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Our file Notre reference
2020-087393

February 9, 2022

Dear Mr. Killeen

We are writing in response to your request for our comments on the scope of the definition of Canadian exploration expense ("**CEE**") as this term is defined in subsection 66.1(6) of the *Income Tax Act*.[1] In particular, you have asked us to comment on whether expenses incurred by a taxpayer "for the purpose of determining the existence, location, extent, or quality of a mineral resource" (the "**CEE Purpose Test**") would generally include expenses for determining the economic feasibility of a deposit, such as expenses for preparing pre-feasibility or feasibility studies (including expenses for determining the cut-off grade of the deposit), market studies or studies for determining the anticipated long-term price of a mineral.

Our Comments

This technical interpretation provides general comments about the provisions of the Act and related legislation. It does not confirm the income tax treatment of a particular situation involving a specific taxpayer but is intended to assist you in making that determination. The income tax treatment of particular transactions proposed by a specific taxpayer will only be confirmed by this Directorate in the context of an advance income tax ruling request submitted in the manner set out in Information Circular IC70-6R11, Advance Income Tax Rulings and Technical Interpretations
"Canadian exploration expense" is defined in subsection 66.1(6). Paragraph (f) of that definition is the paragraph that is generally relevant to expenses incurred in the course of mining exploration. It reads as follows:

> (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) <u>for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada</u> including such an expense for environmental studies or

[1] R.S.C. 1985, c. 1 (5th suppl.) as amended (the "**Act**").

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> 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
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> > (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,
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> 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.
>
> (Emphasis added)

In order for an expense to be considered to be CEE under paragraph (f) above, all aspects of paragraph (f) must be met. The fact that it may be necessary to incur an expense for commercial or securities law reasons (e.g., to complete a technical report) is not directly relevant to the issue of whether the requirements of paragraph (f) have been met.

One key aspect of paragraph (f) is the CEE Purpose Test, which requires that the expense be incurred "for the purpose of determining the existence, location, extent, or quality of a mineral resource". Some commentators have suggested that the word "quality" should be given the widest possible scope. According to this broad interpretation, any expense incurred to assess the economic or market value of a mineral resource would qualify as CEE. In our view, this broad interpretation equates the term "quality" to "economic or market value". We believe that such a broad interpretation cannot be supported under a textual, contextual and purposive interpretation of paragraph (f) of the definition "Canadian exploration expense" in subsection 66.1(6).

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Textual, Contextual and Purposive Approach to Statutory Interpretation

In *Canada Trustco Mortgage Co. v. Canada*, [2005] 2 S.C.R. 601, the Supreme Court of Canada described the approach to be taken when interpreting a statutory provision:

> It has been long established as a matter of statutory interpretation that "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament": see *65302 British Columbia Ltd. v. Canada*, [1999] 3 S.C.R. 804, at para. 50. The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words play a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole. [para. 10]

Textual Interpretation

Dictionary definitions appear to allow for either a broad interpretation of quality (which could include the concept of commercial value) or a more narrow interpretation that focuses on the physical characteristics of the item.

For example, the online *Cambridge Dictionary* defines quality quite broadly as:

> Quality often refers to how good or bad something is.
> A characteristic or feature of someone or something.
> A characteristic or feature of something, that makes it different from other things.

By comparison, the online *Mirriam-Webster Dictionary* defines quality more narrowly as follows:

> 1a : peculiar and essential character: nature
> b : an inherent feature: property
> 2a : degree of excellence: grade
> b : superiority in kind
> 4a : a distinguishing attribute: characteristic
> 6 : vividness of hue

While the concept of commercial or market value could be read into the broader aspects of the above definitions, neither of these definitions expressly reference commercial or market value. Based on these definitions, the word "quality" could be capable of an interpretation that either includes the concept of commercial value or that instead focuses more narrowly on the physical or inherent aspects of a particular item.

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The following guidance was provided by the Supreme Court of Canada in *MF (ON) v. Placer Dome Canada Ltd*.[2] regarding situations where the wording of a provision is capable of more than one reasonable interpretation:

> Where, as in this case, the provision admits of more than one reasonable interpretation, greater emphasis must be placed on the context, scheme and purpose of the Act. Thus, legislative purpose may not be used to supplant clear statutory language, but to arrive at the most plausible interpretation of an ambiguous statutory provision.

It is therefore necessary to consider the context in which the word "quality" appears within the definition of "Canadian exploration expense" and the scheme and purpose of that definition within the Act.

Contextual Interpretation

The word "quality" appears within the CEE Purpose Test as one item in a list of words, with the other three words being existence, location and extent. The statutory interpretation principle known as the limited class rule (*ejusdem generis*) provides guidance on how to interpret a word that appears within a list of items. This rule is described as identifying a class of enumerated items based on a common feature. This common feature fixes the limits to which the general words are confined.[3] The common denominator must be narrower in scope that the general words that follow the class. Lastly, the general words must add something to the identified class. In other words, if the general words do not add anything to the provision, then the limited class rule cannot apply because it would be contrary to the presumption against tautology.

In *National Bank of Greece (Canada) v. Katsikonouris*,[4] the Supreme Court of Canada explained this rule as follows:

> Whatever the particular document one is construing, when one finds a clause that sets out a list of specific words followed by a general term, it will normally be appropriate to limit the general term to the genus of the narrow enumeration that precedes it.

The list of words in the CEE Purpose Test is the "existence, location, extent or quality" of a mineral resource. The first three words of that list all describe different spatial aspects of the mineral resource under review, such as physical existence, area, distance, volume. In other words, they are focused on the inherent physical characteristics of the mineral resource.

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2 2006 D.T.C. 6532 (S.C.C.).

3 Sullivan and Dridger on the *Construction of Statutes*, (4th ed.), Butterworths Canada Ltd. 2002, pp. 175 *et seq.*

4 [1990] 2 S.C.R. 1029.

…./cont'd

The last word in the list, "quality", although potentially capable of a broader interpretation, should be interpreted more narrowly based on the limited class rule. As stated by the Federal Court of Appeal in *MNR v. Cameco Corporation*[5] :

> When two or more words that are capable of analogous meaning are coupled together they take their colour from each other, the more general being restricted to a sense analogous to the less general: R. Sullivan, *Sullivan on the Construction of Statutes* (6th ed. 2014) at 230 (Sullivan) citing *R. v. Goulis*, [1981] O.J. No. 637, 233 O.R. (2d) 55, at 61 (C.A.).

The colour or genus of the first three words in the list in the CEE Purpose Test is the inherent physical characteristics of the mineral resource. The word "quality" should therefore be interpreted in the same manner and should be limited to inherent characteristics of the mineral resource. Even under this narrower interpretation, the word "quality" can be considered to add something to the class of words in the list, as it may encompass aspects of the mineral resource that extend beyond size, volume and location. In particular, the word "quality" could encompass other inherent characteristics of the mineral resource such as its chemical composition or mechanical properties (e.g., strength or porosity).

As a result, based on the application of the limited class rule, the context in which the word "quality" appears in the definition of "Canadian exploration expense" strongly suggests that it should be interpreted narrowly as being limited to the inherent characteristics of the mineral resource, rather than broadly to encompass external elements such as economic or market value.

Purposive Interpretation

An expense that qualifies as CEE is subject to very favourable treatment under the Act. CEE may be renounced by principal business corporations to flow-through shareholders in accordance with the flow-through share regime in the Act. Taxpayers may deduct up to 100% of their cumulative CEE balance at the end of a taxation year, subject to certain restrictions. In addition, there are a number of federal and provincial income tax credits that are based, all or in part, on whether an expense qualifies as CEE.

This favourable tax treatment was proposed in order to alleviate the increased risk that is required to be undertaken when conducting mineral exploration. In 1966, the Report of the Royal Commission on Taxation (the "**White Paper**") examined in detail the structure and efficiency of the Canadian tax system. Its Chapter 23 focused on the Mining and Petroleum Taxation Rules.[6] As one of the foundational premises of the resources taxation regime, the White Paper recognized the inherent challenges of the mining industry:

> The more uncertain the value of the asset created by a particular expenditure, the more rapidly the cost should be written off. Because the probability of success for a particular exploration venture is usually low, it is reasonable to deduct

5 2019 D.T.C. 5042 (F.C.A.).

6 1966 R.C.T. Vol. 4, Chp. 23.

…./cont'd

> exploration costs immediately in determining income. The immediate write-off of these costs would be an effective form of tax incentive to new mineral and petroleum discovery and would also be consistent with the recommended treatment of research and product development costs for businesses generally.

The White Paper also distinguished between expenses incurred at the exploration stage from those incurred at the development stage, stating as follows:

> Given that the risks of failure have been greatly reduced by the development stage, the direct effect of the rapid write-off provisions for development costs is likely to be a more rapid development of known mineral deposits and petroleum reserves rather than a search for new deposits and reserves.[7]

These excerpts identify the risky activity that needs to be incentivized in a targeted, rather than in a general way. They refer to "new mineral discovery" or the "search for new deposits". Along the same lines, the original incentive provided for exploration expenses focused on expenses incurred "in searching for minerals".[8] There is therefore a consistent focus on the search for, or discovery of, the minerals in the ground, rather than a broader incentive for any expense incurred by a mining company that is currently engaged in exploration activities.

The connection between the expense incurred and the search for what is in the ground has also been highlighted by the Courts. In *Gulf Canada Ltd. v. R,*[9] the Federal Court of Appeal stated as follows:

> Furthermore, we would, as a general rule, expect that for any expense to be said to have been incurred for the purpose of determining the existence etc. of petroleum or natural gas on a property, there would have to be at least some connection between that expense and work actually done on the ground.

Similarly, in *Global Communications Ltd. v. Canada*,[10] the Federal Court of Appeal stated:

> [19] In my opinion, a careful reading of paragraph 66.1(6)(a) reveals that the type of expenses contemplated are those which the taxpayer carries out on the land itself.

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7 The Carter Report p. 24.

8 See subsection 53(4) of *An Act to amend The Income Tax Act and the Income War Tax Act*, assented to 10th Dec. 1949, c. 25. Subsection 53(4) was periodically extended and subsequently in 1955, it was re-enacted as subsection 83(A)(3).

9 92 D.T.C. 6123 (F.C.A.D.), aff'ing 90 D.T.C. 6622 (F.C.T.D.), leave to appeal denied, [1992] S.C.C.A. No. 102); [hereinafter "***Gulf Canada***"].

10 99 D.T.C. 5377 (F.C.A.); [hereinafter "***Global Communications***"]. Although both *Gulf Canada* and *Global Communications* dealt with paragraph (a) of subsection 66.1(6), rather than paragraph (f), the purpose tests in both paragraphs are identical.

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We acknowledge that the ultimate objective of an expense that is incurred to determine the inherent characteristics of the minerals in the ground is to gather information that will allow the taxpayer to assess the economic viability of the mineral resource. This was recognized by the Exchequer Court in *Johnson's Asbestos Corporation v. The Queen*[11] when the Court described the expenses at issue in that case as follows:

> The drilling operation in 1956, the expenses of which are in issue, consisted in the taking of test "cores" from 36 holes by way of diamond drilling. The purpose, in the case of each hole, was to ascertain information concerning the existence of asbestos ore when such information previously was not available or not available in sufficient detail to make it, possible to decide what areas warranted extraction on a commercial basis. A few of these holes were sunk on Number 2 Pit area but most of them were outside that area.

The purpose of the drilling was to ascertain information about the existence and extent of the asbestos ore (purposes that fall within the current CEE Purpose Test) in order to ultimately determine whether the asbestos resource could be mined economically. However, the Court was careful to base its decision on the particular physical nature of the asbestos resource rather than on the market conditions.

> [T]he situation is that asbestos exists in the form of veins in rocks, which veins are separated from each other in such an irregular and unforeseeable way that knowledge of their existence in ample quantity in one area is no basis for concluding that they will also exist in adjoining areas, I cannot find that discovery of the existence of the mineral in one defined area is the end of the search in respect of nearby areas when the situation is that the mineral may or may not exist in such nearby areas according to the evidence available as appraised in the light of existing scientific knowledge.[12]

It is clear from the foregoing that the expenses at issue in that case were directly related to the physical characteristics of the asbestos resource. The fact that the information obtained from incurring these expenses would be relevant to the determination of the economic viability of the asbestos resource does not lead to the conclusion that <u>every</u> expense that must be incurred to determine the economic viability of a mineral resource should qualify as CEE. Many factors external to the mineral resource, such as commodity price, advances in mining techniques, local political or socio-economic factors relating to the mine site, will affect the economic viability of the mineral resource. Similarly, the cut-off grade generally represents the economic attractiveness or the value of a given mineral deposit to the particular mine operator which is also influenced by a number of external factors, for example the cost of bringing a product to purchasers, including marketing and distribution

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11 65 D.T.C. 5089 (Ex. Ct.).

12 *Ibid.* at para. 29.

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costs. Expenses related to these external factors, or to the overall assessment of economic viability through a pre-feasibility study or feasibility study, extend well beyond the focused nature of an incentive targeted at the activity of mineral exploration.

Based on the foregoing, expenses that qualify for CEE do not, in our view, include expenses for determining the economic viability of a mineral resource if those expenses do not relate to a determination of the natural (e.g., physical, chemical or mechanical) characteristics of the mineral resource. Such expenses are too remote to be described as expenses incurred for the purpose of determining the "quality" of a resource.

We trust that these comments will be of assistance.

Yours truly,

WHARRAM KIMBERLEY

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