after March 22, 2011, and in certain cases can claim a transitional reserve for the additional income included in that year.

Publicly traded trust structures

Certain earnings of publicly traded income trusts and partnerships, referred to as Specified Investment Flow-Throughs (SIFTs), are subject to a SIFT tax and are deemed to be a dividend when distributed. The SIFT rules are intended to discourage corporations from converting to income trusts, eliminating the tax advantage these structures once enjoyed.

The SIFT tax rate is the federal general corporate rate plus a provincial tax component. The provincial tax component is based on the general provincial corporate income tax rate for each province (except Quebec) in which the SIFT has a permanent establishment and is 10% for SIFTs that do not have a permanent establishment in a province. The combined rate is meant to approximate the rate that would apply if the income were earned by a corporation.

The SIFT rules forced most oil and gas publicly traded trusts and partnerships to restructure their operations to a corporate form before 2011.

Capital tax

The federal and territorial governments do not impose capital taxes. All provincial capital taxes have been phased out. Most recently, Nova Scotia's was eliminated on July 1, 2012. Generally, provincial capital tax paid or payable has been deductible in computing net income for federal income tax purposes.

Saskatchewan

Saskatchewan levies a resource surcharge on resource corporations and resource trusts that in the taxation year have:

- assets exceeding $100 million on an associated corporation basis; or
- a value for taxable paid-up capital (without claiming the deduction for deferred exploration and development expenses) in excess of a $10 million exemption.

The resource surcharge is equal to 3% of the value of resource sales in Saskatchewan for the taxation year, including revenues from the sale of natural gas, petroleum, coal, potash and uranium, The rate is reduced to 1.7% for:

- oil and gas wells with a finished drilling date after September 30, 2002; and
- incremental oil related to new or expanded enhanced oil recovery projects or waterflood projects with a commencement date after September 30, 2002.

The surcharge is fully deductible in calculating net income for income tax purposes both federally and in Saskatchewan.

Resource corporations that have less than $100 million in gross assets may be entitled to deduct up to $2.5 million from the value of resource sales, in calculating the surcharge. The $2.5 million is pro-rated by the ratio of Saskatchewan wages and salaries to total wages and salaries paid by the corporation and associated corporations. This deduction is not available to resource trusts or to resource corporations that are affiliated with a trust.

Scientific research and experimental development (SR&ED)

Scientific research and experimental development tax credits

The Canadian resource sector is in a pivotal stage, with the decline in production of conventional oil and natural gas. To replace production and reserves, greater emphasis is being put on production of heavy oil, oil sands, non-conventional gas (coal bed methane, tight gas, gas hydrates and shale gas) and offshore production. Investment in technology is increasing the life of mature fields and enabling the industry to develop complex, costly and remote resources effectively and in a more environmentally friendly manner. Research and development (R&D) is a key element in achieving this mandate.

Canada's Scientific Research and Experimental Development (SR&ED) program is one of the most generous in the industrialized world in its support of business investment in R&D. The program offers tax incentives to taxpayers that carry on business in Canada and incur qualifying R&D expenditures. Companies file claims for incentives in respect of R&D projects that they believe meet the program's technical eligibility criteria. The SR&ED program provides more than $4 billion in tax credits to Canadian businesses annually. Since its creation in 1985, many companies have used the SR&ED program (the largest federal program supporting industrial R&D in Canada) to increase cash flow, improve profitability and foster an innovative culture.

The scope of eligible projects goes beyond traditional "white lab coat" work, and the majority of the eligible work generally falls under experimental development. In the resource industry, eligible projects can include the development of new petroleum recovery processes such as vapour extraction (VAPEX) and Enhanced Steam Assisted Gravity Drainage (E-SAGD). Bench scale tests as well as field pilots could qualify. In the oil sands surface mining operations, potential projects include bitumen extraction, bitumen/sand separation, tailing pond clean-up, bitumen upgrading, and water treatment and clean-up. In addition, new product development in areas such as corrosion chemicals, demulsifiers, drilling and pumping technologies, sulphur reduction, water-based drilling fluids and information technology may be eligible projects.

2012 federal budget

Changes in the 2012 federal budget:

- reduce the 20% SR&ED ITC rate to 15% for taxation years ending after 2013 (pro-rated for taxation years straddling January 1, 2014);
- provide that capital property acquired (including shared use and leased capital property), generally after 2013, is neither deductible as an SR&ED expenditure nor eligible for ITCs;
- reduce the overhead proxy rate (used to calculate SR&ED overhead expenses as a percentage of eligible salary and wages) from 65% to 60% after December 31, 2012, and to 55% after December 31, 2013 (pro-rated for taxation years that straddle these dates); and
- provide that 80% (reduced from 100%) of SR&ED contract payments (net of SR&ED capital expenditures) to an arm's length contractor incurred after 2012 will be eligible for ITCs.

SR&ED tax incentives

The program allows a 20% ITC (15% after 2013—see "2012 federal budget" above) on qualified SR&ED project expenditures incurred in the year, which can reduce tax otherwise payable. The number of projects and amounts that can be claimed are unlimited, if the technical criteria are met. ITCs can be carried forward twenty taxation years and carried back three, and are included in income in the year after being used.

An enhanced ITC rate of 35% is available for the first $3,000,000 of eligible expenditures for CCPCs whose:

- taxable income did not exceed $500,000 in the previous taxation year; and
- taxable capital did not exceed $10,000,000 in the previous taxation year.

The thresholds are on an associated basis. The tax credits may be refundable to CCPCs.

Qualifying project expenditures are treated as a deductible current expense whether the item is current or capital in nature. This treatment for capital expenditures will be eliminated after 2013—see "2012 federal budget" above. The deduction is discretionary and any unused amount can be carried forward indefinitely.

Various provinces offer additional tax incentives that can be used in conjunction with the federal SR&ED program. These incentives are summarized on:

- pages 6 and 7 of this publication; and
- page 38 of *Tax facts and figures 2012* at **www.pwc.ca/com/taxfacts**.

What projects qualify?

To qualify, work in a project must fall into one of the following categories:

- **Experimental development**: Work done to achieve technological advancement to create or improve new materials, devices, products or processes. More than 90% of SR&ED claims involve experimental development.
- **Applied research**: Work done to advance scientific knowledge with a specific practical application in view (usually performed at corporate R&D facilities or government research facilities).
- **Basic research**: Work done to advance scientific knowledge without a specific practical application in view (usually performed at universities).

A project also includes support work that directly supports and is commensurate with the needs of experimental development, applied research and basic research.

A project must also satisfy all of the following criteria if it is to qualify:

- **Scientific or technological advancement**: The work carried out must generate information that advances the understanding of scientific relations or technologies.
- **Scientific or technological uncertainty**: Uncertainty arises in either of two forms:
  - it may be uncertain whether the advance can be achieved at all; or
  - it is certain the advance can be achieved, but there is uncertainty about which of the alternative methods will work to meet the target technological and/or cost specifications.
- **Scientific or technological content**: There must be evidence that qualified personnel with relevant experience have conducted a systematic investigation through experiment or analysis.

Claiming SR&ED tax incentives

A claim for SR&ED is made in a corporation's income tax return. Form T661 and Schedule 31, which include project descriptions, must be completed and filed with the CRA within 18 months of the taxation year end. A claim consists of both technical descriptions and related expenditures of the various SR&ED projects that are submitted.

Indirect taxes

Federal Goods and Services Tax and the Harmonized Sales Tax

The Goods and Services Tax (GST) is a 5% value-added tax on the supply of all taxable goods and services made in Canada. Residents of Canada that have annual worldwide gross revenues in excess of $30,000 and non-residents of Canada that are carrying on business in Canada are required to be registered for GST purposes.

Registrants must collect GST on all taxable goods and services provided in Canada, and may also be entitled to recover any GST paid to suppliers for goods and services acquired for consumption, use or supply in the course of the registrant's commercial activities. Generally speaking, most GST paid on expenses relating to oil and gas activities in Canada is recoverable.

The Harmonized Sales Tax (HST) is also a value-added tax on all taxable goods and services supplied in a participating province. HST is a harmonization of federal and provincial sales taxes. Five provinces apply the HST: British Columbia (12%), New Brunswick (13%), Newfoundland and Labrador (13%), Nova Scotia (15%) and Ontario (13%).

In a 2011 referendum, voters in British Columbia opted to extinquish the HST and reinstate a provincial retail sales tax system in the province on April 1, 2013. Nova Scotia's rate will decline in stages to 13% by July 1, 2015. Quebec will harmonize with the GST on January 1, 2013, with an effective rate of 14.975%, and Prince Edward Island will adopt a 14% HST on April 1, 2013.

In many respects, HST is similar to the GST in application and, like the GST, is administered by the federal government. A combined GST/HST return must be filed.

Of particular interest to the oil and gas industry is the election that is available to certain oil and gas joint ventures. Normally, each participant in a joint venture is required to report its proportionate share of any net GST/HST owing or refundable for a particular period. When applicable, participants of a qualifying joint venture can elect to have the operator prepare all of the GST/HST returns in respect of the joint venture activities, to further simplify the GST/HST accounting for participants. For GST/HST purposes, a partnership is a separate person and may be required to be registered.

Provincial taxes

Unlike the federal GST/HST, provincial sales taxes are not recoverable and become a cost of doing business in the province for the consumer (individual or commercial) of the taxable goods or services. Provincial sales taxes are generally imposed on tangible personal property and taxable services as defined by each provincial sales tax act. Real property and services in respect of real property are generally exempt.

Alberta

Alberta does not impose a provincial sales tax on goods and services.

British Columbia

A reinstated British Columbia sales tax is likely to resemble the province's previous 7% sales tax on purchases and leases of tangible personal property and taxable services acquired for consumption or use in the province, which was in place until July 1, 2010.

Since July 1, 2008, a carbon tax applies to the purchase or use in British Columbia of fossil fuels such as gasoline, diesel fuel, natural gas, home heating fuel, propane and coal. The tax rate for each fuel has increased each year, reaching their maximums on July 1, 2012. (e.g., for gasoline and diesel fuel, 6.67¢ and 7.67¢ per litre, respectively).

Saskatchewan

Saskatchewan imposes a 5% sales tax on purchases and leases of tangible personal property and taxable services in the province. Some mobile capital equipment used for exploration, development, testing and servicing in the oil, gas and potash industries is exempt. Certain services, including accounting, geoscience, engineering, legal and computer services, are subject to tax. Persons that import taxable property into Saskatchewan are required to self-assess tax on the GST-excluded purchase price at the time of importation, and the property may also qualify for self-assessment on a 1/3 or 1/36 basis (in limited cases).

Insurance premium tax

Canada imposes a 10% tax on net premiums payable in respect of a contract of insurance (other than a contract of reinsurance) that:

- is entered into or renewed against a risk ordinarily within Canada at the time the contract is entered into or renewed; and
- is secured with a non-admitted insurer or through a non-resident broker, subject to certain exceptions.

Taxpayers are required to remit any tax payable on a return on or before April 30 of the year following the year in which the net premiums were payable. The tax does not apply to premiums in respect of contracts that, in the opinion of the CRA, are not available in Canada.

Customs

All goods imported into Canada may be subject to both 5% GST and applicable duties. Under the North American Free Trade Agreement (NAFTA), many goods that are made in the United States and Mexico that qualify for NAFTA treatment are not subject to duties, subject to certain conditions. Any GST paid by a person who is a GST registrant at the time of importation is generally recoverable. However, duties payable at the time of importation are not recoverable.

Alberta's royalty regime

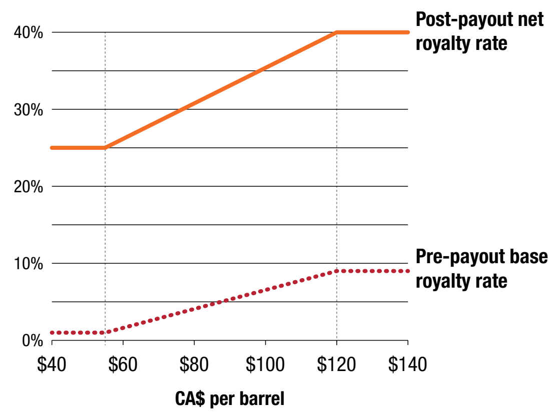
Alberta's royalty tax regime, which has applied since January 1, 2009, has had a significant effect on the oil and gas industry in Alberta and, in particular, the economics of major oil sands projects.

Oil sands

The base royalty rate starts at 1%, increasing for every dollar the oil price is above CA$55 per barrel. The maximum is 9% when the oil price is CA$120 per barrel for the "pre-payout" period of an oil sands project. The base royalty is not payable after the payout period.

The net revenue royalty starts at 25%, increasing for every dollar the oil price is above CA$55 per barrel, to a maximum of 40% when the oil price is CA$120 or higher.

		Pre-payout base royalty rate	Post-payout net royalty rate
Oil price (CA$ per barrel)	≤ $55	1.00%	25.00%
	$65	2.23%	27.31%
	$75	3.46%	29.62%
	$85	4.69%	31.92%
	$95	5.92%	34.23%
	$105	7.15%	36.54%
	$115	8.38%	38.85%
	≥ $120	9.00%	40.00%



Conventional oil and natural gas

Royalties are calculated monthly by a single sliding-rate formula that factors in oil price and well production. Because the formulas and rates change regularly, further discussion of the formula and rates is beyond the scope of this booklet.

Appendices

Appendix A – Income for federal tax purposes

	December 31, 2009	December 31, 2010	December 31, 2011	December 31, 2012
Gross revenues				
Oil sales	600,000	600,000	600,000	600,000
Gas sales	400,000	400,000	400,000	400,000
Royalties	140,000	140,000	140,000	140,000
Dividends	10,000	10,000	10,000	10,000
Other non-resource income	150,000	150,000	150,000	150,000
	1,300,000	1,300,000	1,300,000	1,300,000
Royalty charges				
Crown royalties	(300,000)	(300,000)	(300,000)	(300,000)
Other royalties	(90,000)	(90,000)	(90,000)	(90,000)
	(390,000)	(390,000)	(390,000)	(390,000)
Net revenues	910,000	910,000	910,000	910,000
Expenses				
General and administrative expenses	(100,000)	(100,000)	(100,000)	(100,000)
Operating expenses	(100,000)	(100,000)	(100,000)	(100,000)
Depletion, depreciation and amortization expense	(75,000)	(75,000)	(75,000)	(75,000)
Interest expense	(65,000)	(65,000)	(65,000)	(65,000)
	(340,000)	(340,000)	(340,000)	(340,000)
Net income for accounting purposes	570,000	570,000	570,000	570,000
Add (deduct):				
Depletion, depreciation and amortization expense	75,000	75,000	75,000	75,000
Charitable donations	5,000	5,000	5,000	5,000
Capital cost allowance (see Appendix D)	(175,000)	(181,250)	(160,938)	(133,203)
Canadian oil and gas property expense (see Appendix E)	(35,500)	(44,950)	(53,455)	(61,110)
Canadian development expense (see Appendix E)	(72,000)	(80,400)	(86,280)	(90,396)
Canadian exploration expense (see Appendix E)	(95,000)	(125,000)	(155,000)	(185,000)
	(297,500)	(351,600)	(375,673)	(389,709)
Income for federal tax purposes	272,500	218,400	194,327	180,291

Appendix B – Taxable income and tax (federal tax purposes)

		December 31, 2009	December 31, 2010	December 31, 2011	December 31, 2012
Taxable income					
Income for tax purposes (see Appendix A)		272,500	218,400	194,327	180,291
Less:	Charitable donations[1]	(5,000)	(5,000)	(5,000)	(5,000)
	Intercorporate dividends received[2]	(10,000)	(10,000)	(10,000)	(10,000)
	Non-capital losses from prior years[3]	-	-	-	-
Taxable income		257,500	203,400	179,327	165,291
Tax computation					
Effective federal tax rate (see below)		19.0%	18.0%	16.5%	15.0%
Federal tax		(48,925)	(36,612)	(29,589)	(24,794)
Effective federal tax rate					
Basic rate		38.0%	38.0%	38.0%	38.0%
Less:	Provincial tax abatement[4]	(10.0%)	(10.0%)	(10.0%)	(10.0%)
Less:	Small business deduction[5]	-	-	-	-
Less:	General rate reduction	(9.0%)	(10.0%)	(11.5%)	(13.0%)
Effective tax rate		19.0%	18.0%	16.5%	15.0%

Notes:

1. Charitable donations are deductible up to 75% of income for the year. Excess donations can be carried forward and deducted in computing income for up to five succeeding years, subject to the 75% income limit.
2. Intercorporate dividends between Canadian corporations are generally tax-free. In certain circumstances related to private corporations, a 33 1/3% refundable tax may be imposed on the recipient of dividends.
3. Non-capital losses (e.g., business losses) can be carried back three taxation years and forward twenty in the calculation of taxable income.
4. A tax reduction (abatement) in federal tax otherwise payable of 10% of taxable income is applicable to income earned in a province.
5. A "small business deduction," in lieu of the general rate reduction of 17%, is allowed in respect of a CCPC's active business income earned in Canada that does not exceed the $500,000 small business threshold.

   In general, a CCPC is a Canadian corporation that is not controlled by, or by any combination of, non-resident persons or public corporations. The small business deduction begins to be phased out when taxable capital on an associated basis exceeds $10 million, and is eliminated when it reaches $15 million.

Appendix C – Taxable income and tax (Alberta)

Assumption: Oil and gas operations of this company take place in Alberta only.

	December 31, 2009	December 31, 2010	December 31, 2011	December 31, 2012
Taxable income				
Taxable income – federal tax purposes (see Appendix B)	257,500	203,400	179,327	165,291
Taxable income – Alberta	257,500	203,400	179,327	165,291
Tax computation				
Basic rate:	10.00%	10.00%	10.00%	10.00%
Tax at basic rate:	25,750	20,340	17,933	16,529
Less tax credits: Small business deduction[1]	-	-	-	-
Net Alberta tax	25,750	20,340	17,933	16,529

Note:

1. A small business deduction of 7% of the $500,000 small business threshold is available to CCPCs.

Appendix D – CCA calculation

This illustration shows how the CCA system works for Class 41 property (see page 2), which has a 25% CCA rate.

	December 31, 2009	December 31, 2010	December 31, 2011	December 31, 2012
Tax pool (Class 41)				
Opening balance	550,000	675,000	593,750	532,812
Additions at cost	300,000	100,000	100,000	-
Proceeds of disposition[1]	-	-	-	-
Balance at year end	850,000	775,000	693,750	532,812
CCA claim for year[2]	(175,000)	(181,250)	(160,938)	(133,203)
Closing balance	675,000	593,750	532,812	399,609
Claim calculation				
Opening balance	550,000	675,000	593,750	532,812
CCA rate	25%	25%	25%	25%
	137,500	168,750	148,438	133,203
Additions	300,000	100,000	100,000	-
Proceeds of disposition	-	-	-	-
	300,000	100,000	100,000	-
CCA rate	12.50%	12.50%	12.50%	12.50%
	37,500	12,500	12,500	-
CCA claim – available	175,000	181,250	160,938	133,203
CCA claimed[3]	175,000	181,250	160,938	133,203

Notes:

1. Proceeds of disposition are calculated as the lesser of:
   - the actual proceeds of disposition; and
   - the cost of property disposed of.

   If proceeds exceed cost, a capital gain will result, of which 50% is included in income as a taxable capital gain. If the proceeds of disposition of property of a class exceed the UCC balance in the class, that negative balance will be included in income for tax purposes as "recapture." Any UCC balance remaining after all property of a class is sold can be deducted in computing income for tax purposes as a "terminal loss."

2. CCA on additions is restricted to 50% of the regular 25% rate in the year the asset is acquired. The CCA claims are calculated as shown in the table, under "Claim calculation." In general, CCA cannot be claimed in respect of a property until the property is "available for use."

3. The CCA claim in this illustration is made at maximum. The company can claim any amount from nil up to the maximum amount.

Appendix E – COGPE, CDE and CEE

	December 31, 2009	December 31, 2010	December 31, 2011	December 31, 2012
COGPE (10%)				
Opening balance	225,000	319,500	404,550	481,095
Current additions	180,000	180,000	180,000	180,000
Proceeds on sale of resource properties	(50,000)	(50,000)	(50,000)	(50,000)
Subtotal	355,000	449,500	534,550	611,095
Claim available for the year	(35,500)	(44,950)	(53,455)	(61,110)
Claim made for the year[1]	(35,500)	(44,950)	(53,455)	(61,110)
Ending balance	319,500	404,550	481,095	549,985
CDE (30%)				
Opening balance	140,000	168,000	187,600	201,320
Current additions	100,000	100,000	100,000	100,000
Subtotal	240,000	268,000	287,600	301,320
Claim available for the year	(72,000)	(80,400)	(86,280)	(90,396)
Claim made for the year[1]	(72,000)	(80,400)	(86,280)	(90,396)
Ending balance	168,000	187,600	201,320	210,924
CEE (100%)				
Opening balance	-	-	-	-
Current additions	95,000	125,000	155,000	185,000
Proceeds on sale of seismic data	-	-	-	-
Subtotal	95,000	125,000	155,000	185,000
Claim available for the year	(95,000)	(125,000)	(155,000)	(185,000)
Claim made for the year[1,2]	(95,000)	(125,000)	(155,000)	(185,000)
Ending balance	-	-	-	-
Total COGPE, CDE & CEE claims	202,500	250,350	294,735	336,506

Notes:

1. The resource pool claims in this illustration are made at maximum. The company can claim any amount from nil up to the maximum amount.
2. A principal business corporation (see page 3) cannot create or increase a non-capital loss by claiming CEE.

Appendix F – Abbreviations

CCA	Capital Cost Allowance
CCPC	Canadian-Controlled Private Corporation
CDE	Canadian Development Expense
CEDOE	Canadian Exploration and Development Overhead Expense
CEE	Canadian Exploration Expense
CFRE	Cumulative Foreign Resource Expense
COGPE	Canadian Oil and Gas Property Expense
CRA	Canada Revenue Agency
CRCE	Canadian Renewable and Conservation Expense
E-SAGD	Enhanced Steam Assisted Gravity Drainage
FRE	Foreign Resource Expense
GST	Goods and Services Tax
HST	Harmonized Sales Tax
ITC	Investment Tax Credit
NAFTA	North American Free Trade Agreement
R&D	Research and Development
SIFT	Specified Investment Flow-Through
SR&ED	Scientific Research and Experimental Development
UCC	Undepreciated Capital Cost
VAPEX	Vapor Extraction