Taxation of Resources & Flow-Through Shares

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Overview

- Overview of resource exploration & development costs in Canada (“CEE”/”CDE”)
- Overview of Flow-Through Shares (“FTS”)
- Common FTS errors and CRA tax audits
- Provincial exploration tax credits & incentives

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Overview of Resource Exploration & Development Costs in Canada

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Overview of E&D Resource Costs ("CEE" & "CDE")

- Special treatment of costs during exploration & development stages of mining and oil & gas
- Accumulated in special tax pools with indefinite carry-forward period to deduct vs. ordinary operating expenditures (non-capital loss limited carry-forward period)
  - CEE = Canadian Exploration Expenditures
  - CDE = Canadian Development Expenditures

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Overview of E&D Resource Costs ("CEE" & "CDE")

- <u>Canadian Exploration Expenditures</u>
  - Incurred by taxpayer for purposes of determining mineral or oil & gas resource:
    - Existence;
    - Location;
    - Extent; or
    - Quality
  - Annual deduction limit (principal-business corporation "PBC") = lesser of:
    - (i) income for the year and
    - (ii) CEE pool balance at year-end

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Overview of E&D Resource Costs ("CEE" & "CDE")

- <u>Canadian Exploration Expenditures (cont)</u>
- Costs include:
  - Prospecting
  - Rotary, diamond, percussion or other drilling
  - Geological, geophysical or geochemical surveys
  - Trenching, digging test pits and preliminary sampling
- Excludes:
  - Expenses considered to be CDE (i.e. Development)
  - Expenses reasonably considered to be related to a mine that has come into production in reasonable quantities

Overview of E&D Resource Costs ("CEE" & "CDE")

- <u>Canadian Development Expenditures</u>
  - Bringing a new mine of a mineral resource in Canada (excl oil sands) into production in reasonable commercial quantities, for example:
    - Clearing land, removing overburden/stripping
    - Sinking a mine shaft, constructing an adit or underground entry
    - Mineral prop acquisition costs (O&G acq = COGPE)
    - <u>EXCLUDES</u> costs covered under CEE
  - Deduction limit = greater of POD and 30% of pool

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Overview of E&D Resource Costs ("CEE" & "CDE")

- **Canadian Exploration & Development Overhead Expenditures – "CEDOE"**
  - Subcategory of CEE/CDE for overhead costs
  - Do not qualify for flow-through shares
    - Examples:
      - Admin/mngt/financing costs
      - Profits on pmts to connected persons (10% S/H)
      - Salaries/wages persons duties < 90% Expl&Dev
      - R&M/insurance/leasing assets < 90% Expl&Dev
        - "All or substantially all (90%+)" test

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Overview of Flow-Through Shares

Overview of Flow-Through Shares

- Summary of Topics:
  - Background of FTS program
  - Flow-Through Shares defined
  - Eligible & Ineligible costs to renounce
  - The "Look-Back" Rule
  - "Stacked" or "Two-Tier" Renunciations
  - Advantages & Disadvantages of FTS
  - Compliance – tax forms

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Overview of Flow-Through Shares

- Background:
  - Special common shares issued by mining/O&G company
    - >>> "Principal-Business Corporation"
  - "PBC" = principal business activities relate to mining/O&G operations or exploration
  - PBC uses funds raised from FTS on eligible exploration expenditures
  - Tax deduction/credit passes to investor

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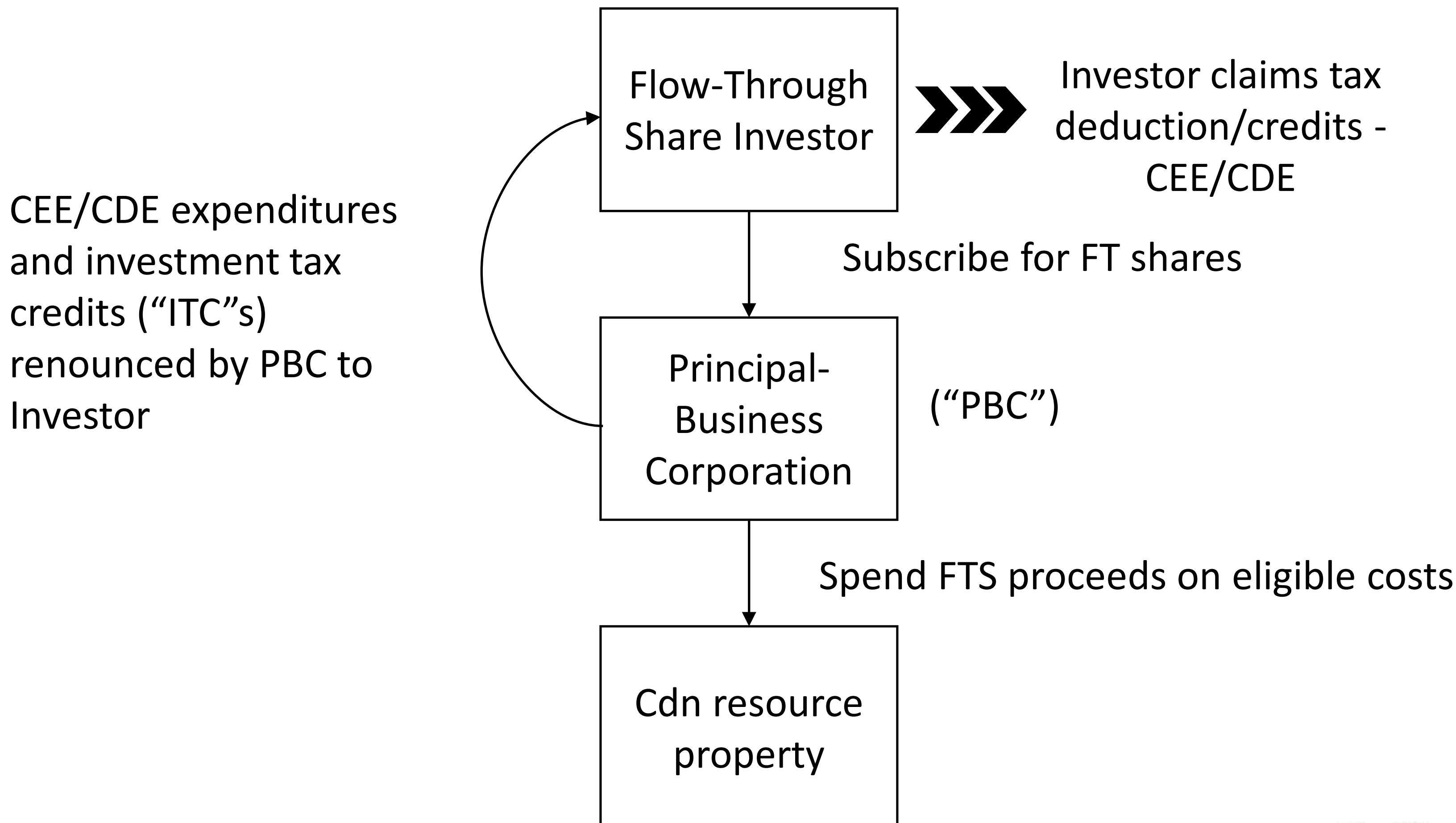
Overview of Flow-Through Shares



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Overview of Flow-Through Shares

- Flow-Through Shares:
  - Common shares issued per subscription agreement w/ commitment to renounce CEE/CDE
    - >>> Cannot be “Prescribed Share” – (i.e. no additional benefit (loss limit/rights etc) provided)
  - Amount renounced cannot exceed consideration received for FTS
  - Indemnification per agreement

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Overview of Flow-Through Shares

- Eligible Costs:
  - "Grass-roots" CEE
    - First $1M of CDE renounced as CEE if PBC's taxable capital below $15M (eliminated after 2018)
  - Incurred after date of FTS agreement but within 24 month period following
  - Must be renounced by end of February of year following 24 month period
  - Super Flow-Through Shares provide add'l Federal investment tax credit of 15% (non-refundable)

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Overview of Flow-Through Shares

- Costs Not Eligible:
  - CEDOE
  - Personal or living expenses
  - Capital cost of depreciable property
  - Seismic Data (“off-the-shelf”)
  - Bulk sampling (sale proceeds/recovery further reduce FTS eligible costs)

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Overview of Flow-Through Shares

- <u>The "Look-Back" Rule</u>:
  - CEE renounced to investor as of Dec 31 of Year 1 (i.e. deducted in Year 1)
  - Eligible costs incurred in Year 2
  - Part XII.6 tax paid based on monthly unspent funds remaining in Year 2
  - Renounced CEE reduced where shortfall as of Dec 31 of Year 2

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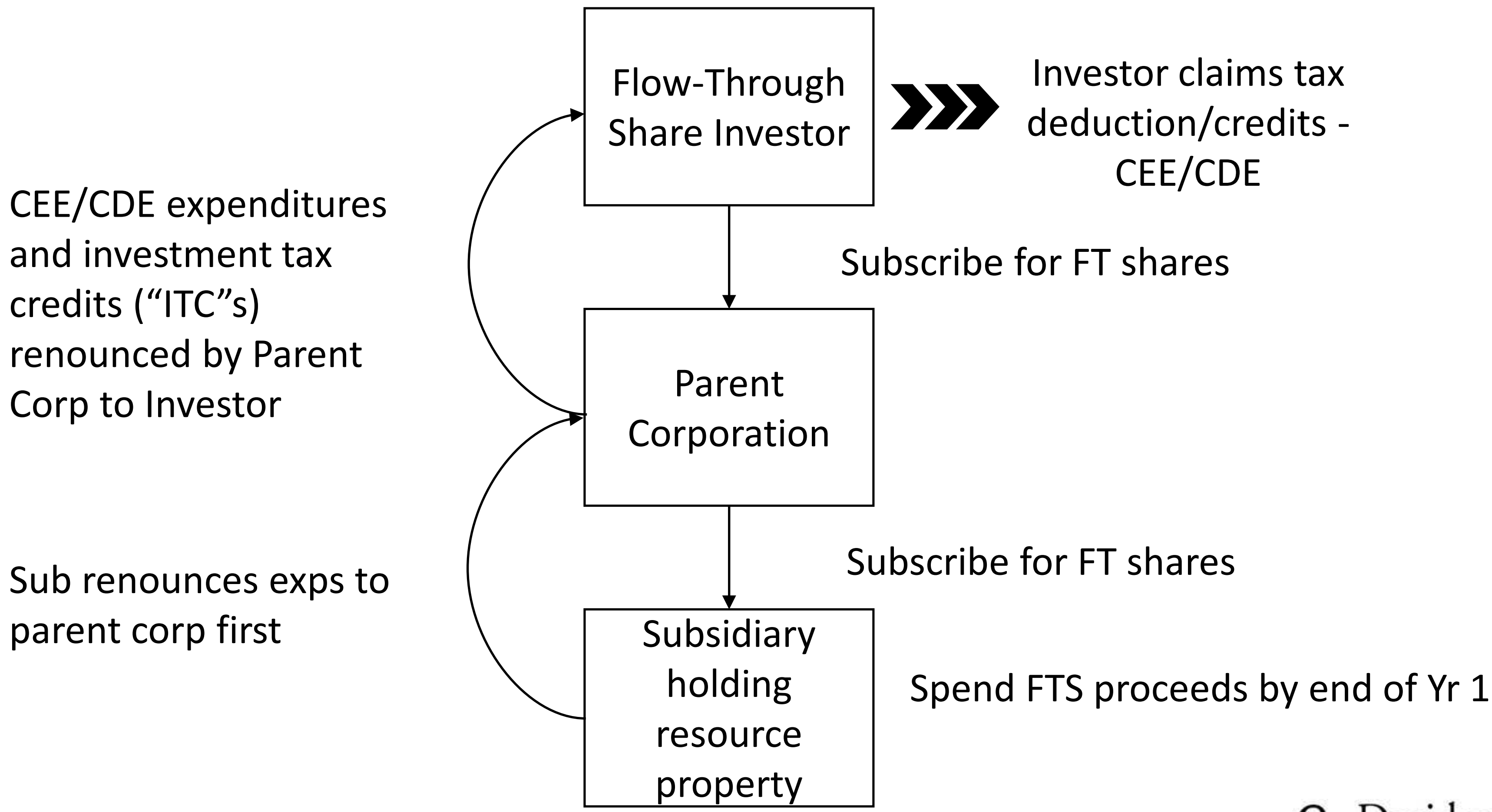
Overview of Flow-Through Shares

- <u>“Stacked” or “Two-Tier” Renunciation</u>
  - Corp issuing FTS may not hold property, but instead a subsidiary/related corp
  - Cannot incur CEE for no consideration
  - Subsidiary issues shares to parent corp and renounces CEE to parent first
  - Not eligible for “look-back” method on first tier of renunciation since non-arm’s length parties

Overview of Flow-Through Shares



Overview of Flow-Through Shares

- <u>Advantages to FTS financing</u>:
  - Attractive to investors
    - >>> Immediate Tax Savings
  - Company normally reports losses during E&D phase, no immediate need for tax deduction, premium share price

- <u>Disadvantages to FTS financing</u>:
    - No tax cost base to investor on sale
    - Compliance requirements

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Overview of Flow-Through Shares

- <u>Compliance – Federal T100 Forms</u>:
  - T100A – App for ID number "TIN"
  - T100B – Details of FTS/Warrants issued
  - T100C – App for TIN on warrants exerc.

- T100A Filing deadline = end of month following first share sub agmt date
- Penalty maximum $15,000

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Overview of Flow-Through Shares

- Compliance – Federal T101 Forms:
  - T101A – Renounce CEE/CDE to investor
  - T101B – Reduce/reclass/amend previously renounced
  - T101C – Part XII.6 tax return
  - T101D – Summary of Assistance

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Overview of Flow-Through Shares

- <u>Compliance – T101A Form</u>:
  - Reports CEE/CDE exp's and investment tax credits renounced to investor
  - Filing Deadline = month end following month of renunciation
  - Maximum late filing penalty = $15,000

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Overview of Flow-Through Shares

- <u>Compliance – T101B Form</u>:
  - Used to adjust/reduce/reclass amount of CEE/CDE renounced per eligible exp's
  - Filing Deadline = before March of Year 3
  - Maximum late filing penalty = $2,500 plus 25% of excess renounced

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Overview of Flow-Through Shares

- <u>Compliance – T101C Form</u>:
  - Calculate Part XII.6 tax – "look-back rule" on portion spent during Year 2 (1/12 of 1% per month unspent + 10% unspent at end of year)
  - Filing Deadline = before March of Year 3
  - Maximum late filing penalty = 17% of total Part XII.6 tax (5% + 1% per mth late)

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Overview of Flow-Through Shares

- <u>Compliance – T101D Form</u>:
  - Reports assistance received reducing CEE/CDE eligible for renunciation
  - Filing Deadline = month end following month of entitled to assistance
  - Maximum late filing penalty = $15,000

Overview of Flow-Through Shares

- Quebec FTS Compliance:
  - Add’l reporting requirements for investors in Quebec (RL-11)
  - Possible to miss when investor is limited partnership – partner/investor residency may be unclear without add’l info

Common Flow-Through Share Errors & CRA Tax Audits

Common FTS Errors & CRA Audits

- Common Errors:
  - Incorrect completion of forms
  - Late filed forms
  - Ineligible costs renounced
  - Stacked renunciation filings incomplete, first tier shares from sub to parent missed
  - Part XII.6 tax overlooked

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Common FTS Errors & CRA Audits

- <u>CRA Audits</u>:
  - Unsupported/ineligible costs renounced leading to spending shortfall
  - Stacked renunciation agreement between parent/sub not in place
  - Mngt/adm fees pd to related party, profit component not eligible FTS cost (i.e. 10%+ shareholder – “connected person”)

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Common FTS Errors & CRA Audits

- Implications of Spending Shortfall:
  - CRA reassesses investor's taxes, reduces CEE and possible tax credits
  - Assessment of Part XII.6 tax at 10%
  - Most share agreements indemnify investor for tax deductions/credits denied, indemnification costs can be significant
  - Investor relations issues >> mitigate by allocating shortfall to specific investor(s)

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Provincial Exploration Tax Credits & Incentives

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Provincial Exploration Tax Credits

- **BC Mining Exploration Tax Credit:**
  - 20% refundable tax credit
  - Qualified mining exploration expenses (similar to FTS eligible costs criteria) incurred in BC
  - Need to have BC permanent establishment
  - Can only claim on exp’s not renounced under FTS
  - Add’l 10% credit if exploration in prescribed “Mountain Pine Beetle” areas
  - Deadline to claim – 36 months after tax year-end

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Provincial Exploration Tax Credits

- BC Mining FTS Tax Credit:
  - Only available to individuals subject to income tax in BC
  - 20% non-refundable tax credit
  - Limit – carry-forward 10 years, carry-back 3 years
  - Qualified mining exploration expenses incurred in BC

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Provincial Exploration Tax Credits

- **Quebec Resource Tax Credit:**
  - 31% refundable tax credit – Near North/Far North region
  - 28% refundable tax credit – Elsewhere in Quebec
  - Qualified exploration expenses (similar to FTS eligible costs criteria) incurred in Quebec (not operating mineral resource in commercial quantities)
  - Need to have Quebec permanent establishment
  - Can only claim on expenses not renounced under FTS
  - Deadline to claim – 18 months after tax year-end

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Provincial Exploration Tax Credits

- **Quebec Mining Tax Refund**:
  - Up to 16% refundable tax credit on eligible expenditures
  - Limited to losses incurred
  - Qualified exploration expenses (similar to FTS eligible costs criteria) incurred in Quebec (not operating mineral resource in commercial quantities)
  - Need to have Quebec permanent establishment
  - Can only claim on expenses not renounced under FTS
  - Quebec Mining Tax Credit claimed reduces eligible expenditures
  - Deadline to claim – 6 months after tax year-end

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Conclusion

- Several rules and tax filings to comply with FTS requirements – ensure deadlines are met to avoid costly penalties.
- Monitor FTS spending on a regular basis to avoid shortfall.
- Ensure costs incurred are eligible to be renounced. Avoid using funds for expenses such as admin.
- Watch for limited partnership investors – may require Quebec FTS tax filings in addition to Federal forms.
- Remember stacked FTS arrangements require two layers of FTS compliance and are NOT eligible under "Look-Back".
- Ensure claims for provincial tax credits are filed on time otherwise refunds can be denied.

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Questions?