BUDGET 2017: TAX CHANGES AFFECTING THE RESOURCE INDUSTRIES

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In Budget 2017, the federal Government proposed new measures affecting Canada's resource industries, notably the oil & gas and mining industries, which may provide an indication of the policy intentions of the Government in the years ahead.

Mandate to redirect deductions from certain exploration expenses into other areas

Junior resource issuers in the oil & gas and mining industries, which are keenly focused on obtaining the financing required for expansion (or their very survival), have faced a notable degree of uncertainty for some time following the issuance of a "Mandate Letter" by the Prime Minister to the Minister of Finance in late 2015 that outlined a Government priority to "[d]evelop proposals to allow a Canadian Exploration Expenses [("**CEE**")] tax deduction only in cases of unsuccessful exploration and re-direct any savings to investments in new and clean technologies". It was unclear how this priority would be reconciled with the current rules in the *Income Tax Act* (the "**Tax Act**") relating to the deductions and credits that may be claimed in respect of resource expenses.

While the Government's first Budget in 2016 did not propose restrictions in this regard, Budget 2017 delivers on the mandate to restrict CEE deductions and re-direct savings, to an extent, to clean technologies (in the latter case, by enhancing special capital cost allowance classes 43.1 and 43.2). The burden of these new proposals falls significantly on the oil & gas industry, with restrictions as outlined below.

(i) Canadian exploration expense treatment restricted for discovery wells

Categorization of an expense as CEE is highly favourable, as such expenses are 100% deductible for tax purposes. In addition, CEE can effectively be passed on to investors through the issuance of "flow-through shares". While other expenses, for example, Canadian development expenses ("CDE"), can also be passed on through the issuance of flow-through shares, the 100% deduction available in respect of CEE makes it particularly favourable. In the beleaguered junior resource space, the ability to raise financing by promising investors a 100% deduction (and other benefits) in respect of their equity investments has been a key factor in the ability of junior resource issuers to raise capital and carry on business.

The categorization of expenses as CEE will now become more restrictive for oil & gas companies. Budget 2017 generally proposes that, for so-called "discovery well" expenses incurred after 2018, the expenses of drilling or completing such a well in Canada (or building a temporary access road or preparing a site in respect of a discovery well) will no longer be categorized as CEE. (A discovery well is essentially a well that results in the discovery of a previously undiscovered reservoir of petroleum or natural gas.) These expenses will instead generally be characterized as CDE, which is deductible at the rate of 30% on a declining-balance basis.

CEE treatment will continue to apply, in accordance with existing rules, in respect of certain wells that have been abandoned or otherwise have not produced within specified guidelines, or that have been certified as unproductive in the near term by the Minister of Natural Resources under other guidelines.

The new restrictions will generally apply to captured expenses incurred after 2018, subject to grandfathering for expenses incurred before 2021 under written commitments made before March 22, 2017. The practical impact of the new restrictions on future flow-through share agreements remains to be seen.

(ii) Ability to reclassify certain CDE as CEE ended

Budget 2017 also proposes to end the ability of qualifying smaller oil & gas issuers to reclassify up to $1 million of CDE (renounced to flow-through share investors) as CEE, generally effective for expenses incurred after 2018, and subject to limited grandfathering for agreements entered into during 2017 but before March 22, 2017.

Mineral Exploration Tax Credit for flow-through share investors extended

The restrictions outlined above can be expected to have some negative impact on junior resource issuers in the oil & gas industry. By contrast, the mining industry is unaffected by these changes and sees Budget 2017 confirming the extension of the "mineral exploration tax credit" for so-called "super-flow-through shares" for another year.

(i) Extension of the "Super Flow-Through Share" Program

The super flow-through share program was initially introduced in October 2000 in response to a severe downturn in mineral exploration in Canada. The program had expired at the end of 2005, but was reintroduced in the 2006 Budget in respect of flow-through shares issued pursuant to agreements made after May 1, 2006 and on or before March 31, 2007. The program was extended for additional one-year periods in each of the 2007 to 2016 Budgets.

The flow-through and super flow-through share programs provide tax incentives to promote the exploration and development of mineral resources in Canada, particularly by encouraging new equity investment in junior mining companies. Under Canada's flow-through share program, a company is permitted to renounce or "flow-through" certain expenses associated with its Canadian exploration activities to investors. In turn, investors can generally deduct such expenses in calculating their own taxable income.

The super flow-through share program provides an additional benefit to those who invest in flow-through shares. Under this program, an investor may claim a 15% tax credit in respect of certain grassroots exploration expenses incurred by the issuer of the shares in Canada and renounced to the flow-through shareholder. The tax credit may be applied to reduce certain federal income taxes otherwise payable by the investor.

Qualifying “grassroots” mining expenditures include expenses incurred in conducting certain mining exploration activities for the purpose of determining the existence, location, extent or quality of a mineral resource.

The Government proposes to extend the super flow-through share program to apply in respect of flow-through share agreements entered into on or before March 31, 2018. Under the "look-back" rule, funds raised in a particular calendar year (e.g., 2017) with the benefit of the program can be spent on eligible exploration up to the end of the following calendar year (2018), and renounced to the flow-through shareholder effective December 31st of the particular calendar year (2017).

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