

GUIDANCE ON THE INTERPRETATION OF CANADIAN EXPLORATION EXPENSES (CEE) FOR AME MEMBERS

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DISCLAIMER

The comments in this guidance document are based on input from AME members, technical guidance and interpretation developed by the Canadian Revenue Agency (CRA) and AME's interpretation of the current federal legislation related to the definition of Canadian Exploration Expense (CEE). CRA's interpretation of the legislation could lead to very different outcome with respect to the classification of CEE than is outlined in this document. Each case is unique and CRA's interpretation is based on the facts and circumstance of each particular project incurring CEE. We cannot provide assurance that the comments here will be accepted by CRA. Please use the information with caution and seek advice from professional tax accountants and lawyers.

INTRODUCTION

Canadian exploration expenses (CEE) as defined in the Income Tax Act, are certain types of exploration expenditures incurred by a company exploring for a mineral deposit in Canada which are 100% deductible by the company. Most CEE can also be renounced to share holders who invest in flow-through shares issued by the company. In addition, the federal Mineral Exploration Tax Credit (15%) and similar provincial tax credits in British Columbia and other provinces, provide for additional tax deductions to flow-through investors. Given the importance of flow-through financing to the Canadian mineral exploration sector, it is important that companies have a good understanding of the type of expenditures that qualify as CEE and that can be renounced to flow-through shareholders.

This document provides an explanation of key elements of CEE as outlined in the Income Tax Act and outlines how the Canada Revenue Agency (CRA) generally interprets tax law related to CEE based on technical interpretations and rulings issued by CRA and by AME member experience. It also contains useful tips and advice from AME members on how companies can effectively plan for and document their exploration expenditures that will be claimed as CEE.

DEFINITION OF 'CANADIAN EXPLORATION EXPENSE' AND 'MINERAL RESOURCE' IN THE INCOME TAX ACT

The definition of Canadian Exploration Expense (CEE) in the Canadian Income Tax Act can be found in section [66.1\(6\)](#) of the Act:

Paragraph (f) of subsection [66.1\(6\)](#) of the act provides the definition of CEE:

(f) any expense incurred by the taxpayer (other than an expense incurred in drilling or completing an oil or gas well or in building a temporary access road to, or preparing a site in respect of, any such well) for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada including such an expense for environmental studies or community consultations (including, notwithstanding subparagraph (v), studies or consultations that are undertaken to obtain a right, licence or privilege for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada) and any expense incurred in the course of

- **(i)** prospecting,
- **(ii)** carrying out geological, geophysical or geochemical surveys,
- **(iii)** drilling by rotary, diamond, percussion or other methods, or
- **(iv)** trenching, digging test pits and preliminary sampling,

but not including

- **(v)** any Canadian development expense,
- **(v.1)** any expense described in subparagraph (i), (iii) or (iv) in respect of the mineral resource, incurred before a new mine in the mineral resource comes into production in reasonable commercial quantities, that results in revenue or can reasonably be expected to result in revenue earned before the new mine comes into production in reasonable commercial quantities, except to the extent that the total of all such expenses exceeds the total of those revenues, or
- **(vi)** any expense that may reasonably be considered to be related to a mine in the mineral resource that has come into production in reasonable commercial quantities or to be related to a potential or actual extension of the mine,

MINERAL RESOURCE

The definition of CEE is specifically related to expenses incurred for the purpose of determining the existence, location, extent or quality of a **mineral resource** in Canada. A mineral resource is defined in subsection [248\(1\)](#) of the act as follows:

mineral resource means

- **(a)** a base or precious metal deposit,
- **(b)** a coal deposit,
- **(c)** a bituminous sands deposit or oil shale deposit, or
- **(d)** a mineral deposit in respect of which
 - **(i)** the Minister of Natural Resources has certified that the principal mineral extracted is an industrial mineral contained in a non-bedded deposit,
 - **(ii)** the principal mineral extracted is ammonite gemstone, calcium chloride, diamond, gypsum, halite, kaolin or sylvite, or
 - **(iii)** the principal mineral extracted is silica that is extracted from sandstone or quartzite; (*matières minéralesressource minérale*)

Please note that this definition is considerably different than the one commonly used by industry that was developed by the Canadian Institute of Mining, Metallurgy and Petroleum (CIM) and that is included

in National Instrument 43-101 (see [CIM Definition Standards for Mineral Resources & Mineral Reserves](#)). Among the key differences is that the definition of a mineral resource in the Income Tax Act makes no reference to ‘reasonable prospects for eventual economic extraction’ which is core to the CIM definition. This is important because some of the guidance provided by CRA does not consider expenditures for ‘economic’ purposes to be CEE. For example, the Mining Expenditure Review Table released by CRA in 2019 states that *“If sampling is done to help evaluating the economic viability or technical feasibility of a project, it is not eligible [as CEE]”*. As such, sampling and exploration expenditures that CRA interprets are for economic purposes may not meet the purpose test. These can include expenditures related to metallurgical studies, bulk samples and feasibility studies.

PURPOSE TEST FOR CEE

In its interpretation of the Income Tax Act, CRA places considerable weight on what it calls the ‘purpose’ test. An expenditure will only be considered CEE if it passes the purpose test as outlined in the definition of CEE, that is *“any expense incurred by the taxpayer for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada”*.

It is important to keep the purpose test in mind for all mineral exploration activities and to connect all expenditures to this purpose test including in invoices and contracts and in documents submitted to CRA. CRA has developed guidelines to help companies understand how it interprets the definition of CEE and the purpose test (see CRA Guidelines section). It is recommended that companies benchmark all their proposed CEE expenditures to this guidance and to the purpose test.

The purpose test is essentially a physical definition to exploring for a mineral resource and does not include reference to economic considerations. One of the challenges with the purpose test is the word ‘quality’. This term can mean different things to different people. While the word ‘quality’ can be interpreted to include economic considerations, CRA generally does not consider economic viability as part of ‘quality’ and thus exploration activities that are undertaken to assess economic viability, such as some metallurgical studies, may not meet the purpose test.

CRA GUIDELINES ON EXPENSES THAT QUALIFY AS CEE

The CRA has released guidance to help mineral explorers understand the types of expenditures that would normally qualify as CEE. While these guidelines are not law, they are CRA’s interpretation of the tax act and provide guidance on how CRA is likely to view different types of expenditures during an audit. It is recommended that companies benchmark all their proposed exploration expenditures to these guidelines and where possible reference these guidelines in their submissions to CRA. While some of these guidelines are open to interpretation and may not always follow industry practices, this is the best available guidance that CRA has provided.

MINING EXPENDITURE REVIEW TABLE - 2019

The [Mining Expenditure Review Table](#) released in 2019 is the most comprehensive set of guidelines that have been released. In many cases the guidelines are clear and helpful. The guidelines also reinforce that CRA generally does not consider expenditures related to economic viability as meeting the purpose test for CEE. For example, footnote 4 of the table states that *“If sampling is done to help evaluating the economic viability or technical feasibility of a project, it is not eligible [as CEE]”*.

Brian R. Carr from Thorsteinssons LLP has written an informative critique of the 2019 guidelines that addresses the issue of economic viability. It is worth reading to assist in the use of the guidelines. [“What is a Canadian Exploration Expense?” by Brian R. Carr](#) (Pages 1, and 2 through 8 in: Resource Sector Taxation, Volume XIII, No. 2, 2019, Thomson Reuters Taxnet Pro™ Federated Press Centre (Corporate), This article is reproduced by permission of Thomson Reuters Canada Limited.)

GUIDELINES FOR ENVIRONMENTAL STUDIES, COMMUNITY CONSULTATION, AND FEASIBILITY STUDIES – 2017 & 2018

CRA has released two sets of recent guidelines related to environmental studies and community consultation and one also includes guidelines related to feasibility studies. These were in response to changes in the Tax Act in 2016 that allowed for some expenditures related to environmental studies and community consultation to be included as CEE. The first set of guidelines referred to as [Guidelines for determining the tax treatment of certain exploration expenses](#) were released in January 2017 and address questions of technical interpretation related to environmental studies, community consultation and feasibility studies.

The second set of guidelines referred to as [Interpretation of expenses incurred in relation to community consultation or environmental studies](#) were released in November 2018 and provide further guidance on the eligibility of expenditures related to capacity payments, on-going consultation expenditures during exploration, and legal documentation expenses related to engagement and consultation with an Aboriginal (Indigenous) community, as well as environmental assessment expenses. Please keep in mind that these guidelines were developed by CRA in response to a hypothetical scenario which may not be applicable to your specific tax situation.

OTHER TECHNICAL INTERPRETATIONS AND TAX RULINGS

The CRA has also released many other tax and technical interpretations, advanced rulings and other guidance related to CEE that may be worth reviewing. However, please keep in mind that there is a large number of publications and finding relevant ones can be a challenge. These publications can be found on <https://taxinterpretations.com/>. Please note that taxinterpretations.com is a private company that reproduces CRA technical interpretations, rulings and guidance. Some of the information is available only with a paid account. CRA does not maintain its own online library of rulings.

90% RULE FOR WAGES AND PROPERTY USED IN MINERAL EXPLORATION AND RENOUNCIATION TO FLOW-THROUGH SHAREHOLDERS

One area that mineral explorers should be aware of is that administrative expenses, known as a Canadian exploration and development overhead expense, while considered CEE in the Tax Act, cannot be renounced to flow-through shareholders. This is outlined in section [66\(12.6\)](#) of the Tax Act.

This has led to some confusion, particularly around employees who undertake both administrative duties and field-based exploration. Likewise, there is uncertainty whether the cost of property used for mineral exploration and for other purposes is an eligible CEE that can be renounced to flow-through shareholders.

Canadian exploration and development overhead expense are defined in subsection [1206\(1\)](#) of the Income Tax Regulation. This definition says that salary, wages or other remuneration for people employed by the company, and rents, taxes, etc. paid for a property must be *all or substantially all* directed (or paid) towards exploration or development activities to be renounced to flow-through shareholders. The question arises as to how *all or substantially all* is defined. That issue was commented on by CRA in 2007 in [Technical Interpretation 2007-0246921E5](#). In this publication, CRA states that *all or substantially all* means 90% or more of a worker's time must be devoted to exploration or that the property must be used 90% of the time for exploration activities. They provide an example to help clarify the point: "For example, if a geologist is paid on a salary basis with a company and spends 60% of the time on geological work, and 40% on administration, the full amount of the geologist's salary would not be eligible." In this case, the full amount means 100% of the geologist's salary is not eligible to renounce to flow-through shareholders.

The time frame generally considered by CRA is the tax year, so 90% or more of the geologist's time for the entire tax year, must be directed toward geological work to be renounced.

The bottom line is that salary and payments to workers and rents and other payments for properties can only be renounced to flow-through shareholders if at least 90% of the worker's time or 90% of the property's use is for mineral exploration activities.

CRA ADVANCE RULING – AN OPTION FOR SOME TYPES OF PROJECTS

In some cases, it may be advantageous to apply for an advance tax ruling from CRA to determine whether proposed exploration activities will be considered CEE. According to CRA, "*A ruling is a written statement confirming how the CRA's interpretation of specific provisions of Canadian income tax law applies to a definite transaction or transactions that a taxpayer is contemplating.*" See here for [IC70-6R9 Advance Income Tax Rulings and Technical Interpretations](#). A ruling is considered binding by CRA, subject to a number of terms and conditions specific to the ruling. If exploration work deviates from the specifics considered by CRA in their ruling, which can often happen in mineral exploration, the advance

ruling may no longer be valid or binding on CRA. In addition, the work must be started by a date specified in the ruling for it to be binding.

Advance rulings are normally used where there is uncertainty whether the proposed exploration activities qualify as CEE. This should be considered for brownfield sites including exploration underground, and for metallurgical studies, bulk samples and exploration on a property for which a prefeasibility or feasibility study has been released.

An advance ruling typically takes 3 to 12 months to complete, and CRA will normally consult with technical experts in Natural Resources Canada to support their decision. There are hourly fees for all the work undertaken by CRA to arrive at the advance ruling and total costs for a ruling could exceed \$25,000 plus legal and accounting fees depending on the complexity of the case.

Information on advance rulings and how to apply can be found here: [IC70-6R9 Advance Income Tax Rulings and Technical Interpretations](#). The Rulings Directorate can be contacted at the following coordinates:

Income Tax Rulings Directorate

Canada Revenue Agency
9th floor, Tower A
Place de Ville, 320 Queen Street
Ottawa ON K1A 0L5
Email: itrulingsdirectorate@cra-arc.gc.ca
Fax: 613-957-2088

An example of an advance ruling for a bulk sample that CRA references in the 2019 [Mining Expenditure Review Table](#) can be found here: [2007 Ruling 2006-0211941R3 - Canadian exploration expense](#).

EXPLORATION ON BROWNFIELD PROJECTS AND INTERPRETATION OF A 'NEW' MINE

As outlined in paragraph (f) of subsection [66.1\(6\)](#) of the Tax Act, CEE does not include development expenses or *“any expense that may reasonably be considered to be related to a mine in the mineral resource that has come into production in reasonable commercial quantities or to be related to a potential or actual extension of the mine”*.

When exploration is undertaken on a brownfield project that was once an operating mine, CRA may deem that the work is related to the potential or actual extension of the mine and thus would not be eligible as CEE. However, in other cases, such as when a former mine has been fully closed for an extended period of time, the work may be interpreted as exploration toward the ultimate development of a 'new' mine that has never come into production in reasonable commercial quantities and thus would be eligible for CEE.

This is where an advance ruling may be warranted to get a determination from CRA on whether the exploration will be considered work toward a 'new' mine rather than extension of an existing mine (see advance ruling section). In these situations where a technical interpretation is requested of CRA, they will consult with Natural Resources Canada to support their ruling.

Some of the factors that are considered in determining whether the exploration work is related to an existing mine or a new mine are outlined below. However, we emphasize that every case will be unique and will be assessed on its own merits.

- Was production in reasonable commercial quantities ever achieved on the property?
- Is the property abandoned or derelict? Has the mine entrance been permanently blocked?
- Is there a mine closure report?
- When mining stopped previously, did knowledge exist of additional mineralization?
- What was the time period between when production ceased and the proposed restart?
- Will previously developed workings be used in the new operation? What is the level of usage?
- What equipment from the previous operation can be used in the current operation?

EXPLORATION SUBSEQUENT TO THE RELEASE OF A PRE-FEASIBILITY OR FEASIBILITY STUDY

Exploration activities that take place after a company has released the results of a pre-feasibility or feasibility study may receive additional scrutiny by the CRA and some or all of the expenditures may not be deemed eligible as CEE. The issue is whether the work is still exploration after the release of a pre-feasibility or feasibility study or whether it is related to the development of a mine. Layered over this is the issue that activities that are undertaken specifically for economic purposes are generally not considered to be CEE by the CRA.

Some aspects to consider:

- If the results of a pre-feasibility or feasibility study are economically positive, it is possible that future activities on the same deposit may be considered development work, rather than exploration.
- Exploration activities on a property where a positive pre-feasibility or feasibility study has been released that are aimed at determining the existence, location, extent or quality of a new mineral resource (not an extension of the existing one) should be eligible as CEE. However, there are many potential gray zones in this situation and every case is unique. This is where seeking an advance ruling may be warranted.
- All expenditures should be benchmarked to the purpose test in submissions to CRA and each different type of expenditure should be separated out in invoices and documentation. When many expenditures are grouped together and there is question if some of the expenditures are CEE, all the expenditures may be denied, rather than just those in question.

- Marketing studies, transportation analysis and other activities that are designed to support the business case for developing a mine, and that cannot be tied directly to the purpose test will not be considered CEE.

OPTION AGREEMENTS

Mineral exploration expenditures undertaken as part of an option agreement have received variable treatment by the CRA. The issue is whether the exploration expenditures are considered a cost to acquire the property, in which case they would be considered a Canadian Development Expense (CDE) rather than a Canadian Exploration Expense (CEE).

Option agreements, or ‘farm-out’ agreements are discussed in [Interpretation Bulletin IT-125R4 – Disposition of Resource Properties](#). CRA considers that the acquisition of a Canadian Resource Property under a farm-out (or option) agreement does not involve any proceeds of disposition (or any cost to acquire) and thus exploration expenditures under the farm-out agreement can be claimed as CEE since they are not considered to have been payment toward acquisition of the property (which would classify them as CDE). Paragraph 14 in IT-125R4 outlines different examples of agreements that would be considered ‘farm-out’ agreements and thus exploration expenditures undertaken as part of the agreement would qualify as CEE.

An important part of the examples in paragraph 14 of IT-125R4 is that the farmee (or optionee) acquires an interest or right in the property for the work that was performed. In some cases, CRA has taken the position that an option agreement does not provide for an interest or right in the property, only the option to acquire that right. In this interpretation, treatment of option agreements as outlined in IT-125R4 would not apply and exploration expenditures would be considered to be CDE by CRA. However, CRA Technical Interpretation 2010-038908117 found that an interest in a Canadian Resource Property occurs at the effective date (signing date) of the option agreement even though legal transfer of the property has not yet occurred and may never occur if the option is terminated.

One additional challenge related to option agreements is that IT-125R4 refers to an ‘unproven resource property’ such that only ‘unproven resource properties’ are eligible for the tax treatment considered in IT-125R4. However, the definition of an ‘unproven resource property’ was for the oil and gas sector rather than for minerals sector. This leads to uncertainty on how CRA will interpret an ‘unproven resource property’ in the context of option agreements for mineral properties.

"Unproven resource property" refers to a resource property for which proven reserves have not been attributed. Proven reserves for an oil and gas resource property are the estimated quantities of petroleum and natural gas which geological and engineering data demonstrate, with reasonable certainty, to be recoverable in the future under existing economic and operating conditions. (IT-125R4)

Given the challenges with how CRA classifies exploration expenditures under an option agreement, it is advisable that companies use the services of an experienced lawyer or tax accountant who can structure options agreements to meet CRA requirements. In general, simple option agreements that involve the

exclusive right to explore on the property during the term of the option and that involve components of cash, shares and exploration expenditures over the term of the option, should allow the exploration expenses to be treated as CEE according to IT-125R4 (note that only the exploration expenses should qualify, not the cash and shares payment that are part of the option agreement).

BEST PRACTICE APPROACHES RECOMMENDED BY AME MEMBERS

CLARITY IN INVOICES AND CONTRACTS

The primary approach that CRA takes when assessing the eligibility of expenses as CEE is to apply the purpose test: that is whether the expense was for the purpose of determining the existence, location, extent or quality of a mineral resource. This purpose test, and where applicable, the guidance outlined in the [Mining Expenditure Review Table](#), should be connected with each invoice and contract so a CRA auditor can readily see how the work meets the purpose test.

Some recommended approaches:

- Employment contracts and responsibilities should satisfy the purpose test. Be particularly careful with employees or contractors whose work is not all or substantially all directed to exploration activities (90% or more). Employment contracts can be used as supporting documentation in the tax submission.
- Wording of invoices should be specific to an allowable expense. The breakdown of the invoices should follow the guidance in the Mining Expenditure Review Table and pass the purpose test. Large invoices in particular need to be very clear as to the purpose.
- Invoices that are for a range of work, not all of which may be eligible for CEE, should be split; otherwise, the entire invoice may be denied. For example, in the 2019 CRA guidance (mining expenditure review table), a bulk sample that is collected for the purpose of testing the physical and chemical characteristics would qualify for CEE, but it would not qualify if the purpose is to evaluate the optimal processing method. In an example like this, invoices and documentation for the bulk sample need to clearly express the purpose of the sample and only those costs that are CEE eligible should be claimed; otherwise, all expenditures related to the bulk sample will be denied. Regardless, expenditures related to bulk samples are often scrutinized by CRA and can be difficult to get approved as CEE.
- Engineering invoices will often get extra scrutiny.
- If drilling for engineering design purposes and also for mineral exploration (such as assaying), then make sure the cost of the different activities are clearly divided, tracked and documented.

FINANCIAL AND ACCOUNTING SYSTEMS

It is recommended that particular attention is paid to the set-up of general ledgers. Make sure general

ledger codes are clear and that the names are consistent with the work done and match invoices. When invoices or general ledger codes are unclear or do not match, CRA may ask for contracts and agreements to make sure they match and are CEE. Exploration and accounting teams should both be clear on the work that is eligible as CEE and ensure it is documented properly.

The purpose test for CEE should be top of mind when naming and setting up accounting systems.

ADVANCE PLANNING BETWEEN EXPLORATION AND ACCOUNTING TEAMS

Make sure that the exploration and accounting teams both have a good understanding of eligible CEE expenditures and how those should be recorded and documented on every invoice and contract. Discussions and meetings between the exploration teams and accounting team or firm should take place before exploration commences to ensure eligible expenses are tracked and reported to meet CEE requirements.

The team who will ultimately be responsible for tracking spending and preparing and submitting the return (controller/accountant) needs to have a good understanding of the work programs, and the exploration teams need a good understanding of the flow-through tax regime. This enables teams to communicate the implications and differences from a tax perspective and to ensure they make and use a financial tracking system that aligns with CEE. This is especially important when multiple projects are underway or if a project is at an advance (pre-feasibility/feasibility) stage.

FACTOR IN A BUFFER OF EXPENDITURES

It is common for at least some expenditures submitted as CEE to be denied by CRA. Companies should think carefully about expenditures and what might not be allowed. Factor in some buffer. It is worth the time to look at CEE and CDE from a workplan and tax credit perspective to evaluate what might qualify. It is prudent to assume that not everything will be eligible.

TECHNICAL INTERPRETATIONS AND TAX RULINGS

CRA has issued many [technical interpretations and tax rulings related to CEE](#). Technical interpretations are generic in nature and provide CRA's interpretation of an aspect of tax law. A ruling is case-specific and provides CRA's interpretation of a specific proposed transaction. CRA does not release interpretations and rulings directly but provides them to third party distributors (as discussed in Information Circular IC70-6R9). For example, they can be found here: <https://taxinterpretations.com/> and through other private websites. Access to many of the rulings requires a paid subscription.

While there are many interpretations and rulings, they are helpful in understanding how CRA is likely to consider different types of expenditures or expenditures under different scenarios. It is worth being familiar with the ones that are referenced in this document.

The following CRA technical interpretation, rulings and guidance documents are referenced in this guidance:

- [Mining Expenditure Review Table \(2019\)](#).
- [Guidelines for environmental studies, community consultation, and feasibility studies \(2017\)](#).
- [Interpretation of expenses incurred in relation to community consultation or environmental studies \(2018\)](#).
- [Interpretation of 'all of substantially all' in relation to Canadian exploration and development overhead expenses](#).
- [Advance tax rulings and how to apply: IC70-6R9 Advance Income Tax Rulings and Technical Interpretations](#).
- [Advance tax ruling for a bulk sample that CRA references in the 2019 Mining Expenditure Review Table: 2007 Ruling 2006-0211941R3 - Canadian exploration expense](#).
- [Option or farm-out agreements: Interpretation bulletin IT-125R4 – Disposition of Resource Properties](#).