Commelin – Rewrite

~~Ferries – LITERATURE: DEMAND~~

RE: Gaffney Manuscript for Crommelin Volume

Corrections, additions, in response to Crommelin letter, April 8th, 1976 (copy attached).

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(b) Hanzlik Formula. "This formula is used to calculate 'allowable cut' from public forests in Canada and the U.S. It says that the annual cut should be no greater than the mature stock divided by the putative future rotation age (usually overstated) plus current annual increment."

2. James R. Nelson, "Energy Industry Alternatives for the Future", to be published in John W. Wilson (ed.) The Energy Industry, proceedings of a conference held in Vancouver, 1974.

3. Harvey Averch and Leland Johnson, "Behavior of the Firm Under Regulatory Constraint," American Economic Review, December 1962, Vol. 52, pp. 1052-69.

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Replace "c.f." by "CF".

$$CF = \frac{i}{1-e^{-ni}}, \text{ where}$$

CF = required cash flow or yearly payment

i = interest rate, here 10%

n = years required to amortize

e = base of natural logs [e^{-ni} is a shorthand way of writing $(1+i)^{-n}$].

5. Rewrite, paragraph on pp. 12-13, and first full paragraph page 13:

After one finds a deposit or a field, and before one produces it, it normally appreciates. Accrual of value is not taxable before realization -- a provision that in effect lowers the effective tax rate on all assets that appreciate over some years before sale. It is the deferral of tax that lowers the effective rate, regardless of other provisions. But in addition there is a depletion allowance so that part of the cash flow of producing deposits is untaxed. This allowance is limited, since May 6, 1974, to 25% of production income, a less generous allowance than that in the United States, but still one not limited to costs. In Canada bonus bids and other land leasehold acquisition costs are deductible -- in the States they are not. To deduct the costs of acquiring and building up an asset, and then besides to deduct 25% of its income, entails substantial double counting.

6. Omit paragraph top of page 15. Move note 2 to page 9. On page 9, last full paragraph, first sentence, rewrite as follows: "Another bad practise is the one Alberta followed 1950-64 of allocating allowables in proportion to well capacity, and well depth." Note 2 comes here.

7. Garrett Hardin, "The Tragedy of the Commons," Science (Dec. 13, 1968) pp. 1243 following.

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5th. Rewrite – See p. 2A

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University of British Columbia Press
2075 WESBROOK PLACE
VANCOUVER, B.C.
CANADA V6T 1W5

May 5, 1976

Dr. Mason Gaffney
Executive Director
British Columbia Institute
For Economic Policy
Analysis
3771 Haro Rd.
Victoria, B.C.

Dear Mason:

There is no record here of your reply to Michael Crommelin's letter to you 8 April. Are you able to supply these references, and do you agree with the suggested changes? When the contract is sorted out we will very shortly be going to the printer.

Regards,

Jane

Jane C. Fredeman, Ph. D.
Senior Editor

JCF/ajb

TELEGRAMS: UNIMELB PARKVILLE

UNIVERSITY OF MELBOURNE
Parkville, Victoria, Australia, 3052

LAW SCHOOL

April 8 1976

Dr. Mason Gaffney,
Executive Director,
British Columbia Institute
for Economic Policy Analysis,
3771 Haro Road,
VICTORIA, BRITISH COLUMBIA,
CANADA, V8 T5 C3.

Dear Mason,

I have recently received the manuscript of the mineral leasing book from UBC Press for checking of their editorial changes. The Press has also advised me of the very tight schedule which they wish to follow in publication. This schedule requires me to return the manuscript to them by April 20.

This has given rise to some difficulties concerning your paper, since we have not resolved some of the issues originally raised by me. After consideration, it seemed to me that the best thing to do was to return your paper to the Press and to ask you to get in touch with them regarding the following matters:

1. Page 3. Footnotes required for two references, (a) Robert Triffin and (b) the Hanzlik Formula.
2. Page 6. Footnote required for the James R. Nelson reference.
3. Page 8. Footnote required for the "Averch-Johnson Effect" reference.
4. Page 10. (Table 1). What does "e" in the formula refer to?
5. Page 13. (Line 1). I believe that "depletion allowance" should be deleted in favour of "depreciation" (refer my letter of January 21). and Thompsons
6. Page 15. I feel that the first paragraph should be deleted entirely (refer my letter of January 21).
7. Page 20. Footnotes required for references to (a) Arthur Young and (b) Garret Hardin.

I would very much appreciate it if you could handle these matters directly with the Press. The person to deal with there is Andrew Pottinger. I am afraid that if you and I continue to discuss these things by correspondance, the schedule will be severely disrupted.

All best wishes. Ros and Alexander are both very well. Hope the Gaffneys are likewise.

Yours sincerely,

Michael Crommelin,
Senior Lecturer in Law.

cc. Mr Andrew Pottinger

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3771 Haro Road,
VICTORIA, BRITISH COLUMBIA,

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UNIVERSITY OF MELBOURNE
Parkville, Vic., Australia

POSTCODE 3052

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Moser:

The first 5 articles are on depletion, synthesizing and torcatrin. I have not misled you, I believe. The last is nothing more or promotioning. I was wrong, allowables are a more a function of depth — but only the minimum allowable would have been of much importance for some time.

Irene

Vol. XXII, No. 4
July-August 1974

CANADIAN TAX JOURNAL

ARTICLES

THE FIGHT OVER RESOURCE PROFITS ..... *R. D. Brown*

INDEXING THE PERSONAL INCOME TAX:
A FEDERAL PERSPECTIVE ..... *J. R. Allan, D. A. Dodge and S. N. Poddar*

INDEXING THE PERSONAL INCOME TAX:
AN ONTARIO PERSPECTIVE ..... *Brian Hull and Lawrence Leonard*

DEEMED RESIDENCE ..... *Gwyneth McGregor*

EQUALIZING LOCAL GOVERNMENT REVENUES ..... *James A. Maxwell and George E. Carter*

FEATURES

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Around the Courts

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Federal Court of Appeal: In re Galway

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Estate Planning in Canada

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International Comparisons of Tax Levels

The Fight Over Resource Profits

R. D. Brown*

During the past year changes in the taxation of Canada's resource industries have led to the imposition of higher taxes and royalties, which the writer of this article feels are contrary to the interests not only of the industries themselves but also of the Canadian economy. To make matters worse, this increased taxation has been imposed without any coordination between the governments involved, and amidst squabbles between the federal and provincial governments over the sharing of resource profits. Some coordination of federal and provincial tax policies and rationalization of objectives are essential, this writer points out, if a "tax jungle" inhibitive to both future growth and present production is to be avoided.

Within the short span of three years, Canada's resource industries[1] have shifted from being the recipients of long-standing tax incentives and low tax rates to being the most heavily taxed sectors in the Canadian economy, with effective tax and royalty rates running up to, and in some cases exceeding, 100% of income. The mining, oil and gas industries have also moved from a situation where their development was favoured by both federal and provincial governments to a point where their prosperity and growth seems less certain in the face of increasing government regulation of their activities and inter-government squabbles about the taxation of their revenues.

It is only seven years since the *Carter Report*[2] first recommended that the tax incentives granted on oil, gas and mining profits should be withdrawn and that resource income should be taxed in the same way as other business income. At the time that the *Report* was being debated, spokesmen for resource companies reacted in shock and horror to its proposals and stated that their implementation would be totally destructive of the resource sector. It is ironic that many of the same corporations would today be only too willing to settle for having their income taxed at the same effective rates as manufacturing and other business profits, in view of the worse tax developments which have since overtaken the resource industries.

The reasons for the trend towards higher taxation and tighter regulation of the resource industries are complex. Escalating world prices for oil, gas and minerals have swollen resource company profits over the past two years, and both federal and provincial governments have reacted by demanding an increasing share of the industry's "windfall" gains. Further, some provincial governments have developed the view that they are entitled to a significant minimum return for the exploitation of irreplaceable

* Senior Tax Partner, Price Waterhouse & Co.: the author gratefully acknowledges the assistance of members of his firm, including H. Barclay, P. Mercer, M. Hirsch and J. Broley in assembly of information.

1 In this article, "resource industries" refers only to the mining, oil and gas industries, including related processing activities.

2 *The Report of the Royal Commission on Taxation*, Queen's Printer, Ottawa, 1967.

provincial resources, regardless of the level of industry profits.

But there are also other factors at work. There has been strong public and government reaction against the tax concessions offered to the resource industries in the past, and against previous policies of encouraging the rapid development of natural resources in all circumstances. The view is increasingly held that the depletable natural resources must be husbanded, developed only where positive benefits to Canada would result, and not "squandered" by being exported in an unprocessed state and without major contributions to domestic employment and industrial development.

While higher taxation of resource industry profits has been an active topic of discussion ever since the release of the Carter proposals, the last year has seen a sharp acceleration in the escalation of taxes and royalties imposed on the industry. The purpose of this article is to review these recent developments, primarily from the point of view of identifying the magnitude of the changes and outlining their possible implications on the resource industries in Canada.[3]

Before considering the latest round in tax increases on the resource industries, it may be useful to review briefly their past tax position.

Income Tax Incentives before Tax Reform

Prior to 1972, the resource industries enjoyed important tax incentives for a number of years, during which, through their growth, they had made a substantial contribution to Canada's economic development. The tax incentives available under federal and provincial income tax legislation included the following.

1. A 33⅓% depletion allowance on mineral profits, reducing the effective corporate income tax on mining, oil and gas income by one-third. This depletion allowance was given on mining profits right through to the processing of ore into prime metal, but the allowance for petroleum and natural gas depletion extended only through to the production of crude oil and gas and not to income from refining or other processing.

2. A three-year "tax holiday" for new mines.

3. Immediate write-off of exploration and development expenses by companies in the resource business ("principal business corporations"). Since 1962, these expenses have included the cost of acquiring new oil and gas interests and properties.

These tax incentives were criticized severely by the Royal Commission on Taxation, which recommended that all "special treatment" of the resource industries should be immediately cancelled. The initial response of the government, as set out in its 1969 White Paper[4] was to adopt a somewhat intermediate position, proposing the gradual withdrawal of the bulk of the incentives but still leaving the industry with some recognition of its special problems.

The final position of the federal government during the tax reform review veered back slightly in favour of the industry. In the face of heavy criticism of its original proposals from representatives of the resource industries and the provinces, the federal government agreed[5] to abate some part of its taxation of the mining industry in order to leave additional fiscal room to the provinces either to continue a level of tax incentives or to impose their own heavier taxation on the industry.

[3] In view of the pace of developments in this field, it is necessary to note that this article was completed shortly after the federal election on July 8. Because of the article's broad scope, it is not possible to provide anything resembling a complete technical description of the tax changes noted herein, and the reader is referred to other sources for such information.

[4] *Proposals for Tax Reform*, Queen's Printer, Ottawa, 1969, especially paragraphs 5:23 to 5:45.

[5] Letter from Finance Minister Benson to provincial Treasurers and Finance Ministers dated August 26, 1970.

The tax reform amendments in Bill C-259 passed by Parliament at the end of 1971 reflected the federal government's modified position on the taxation of resource income, and (with consequent changes in Income Tax Regulations) included the following.

1. The withdrawal of automatic percentage depletion, effective from the end of 1976.[6]

2. The introduction of a system of "earned depletion" effective after 1976. Taxpayers would no longer be entitled to an automatic 33⅓% depletion on resource income, but would receive $1 of depletion allowance for each $3 of spending in Canada on "eligible expenditures" such as most exploration and development activities, plant and equipment for a new mine or the major expansion of an existing mine, and certain new processing facilities. The new depletion allowance could not exceed the previous "unearned" depletion allowance in any one year, but all eligible expenditures incurred by taxpayers after November 7, 1969 would be accumulated and would count towards earned depletion deductions after 1976. One purpose of this feature of the new rules was to allow companies to accumulate a substantial bank of eligible expenditures so that their transition to a system of earned depletion after 1976 would be made somewhat easier.

3. A reduction in the federal rate of income tax on mining profits (only) accompanied by a denial of any deduction for provincial mining taxes, with both features to commence after 1976. The federal rate of income tax on mining profits after 1976 would be set at a rate 15% lower than that applicable to general business income, so as to leave tax elbow room to the provinces to develop their own tax policies for the industry. This increased federal abatement on mining profits would have resulted in an effective 21% federal tax on mining income after 1976 (46% basic federal rate, less 15% abatement for mining income and 10% abatement for provincial taxes).

4. The withdrawal of the three-year tax-exempt period for new mines, effective from 1972.[7]

The federal tax reform changes would have resulted in a substantial differentiation in the federal taxation of mining income (subject to a lower rate of federal tax and the disallowance of provincial mining taxes) and the taxation of oil and gas income, which was not to be subject to these particular rules.

These federal proposals represented in part an abdication of federal influence over the mining industry in favour of the provinces. The reduction in the level of federal taxes on the mining industry, coupled with the establishment of a federal system of taxation which is completely independent of, and does not allow any specific deduction or relief for, provincial mining and income taxation, was obviously designed both to satisfy the demand of the provincial governments for greater influence in mining taxation, and to allow for the development of independent federal and provincial tax systems. This withdrawal of federal leadership in the taxation of mining profits has undoubtedly contributed to the subsequent proliferation of separate provincial tax initiatives in this sector.

Past Provincial Taxation of Resource Profits

Those provinces with important mining developments within their borders

[6] This and the following two points are outlined in a Department of Finance paper dated July 6, 1971: see also Part XII of the Income Tax Regulations and Section 124(2) of the Income Tax Act.

[7] At the same time, a system of accelerated capital cost allowance was introduced on depreciable property acquired for a new mine so that the allowance on such assets is now the greater of regular capital cost allowances or the net income of the new mine before depreciation.

have for many years[8] imposed separate mining taxes on the profits of the industry in addition to the normal federal and provincial corporation income taxes imposed on all corporate profits.[9] Historically, the provinces were considered entitled to some special share of the profits generated from the extraction of mineral ores, presumably to compensate the province for the depletion of a provincial wasting asset. Such taxes were—in theory — normally imposed only on profits from actual mining activities—the "pit's mouth" value of the ore less direct mining expenses. In practice, the general approach was to determine a mining company's income from its total extraction and processing activities, and then to deduct from such profits an amount known as a "processing allowance" representing the portion of the mining company's total income which was deemed attributable to processing activities: the remaining balance was taken as profits attributable to the extraction of ore and subject to mining tax.

While provincial taxes based on income would not normally be allowed as an expense in determining income for federal income tax purposes the federal Act has, since 1946,[10] specifically permitted a limited deduction for provincial mining taxes. Because of this, provincial taxation of mining profits tended in most cases to parallel the federal rules relating to the deductibility of mining taxes for federal income tax purposes. Under the provisions of Income Tax Regulation 701, provincial mining taxes are deductible for federal income tax purposes only to the extent that they are imposed on "income from mining", determined as a mining company's total profits from the extraction and processing of minerals to the prime metal stage less a processing allowance.[11] Following the pattern of Regulation 701, the processing allowances under provincial mining tax rules are typically determined as a percentage (frequently 8%) of original cost of depreciable property used in the processing of ores, with such processing allowance not to be less than 15% of mining profits before processing allowance, and not to exceed 65% of such profits. However, the actual provisions of the provincial mining tax Acts differ significantly from one another, and over time.

The determining of mining profits under provincial mining tax legislation is frequently subject to special provisions; in most provinces, for example, interest on borrowed funds and mining royalties paid to resource owners are not allowed as an expense for mining tax purposes, and certain administrative and overhead costs may also not be recognized.[12]

Because of the deduction of the processing allowance in determining mining profits subject to provincial mining taxes, and because of arbitrary disallowances and other differences in the calculation of income for mining tax and income tax purposes, it has always been difficult to express provincial mining taxes as the equivalent of effective corporate income tax rates. Up until this past year, the maximum rate of provincial mining tax in the more important mineral-producing provinces (including Ontario, Quebec, Manitoba and British Columbia) was 15%, but in many cases

[8] The combined province of Upper and Lower Canada, for example, imposed a mining royalty tax before Confederation, and the antecedents of the Ontario mining tax date back to 1891, with a special tax on mining profits being introduced in 1907.

[9] Since the end of World War II, and until federal income tax reform, provincial income taxes were levied on resource profits on the same basis as determined for federal tax purposes, with some exceptions in the case of Quebec. Since 1971, the Ontario corporation tax rules have diverged from the federal provisions since Ontario did not adopt many of the federal changes in this area.

[10] Section 5(1)(w) of the Income War Tax Act, subsequently Section 20(1)(v) of the present Act.

[11] See *Rio Algom Mines Ltd. v. M.N.R.*, 70 DTC 6046, for an interpretation of the provisions.

[12] B.C. mining tax is based in large part on a tax base derived from taxable income for federal tax purposes, and hence does not involve the arbitrary disallowances found in Ontario, Quebec and other mining tax laws.

the effective rate of such taxes after processing allowances and after allowing for their deductibility for income tax purposes was very substantially less. (As noted later in this article, provincial mining tax rates have undergone substantial increases in the past few months.)

In the case of oil and gas, continuing[13] provincial revenues from the industry have normally taken the form of royalties, typically payable only on the production of petroleum and gas from provincially owned reserves. (Most mineral and oil rights in the western provinces of Canada are owned by the Crown in right of the province.) Such provincial royalties are typically determined as a percentage of gross well production and have—until now—been recognized as a deductible expense for income tax purposes. In addition, the western provinces have recently taken to levying an annual tax on the "value" of privately owned oil and gas rights (and in B.C., mining rights): the general intent of these special taxes on freehold oil and gas rights is to raise revenues equivalent to those which would be generated if the rights had been owned by the Crown and the production had been subject to the normal royalties.

The position of the provinces with respect to the taxation of minerals and oil and gas derived from privately owned mineral rights has undoubtedly been influenced by the constitutional difficulties of the provinces imposing a royalty on general mineral production. The 1928 decision of the Privy Council in *Rex v. Caledonian Collieries, Ltd.*[14] would seem to indicate that a general tax on the revenues received from the sale of mineral products was an indirect tax which is *ultra vires* a province. The general constitutional position would appear to be that it is within the power of a province to levy any special form of income tax on resource activities in the province, and any type of royalty on production from provincially owned resource rights.

However, there is some question as to the constitutionality of provincial taxes imposed on freehold mineral rights and production therefrom, in a form different from that of the typical Crown royalty but of the same general magnitude. A case testing the constitutionality of certain Saskatchewan tax legislation of this sort is now before the courts and other provincial enactments could conceivably be challenged on the same grounds.

May 1974 Federal Budget

The federal budget presented to the House of Commons by Finance Minister Turner on the night of May 6 marked a further shift in federal policies towards the taxation of resource income, with the primary view of gaining additional resource revenue (especially from oil profits) for the federal treasury.

The main proposals affecting the resource industries, all generally to be effective from May 6, 1974, were as follows.[15]

1. The basic federal rate of tax on resource profits (profits from mining, oil and gas production previously eligible for percentage depletion) was to be fixed at 50% instead of the declining corporate rate which is scheduled to reach 46% in 1976. Resource profits would also be exempt from the temporary 10% corporate tax surcharge proposed for most corporate income.

2. An additional abatement of federal tax on resource profits was to be introduced in the amount of 15 percentage points in the case of income derived from mining and mineral processing,

[13] The provinces, especially Alberta, have also obtained substantial revenues from the sale of oil and gas leases.

[14] 1928 A.C. 358.

[15] Notice of Ways and Means Motion, May 6, 1974, together with the Budget Speech.

and 10 percentage points for oil and gas production profits. This would have resulted in an effective federal rate of tax on mining income of 25% (basic federal tax rate of 50%, less 10% provincial abatement and 15% mining abatement) and on oil and gas production profits of 30% (50% basic rate less 10% provincial abatement and 10% oil and gas abatement).

3. The previous system of automatic percentage depletion of 33⅓% of resource profits was to be cancelled forthwith, and replaced with the "earned" depletion system (one dollar of depletion allowance for each $3 of "eligible expenditures"). However, the maximum rate of earned depletion would be set at only 25% of resource profits.

4. All provincial mining taxes, and most significantly all provincial royalties payable in respect of oil, gas, and mineral production, were to become ineligible for deduction in calculating taxable income.

5. Canadian exploration and development expenses incurred after May 6, 1974 would be deductible only at a maximum rate of 30% per annum (on the diminishing balance basis) instead of in full as under the previous law. (Exploration and development expenses are generally deductible only to the extent of the income of the corporation in question, and this provision is evidently to remain.)

The Finance Minister estimated that the above package proposals would increase federal tax revenues from the mining industry for fiscal 1974/1975 by some $40 million and revenues from the oil and gas sector by $410 million. (Additional revenues of $120 million would have accrued to the eight provinces with which the federal government has tax collection agreements.)

The most significant feature in the new set of proposals for the taxation of the resource industry was the disallowance of provincial mining taxes and provincial royalties. It seems quite clear that the recent increases in deductible provincial oil and gas royalties combined with the initiative of British Columbia in introducing a supposedly deductible mining royalty instead of increasing provincial mining taxes subject to disallowance after 1976 were a major irritant to the federal government.

With the defeat of the federal budget on May 8, no further elaboration has been forthcoming with respect to the details of the federal proposals. A number of the proposed changes require additional explanation before their implications can be fully understood. For example, the disallowance of provincial mining taxes and resource royalties would seem to extend even to resource royalties which are taken in kind by provincial governments in respect of the production of resources from provincially owned mineral rights: the budget resolutions specifically include the value of such provincial production payments in the income of the operator of the resource, and then deny him a deduction for the income which he has not received. (The technical wording of the resolution might be so broad as to require each of the participants in an oil and gas syndicate to add the entire amount of provincial royalties to each of their incomes.)

Reasons for Federal Proposals

In his May budget address[16] Finance Minister Turner outlined the reasons for the new federal initiative in the taxation of mining, oil and gas profits. The Finance Minister first of all referred to the original tax reform measures enacted at the end of 1971, and to the subsequent price increases in oil and gas, and to a lesser extent in minerals, which would justify the striking of a "new balance appropriate to these changed circumstances". He then went on to say that while the provinces had already

16 Budget Speech, Ottawa, May 6, 1974, pp. 8 to 11.

adjusted or were seeking to adjust royalties, mining taxes and other arrangements to "derive what they perceive to be a fair share for the benefit of their people", the federal government believed that a provincial resource was also a national resource and the federal government had the responsibility to see that a reasonable portion of this gain was shared by all Canadians. The Finance Minister also noted that recent provincial tax development had made the previous distinction in the federal tax treatment of provincial royalties and provincial mining taxes inappropriate.

The dramatic increase in provincial resource revenues following the recent provincial tax and royalty increases would naturally tend to result in a decline in the proportion of the total tax and royalty burden on the industries going to the federal government. Without further federal initiatives, this decline would probably continue in the years ahead, consequent on the scheduled reduction in the effective federal tax rate on mining profits after 1976 and probable future provincial increases in mining taxes and oil royalties. The result was that the federal government would receive a sharply lower proportion of what was turning out to be an extremely lucrative tax field, as well as having a declining influence generally on the industries. This position, on reflection, obviously did not seem attractive to Finance Minister Turner, and he moved to redress the balance by increasing his government's share of resource income.

In his budget speech, the Finance Minister specified five main policy reasons for his new initiatives in the federal taxation of resource profits:

1. the resource sector should bear a "reasonable" burden of tax on its profits relative to other sectors of the economy;
2. all the people of Canada (through the federal government) should derive a fair share of the increased revenues of the industry;[17]
3. the federal government should recognize the "special position of the provinces with respect to the taxation and charges on resources within their boundaries";
4. the federal government must ensure that provincial royalties, taxes, and other arrangements do not "unreasonably erode" the federal corporate income tax base; and
5. overall Canadian tax policy must have regard for the competitive international position of the industry and the financial resources it requires to bring forward production needed in future years.

The fundamental conclusion that can be drawn from the May budget is that the federal government had decided that it was not prepared to leave the taxation and regulation of the resource industries primarily to the provinces.

Another dimension to future federal policies affecting the resource industries was unveiled unexpectedly during the recent election campaign by Prime Minister Trudeau when he stated that,[18] if re-elected, his government would require majority ("50% and preferably 60%") Canadian ownership of major new projects in the natural resource area. Mr. Alastair Gillespie, the Minister of Industry, Trade and Commerce, subsequently explained that the new ownership restrictions would apply to any foreign company or foreign controlled company developing new mines or new oil pools (as well as being involved in new timber or pulp developments). The implications of this policy could seriously affect the exploration and development activities of the major resource companies controlled outside of Canada.

17 Finance Minister Turner in a Calgary address on June 21, 1974 said specifically that "ownership of or jurisdiction over a resource does not mean the exclusive right of taxation". (*Globe and Mail*, July 3, 1974.)

18 In a speech on June 28, 1974 in Sault Ste. Marie (*Globe and Mail*, July 10, 1974).

Increased Provincial Taxation of Mining Income

As noted in Finance Minister Turner's budget address, the past year has seen a rapid escalation in the provincial taxation of resource income. In the case of mining profits, British Columbia and Manitoba and Ontario have already brought in substantial tax increases to obtain a larger share of higher industry profits, and other provinces will not be far behind.

While a good deal of the impetus for higher provincial taxation of the industry came from its higher profits (combined with the perennial need for additional provincial revenues) other factors were also undoubtedly at work. All the provinces with the important mineral resources have adopted policies of encouraging a higher degree of domestic processing and one potential means of achieving this aim is to combine high mining taxes with incentives to induce domestic processing of the ores produced.

Further, recent trends in world commodity prices and energy and other shortages have convinced at least some politicians that it is not always desirable to encourage the most rapid development possible of natural resources. Higher taxation of profits combined with various regulatory proposals are a means of exerting increased provincial influence over the pace of resource development.

British Columbia

The province of British Columbia was the first to take steps this past year to increase drastically the taxation on mining companies. On February 19, 1974, the B.C. government introduced new mineral royalties legislation[19] to provide an additional level of taxation of mining in British Columbia beyond both the corporate income tax and the existing British Columbia mining tax, levied at a rate of 15% of mining profits.

The Mineral Royalties Act is generally applicable only to minerals produced from Crown lands[20] in British Columbia and provides for two additional royalties to be payable by B.C. mining companies, effective from the beginning of 1974:

- a basic royalty of 5% (2½% for 1974 only) of the selling value (generally gross sales value minus smelting and transportation costs) of "designated minerals" produced in B.C., plus
- an additional royalty of one-half of the amount by which the gross value of mineral production based on international price levels exceeds 120% of the predetermined "basic value" of the mineral—in general terms its average selling price in a base period (initially 1969 through 1973).

Rules relating to the calculation of these royalty amounts are complex and, despite the passage of the legislation, are subject to some continuing uncertainty. Amongst other provisions, the Bill includes a reduction in the basic royalty rate of one percentage point if the smelting or refining of the mineral is carried out in British Columbia. The basic royalty may also be slightly abated in some circumstances where the gross value of the mineral production is less than the "basic value" of the minerals, i.e., where there has been a decline in the selling price of the metal over its average value in the base period.

What in essence the new B.C. royalty provisions do is to provide for a minimum annual royalty to the province of 5% of the production value of minerals extracted in British Columbia, payable regardless of whether or not the mine in question is operated on a profitable basis, plus a "super royalty" which is designed to return to the province one-half of the additional revenue accruing to a mine operator because of the increased metal prices over a prescribed base price determined by regulation. (The Minister of Mines has just announced that the standard basic value (excluding the 20% allowance) for the current year for copper has been established at 58¢ per pound.)

The "super royalty" provisions do permit the government to allow an escalation after 1974 of the "basic value" (i.e., a reduction in the amount on which the 50% super royalty is to apply) with respect to future increases in operating costs or changes in exchange rates. This adjustment to basic values and many other aspects of the legislation is however completely discretionary with the

[19] Bill 31, The Mineral Royalties Act, was subsequently passed by the Legislature and received Royal Assent on June 20. The Bill has not yet been proclaimed.

[20] The owners of private mineral rights are subject to taxation under the Mineral Land Tax Act; the tax is based on the "value" of the undeveloped minerals in designated sites, determined under complex formulas designed to produce revenues equivalent to those that would be exigible under the Mineral Royalties Act.

Table I

POSSIBLE EFFECTIVE ROYALTY AND TAX RATES FOR 1975 ON B.C. COPPER MINING COMPANIES

	Copper prices (per pound)			
International copper price	.75¢	$1.00	$1.25	$1.50
Revenue	$750	1000	1250	1500
Less—smelting and refining costs (assumed)	140	170	190	220
Net smelter return (gross value)	610	830	1060	1280
Less—transportation (assumed)	40	40	40	40
Net value	570	790	1020	1240
Less—operating costs (assumed)	450	450	450	450
Income (before royalties and tax)	120	340	570	790
B.C. Royalties				
Basic royalty—5% of net value	29	40	51	62
Super royalty—50% of excess of gross value over 120% of 58¢ per pound	—	67	182	292
	29	107	233	354
Provincial mining tax—15% of mining profits[1]	15	43	73	101
Income tax[2]				
Federal—25% of Income	30	85	143	198
Provincial—12% of Income	14	41	68	95
	44	126	211	293
Total taxes and royalties	88	276	517	748
Net income, after taxes and royalties	32	64	53	42
Overall effective tax/royalty rate	73%	81%	91%	95%

[1] Royalties assumed not to be deductible: if, as indicated, B.C. Mining Tax Act is amended to make them deductible, overall effective tax/royalty rate becomes:

71%	77%	85%	89%

[2] Calculations based on present understanding of law, and assume minimum processing allowance for mining tax, and no "earned" depletion for income tax. (Maximum earned depletion, if available, would reduce effective rates by 9.25 percentage points, and substantial earned depletion would typically be available in the short run only.)

provincial cabinet and the Minister of Mines.

There is little doubt that the B.C. mining royalties were designed to extract revenue not only from the industry but also from the federal government; the supposition was that these mining royalties would be deductible in computing taxable income and that therefore part of their cost would be paid by the federal government (through reduced corporate income taxes) as well as by the industry. However, in the May 6 budget proposals, the federal government (perhaps in response to the B.C. initiative) proposed that provincial mining royalties as well as mining taxes of whatever description would no longer be deductible for federal tax purposes. The net result is that B.C. mining companies are placed in the middle of a battle between the province and the federal government over resource revenue.

Table I shows a calculation of a possible range of total tax burdens on a B.C. copper producer under the simplifying assumption as stated, and illustrates both the high tax burden and the variations of that burden caused by the combination of the new B.C. royalties and proposed federal tax rules. While the full implications of the B.C. tax changes remain unclear, even a relatively favourable interpretation of the B.C. provisions, along with the federal budget proposals, will mean that effective total tax rates are unlikely to be below 70% and could range up to 90% or higher as copper prices increase.

One interesting feature of the position of B.C. companies under the new B.C. legislation and the proposed federal tax rules is that mining companies will tend to earn lower profits on some minerals if their selling price goes up. A combination of sharply higher B.C. mining royalties on the increased value of minerals, plus the disallowance of these taxes for federal income tax purposes, can cause producers to pay more than 100% of increased revenue from higher mining prices in the form of taxes and royalties. This feature is also illustrated in Table I.

Another aspect of the new B.C. tax regime is the provision of a basic 5% royalty based on selling values, irrespective of the profitability of the mining development; this aspect of the new rules will have a particularly adverse effect on the profitability of existing and potential low-grade, high-cost mining projects.

Manitoba

In its April budget, Manitoba brought forward its proposals for higher tax burdens for the mining industry in that province. For 1974, the changes are relatively simple: the basic 15% rate of Manitoba mining tax is to be increased to 23%.[21] However, Manitoba has also proposed that for 1975 and subsequent years an entirely new system of "variable volumetric" mining royalties will be established in addition to the mining income tax.

The basic features of this new royalty system, as contained in a Bill[22] tabled in the Legislature on May 29, 1974 by Mines Minister Sidney Green, include the following.

— A basic royalty of up to 33⅓% of the net value of production at each mine; the actual rate would be determined annually by Order-in-Council.

— An incremental royalty of up to 50% of net value of production in excess of the average profits for the five years ending in 1973. Again, the actual rate would be determined annually by the Cabinet and might vary with such factors as the taxpayer's new investment in Manitoba, and possibly with the company's return on invested capital.

— An additional surcharge of up to 100% of profits attributable to excess production where a mine had exceeded its assigned operation levels. The province would annually determine the level of production from each mine for the coming year, and tax penalties would be provided for mines which exceeded these "production ranges"; this device would also be used to control the grade of ore extracted.

It has been indicated that if the "flexible volumetric" royalties are introduced in 1975, the rate of provincial mining tax will be reduced. The announced purpose of the new system, as well as the temporary increase in the mining tax rate, is to double Manitoba's revenues from the mining industry.

In the absence of full details, it is extremely difficult to estimate the incidence of the new Manitoba mining tax royalties. The Bill imposing this new tax system was subsequently withdrawn for further consideration, but the Mines Minister has indicated that he is determined to gain substantially increased revenues from the industry as well as to obtain some government control over operating levels.

Ontario

The provincial budget of Treasurer John White presented on April 9, 1974 contained some unexpectedly harsh news for Ontario's mining industry. The province, after a review of its system of mining taxation, had decided to "secure for the people a higher return from our natural resources", especially in view of "substantial windfall gains" realized by the Ontario industry because of higher world metal prices.[23]

Mr. White rejected the option of mining royalties as a means of achieving such increased revenues, and instead opted for higher mining taxes based on net mining income as a fairer approach. He proposed to almost triple the maximum rate of Ontario mining tax from 15% to 40%, through the introduction of a new graduated tax rate scale,[24] shown in Table II.

Mr. White also proposed other tax changes affecting Ontario mining companies:[25]

— a deduction for exploration and development and preproduction expenses incurred in Ontario after April 9, 1974 in calculating profits subject to mining tax;

— the repeal of the three-year tax-exempt period for new mines for Ontario corporation income tax purposes, effective from January 1, 1974; this would be replaced by an acceler-

Table II

NEW ONTARIO MINING TAX RATES

Mining profits	Marginal tax rate	Average tax rate (top of the range)
$ 0 — $ 100,000	0%	0%
$ 100,000 — $ 1,000,000	15%	13.5%
$ 1,000,000 — $10,000,000	20%	19.4%
$10,000,000 — $20,000,000	25%	22.1%
$20,000,000 — $30,000,000	30%	24.7%
$30,000,000 — $40,000,000	35%	27.3%
over $40,000,000	40%	..

Note: All Ontario mines of a taxpayer must generally be aggregated in one return for the purposes of the mining tax, except for new mines coming into production after April 9, 1974.

21 The rate of tax on the first $50,000 of mining profits remains at 6%.

22 The Principal Minerals Royalty Act, (Bill 82).

23 Budget Statement, 1974 Ontario Budget, April 9, 1974.

24 Bill 111, with provisions generally effective from April 9, 1974: it has not yet been passed by the Legislature.

25 1974 Ontario Budget, April 9, 1974—p. 15.

Table III

POSSIBLE EFFECTIVE
TAX RATES ON LARGER ONTARIO MINING COMPANIES

	Previous tax provisions	Revised Ontario and proposed federal rules	
		Maximum earned depletion	No earned depletion
Mining profits	$100	$100	$100
Mining tax[1]	$ 12	$ 34	$ 34
Taxable income calculation			
Mining profits (less mining tax under "previous" calculation only)	$ 87	$100	$100
Less depletion:[2]			
Federal	(29)	(25)	(—)
Ontario	(29)	(33)	(33)
Federal taxable income	58	75	100
Ontario taxable income	$ 58	$ 67	$ 67
Income tax—previous rules			
Ontario tax (12% of $58)	$ 7		
Federal tax (38% — 1974 — of $58)	22		
	$ 29		
Income tax—proposed basis			
Ontario tax (12% of $67)		$ 8	$ 8
Federal tax (25% of $75 and $100)		19	25
		$ 27	$ 33
Total taxes	$ 42	$ 61	$ 67
Possible maximum marginal tax:[3]			73%

Notes:

1 Ontario mining tax is imposed on a tax base which differs significantly from taxable income for income tax purposes, but such differences have been ignored. Mining tax is also now calculated at graduated rates: rate shown is maximum rate less minimum processing allowance. If the producer is eligible for maximum processing allowances, the effective mining tax under the revised rules drops to 14% and "total taxes" are reduced to $41 (maximum earned depletion) and $47 (no depletion).

2 Under "previous" federal calculation and all Ontario calculations, at 33⅓% of mining profits: under revised federal calculation, maximum "earned" depletion is 25% of mining profits.

3 40% mining tax, plus 25% federal and 8% (12% × ⅔) Ontario income tax.

ated capital cost allowance system paralleling that under federal income tax rules;

— the disallowance for corporate income tax purposes of mining taxes or mining royalties paid to any jurisdiction; and

— an immediate deduction for all corporations (not just principal business companies) of Ontario exploration and development expenses.

Ontario will, however, continue to allow all mineral operators and non-operators a uniform percentage depletion rate of 33⅓% for Ontario corporate income tax purposes, and Ontario will not follow the federal rules relating to "earned" depletion.

Ontario Treasurer John White estimated in his budget address that the total proposed changes in the taxation of mining income in Ontario would raise an additional $50 million in revenue for the province in 1974, bringing total provincial revenues from this source to about $125 million. In fact, this estimate turned out to be as inaccurate as the estimates of other governments of the effect of mining changes on the industry; in a statement before the Legislature on June 20, 1974, less than three months after the introduction of his budget, Mr. White had to revise his estimates of the additional revenue produced by the tax changes from $50 million to $127 million, and even this latter estimate takes into account concessions to the industry which were perhaps not contemplated at the time of the April 9 budget.

An illustration of the overall impact of the new Ontario mining tax, combined with the federal budget proposals, is set out in Table III.

Along with the dramatically higher mining tax rates, Ontario proposed—after some discussions with industry representatives—an expanded set of tax incentives and reliefs to the industry through higher mining tax processing allowances and increased depreciation rates.

The changes in the processing allowances—the deduction allowed in computing mining profits in respect of processing carried on beyond the pit's mouth—will be of extreme significance to the industry, and will partially ameliorate the impact of the higher tax rates for those large mining operations which conduct significant processing activities in Canada.

The following is a summary of the previous and proposed processing allowance rates under the Ontario Mining Tax Act.

Table IV

ONTARIO MINING TAX PROCESSING ALLOWANCES

Degree of Processing Achieved	Previous rules	Revised Rules	
		Northern Ontario[26]	Rest of Canada
Concentrating	8%	8%	8%
Smelting	16%	16%	16%
Refining	20%	30%	20%
Further processing (fabrication)	—	35%	—
All processing outside Canada	8%	—	—

26 North of the French River.

In addition, the new processing allowance will be granted on the cost of all capital works and assets as acquired, rather than on the cost of processing assets actually in use. The new processing allowances provide special benefits for processing activities in Northern Ontario, as well as a new "fourth stage" processing allowance for those mining companies that not only process mineral ores to the prime metal stage, but further fabricate metal into manufactured products in Northern Ontario.

The incentive aspect of these processing allowances on inducing new processing activities in Canada and especially Northern Ontario is extraordinary. For example, if a mining company which is subject to the highest rate of Ontario mining tax, constructs additional processing facilities in Northern Ontario, it can obtain a permanent annual tax saving equal to 40% (the marginal Ontario mining tax rate) times 30% (the processing allowance rate) of the original cost of the facility for as long as that facility is in use. This means an indefinite increase in annual after-tax income of 12% of the cost of the facility, even before taking into account any additional income which the facility itself might be expected to produce. The generosity of the processing allowance for those mining companies which undertake concentrating, smelting and refinery activities is of course contrasted with the exceptionally high taxes that will be imposed on large mining producers which do not carry on important processing activities in Canada. Indeed, it is a question of semantics whether the new rules involve tax incentives for processors, or tax penalties for mines without processing facilities.

The new Ontario rules, as presented to the Legislature, provide that the income of a new mine developed by an existing mining company does not have to be aggregated with the other mines of that company for taxation under the progressive rate scale. This means that the marginal tax rate applicable to new mining developments of existing large mining groups may well be substantially less than would otherwise apply since the new mine can, by election, be treated as a separate taxpayer for Ontario mining tax purposes, with its income taxed at the bottom of the rate scale. The implications of this provision are not entirely clear since the separate taxation of a new mine could lead to a denial of immediate deduction for its development costs; the provision also poses problems in the calculation of an appropriate processing allowance.

One of the most remarkable things about the Ontario amendments is the introduction of a steeply graduated tax rate for mining income. The theoretical justification for imposing a progressive tax structure on the income of corporations might perhaps warrant further study and comment beyond that possible in this article.[27] The approach of the Ontario government has evidently been to confine the main burden of the increased tax rates on the larger companies in the belief that they are more capable of bearing it; if it is assumed that the purpose of the Ontario government is to load a large share of the increased tax burden on a few specific large mining companies, the Ontario approach becomes more understandable, although perhaps no more supportable.

[27] The progressivity of the Ontario mining tax is based solely on mining profits in Ontario, and not on total profits or other measures of corporate size. The tax takes no account of return on invested capital, and imposes a higher tax burden on the return from additional increments of capital (except processing assets) invested by existing companies relative to new investors. The revised Ontario mining tax also provides a lower effective tax rate on metal fabricating activities carried out in Northern Ontario by mining companies than that applicable to other taxpayers; it also provides higher taxes for mining producers using independent custom smelters, etc., rather than their own facilities.

Other Provinces

British Columbia, Manitoba and Ontario are not the only provinces actively engaged in revising their system of taxation of mining income. Quebec has a committee reviewing its taxation of the mining industry, and the province will be bringing forward proposals, probably later this fall, to secure a "fair share" of mineral production in that province. Preliminary indications are that while the Quebec proposals almost certainly involve a large tax increase on the industry, the escalation in mining taxes may not be as sharp as in some other provinces. In Newfoundland, the government is also studying the reform of its tax and regulatory system for mineral exploration and production in that province, with proposals likely to come forward within the next year. Nova Scotia is re-examining its taxation of the mining industry for the first time in 25 years, and increases in mining taxes are quite likely. A revision of the Yukon Mining Tax Act was brought forward some time ago by the federal government but has not yet been enacted into law; these changes too, involve an increase in mining tax rates in that territory. Saskatchewan has been engaged in a continuing and highly complex fight with the potash industry in that province concerning royalties and industry regulations, with some aspects of this matter already before the courts.

All in all, there is no province in Canada with important resource developments that either has not increased its taxation of the resource industries in the last year, or is not now considering such a step.

Oil Export Tax

The rapid escalation in world petroleum prices in the fall of 1973 had its repercussions in Canada. The federal government and the affected provinces were entirely in agreement on one matter: the bulk of the additional revenue generated from higher oil prices should flow to government, and not to the industry itself. However, the federal and provincial governments were sharply divided on just who should reap the bonanza; producing provinces were of the view that most of the increases should accrue to them through higher provincial royalties, while the federal government—supported in part by the non-producing provinces—felt that the revenue should flow to the federal government and be used in part for subsidies on oil and gas prices and the development of a Canadian-controlled oil and gas industry.

The dispute which went through a number of stages was not resolved until the March 27 meeting of provincial and federal premiers which agreed—on an interim basis—on a uniform $6.50 a barrel price for oil (wellhead basis) throughout Canada. The federal government was to be entitled to impose an export tax (currently $5.20 a barrel on crude oil, and the equivalent of $4.00 a barrel on refined products) to give it the difference between its posted Canadian price and world market prices on exported oil: the anticipated revenues from such a tax (about $1.7 billion a year) would be just about sufficient to enable the federal government to provide a subsidy on the price of imported crude oil to Eastern Canada to bring it down from world prices to the established $6.50 a barrel Canadian level. The producing provinces, by implication, considered themselves entitled to take whatever slice they desired out of the $6.50 a barrel basic Canadian price.

Federal legislation to implement the agreement reached at a meeting of first Ministers held on March 27, 1974 was contained in Bill C-18 (an Act to amend the Petroleum Administration Act) introduced in the House of Commons on April 2, 1974. This bill provided for the levying of an export charge on both crude and refined oil products, in a manner to be determined by regulation, and set out broad federal authority over

crude oil pricing and sales arrangements in interprovincial and export trade. Bill C-18 was not passed before the dissolution of Parliament in May and hence is not law; the federal government, however, continues to collect the export tax on oil on a "voluntary" basis, with the legislation undoubtedly to be re-introduced at the next session of Parliament.

Provincial Petroleum Royalty Increases

Following the recent dramatic rise in the price of oil and gas, all the provinces having important oil and gas resources have substantially recast their oil royalty systems to increase their revenues from oil and gas production.

In Alberta, the provincial oil royalty on production from Crown leases has increased in the past year from a basic rate of about 22% of gross production to a split royalty rate designed to yield the province additional royalties of about two-thirds of the increase in the value of production resulting from recent oil price hikes.

The general rate of Alberta oil royalties is now set at about 22% on the value of oil production based on the old (early 1973) selling price of oil, plus perhaps 65% of the increase in that production value resulting from recent increases in oil prices. On the basis of a current wellhead selling price of $6.50 a barrel, Alberta's royalty revenue per barrel has risen from perhaps 84¢ to $2.60 in the last year.[28]

However, in the case of "new" oil (oil produced from new wells) Alberta accepts a reduced royalty rate of 22% on the value of production at old prices, and only 35% on the excess. This and other features of the Alberta royalty system provide substantial incentives for the development of new oil production and in some cases for the extraction of high cost oil. In addition, Alberta has granted direct incentive payments to the industry for exploration wells drilled in Alberta. The current warfare between provincial and federal authorities has broken out here also: after initially ruling that these exploration well payments did not represent taxable income for federal tax purposes, Revenue Canada has recently reversed its ground and has indicated that such payments are — in effect — taxable by reducing the recipient's deductible exploration and development costs.

When the higher Alberta royalties are combined with the new income tax proposals, including the disallowance of provincial royalties as an expense for federal income tax purposes, most Alberta producers of "old" oil will find that their net cash flow after all taxes and royalties will actually be lower under the new higher prices and higher taxes than they were before the recent oil price increases and the consequent tax and royalty changes. Because of variations in the position of individual producers, it is extremely difficult to provide any meaningful general summary of the impact of the new provisions on the Alberta industry in general. However, one possible typical calculation, based on the taxation of "old" Alberta crude, is set out in Table V.

Corresponding calculations done with respect to the taxation of "new" Alberta crude (subject to reduced provincial royalties) would indicate that producers will obtain a moderate improvement in their position as a combined result of the recent oil price increases and tax and royalty changes.

Total effective royalty and tax rates on Alberta producers are now approaching unprecedented levels, overall effective rates in excess of 90% being quite

[28] The calculation of oil and gas royalties in Alberta and other provinces is based on complex rules which cannot be even summarized in this article. The descriptions of the royalty rates and selling values in the text must be regarded only as a gross simplification of the actual situation; they do not reflect factors such as differing oil grades, values, locations, transport costs, etc.

Table V

COMPUTATION OF NET RETURN PER BARREL OF "OLD" ALBERTA CRUDE OIL[1]

	After giving effect to increased crude oil price and federal budget	Before increase in price of crude oil and prior to federal budget	Increase (Decrease)
Crude oil export prices	$11.70	$3.80	$7.90
Less—Federal export tax	5.20	—	5.20
Gross to producer	6.50	3.80	2.70
Alberta royalty:			
65% of $2.70	1.76	—	1.76
22% of $3.80	.84	.84	—
$6.50	2.60	.84	1.76
Net revenue after export tax and royalty	3.90	2.96	.94
Estimated lifting cost (excluding depletion and recovery of capital costs)	.60	.60	—
	3.30	2.36	.94
Income taxes:			
Federal—			
30% of $5.66 ($6.50 less lifting cost 60¢ and assumed "earned" depletion of 24¢)[2]	1.70	—	—
36% of $1.57 ($2.36 less 33⅓% depletion of 79¢)	—	—	1.13
	—	.57	—
Alberta—			
11% of $5.66	.63	—	—
11% of $1.57	—	.17	.46
	2.33	.74	1.59
Net cash flow before recognizing any recovery of exploration development and capital cost[3]	.97	1.62	(.65)

Notes:

1 Calculations based on assumed costs, and present understanding of tax, royalty rules. Actual costs, royalty rates may vary significantly.

2 Estimate of "earned depletion" is arbitrary.

3 If amortization of exploration development and costs of 75¢ a barrel is assumed, then effective current overall tax and royalty rates is 98% of income before all levies. Income taxes alone would take 91% of income after royalties but before income taxes.

typical. With the federal and provincial governments between them taking the lion's share (and frequently the entire amount) of recent price increases the incentive for future exploration and development has been reduced. A number of companies have already announced the postponement of future exploration and drilling programs until the present tax situation stabilizes.

In Saskatchewan, the provincial government has demanded a far higher share of increased oil revenues than has been the case in Alberta. The typical rate of Saskatchewan oil royalty before the recent oil price increases was about 17% of production, but this has now been supplemented by a surcharge of about 83% of an amount roughly equivalent to the difference between the selling price of crude oil before the recent price increases and its present market value. In effect, Saskatchewan has taken 100% (actually perhaps a little over 100%) of the entire increase in the selling price of a barrel of oil through additional royalties. Again, there is some concession in the case of "new" oil production, where the surcharge of 83% is limited to an amount of about $2 per barrel of additional revenue. Typical Saskatchewan royalty rates, per barrel of crude, would now amount to perhaps $3.56 for "old" crude, and $2.71 for "new" crude, as opposed to a previous rate of 60¢ per barrel.

The combined effects of the higher Saskatchewan royalties and the proposed federal disallowance of provincial royalty payments will generally prove disastrous to Saskatchewan producers. In highly simplified terms, the Saskatchewan government is already taking 100% of the increase in the posted wellhead price in additional royalties in the case of "old" crude, and the federal government now proposes to levy a combined federal and provincial income tax on the same increase of approximately 42% (or somewhat less if "earned" depletion is available), plus additional taxes through the disallowance of the original Saskatchewan royalty.

The result will be that up to 150% or more of the price increase will go in additional royalties and taxes, and many Saskatchewan operators, whether they are producing new or old crude, will find themselves in a net overall loss position. Even before the federal budget proposals were brought forward, oil exploration activity in Saskatchewan had come almost to a stop, and future developments in the province with private capital appear unlikely under the present situation.

In British Columbia, present royalty rates of between one-tenth and four-tenths of production in the case of petroleum are now under review. While new royalty rates have not yet been announced, the government has indicated that it anticipates that a new royalty system will triple provincial revenue from oil and gas royalties from $22 million to $65 million a year.

The increased B.C. oil royalty rules are evidently designed to recover about 80% of the increase in the posted wellhead price of the oil in additional royalties. Again, if this increase is combined with the federal disallowance of the oil royalty payments as an expense for tax purposes, B.C. producers will suffer a net reduction in revenue as the result of the combined effects of the wellhead price increase and the tax and royalty changes.

Ministerial Discretion in the Provinces

All the provincial tax and royalty changes with respect to resource profits have one major feature in common, and that is the great reliance on discretionary provisions and arbitrary determinations. The legislation of almost all the provinces in this regard is so littered with clauses giving the provincial cabinet or a Minister authority to determine profits, prescribe allowances, assess

values, and generally fix everything — including in many cases the tax rate itself—that federal income tax provisions containing ministerial discretion (such as section 248) begin to look like models of certitude and fairness.

Re-introduction of the Federal Budget

The federal budget proposals of May 6 were of course not proceeded with at the last session of Parliament because of the defeat of the government in a motion of non-confidence on the budget. Immediately following the defeat of the federal government on the May 6 budget, Finance Minister Turner said that if the Liberals were returned to Parliament the budget would be re-introduced in essentially the same form and with the same effective dates for most of the amendments (i.e., May 6, 1974 for the bulk of the tax changes affecting the resource industries). With the re-election of the Liberal government with a clear majority on July 8, the federal budget proposals will undoubtedly be re-introduced shortly after the convening of the new Parliament.

However, in a press statement immediately following the election[29] the Finance Minister indicated some possible flexibility with respect to the May budget proposals affecting the resource industries. He stated that "both the Prime Minister and I are committed to re-introducing the budget in its present form", but with two major qualifications: "subject to the economic conditions at that time", and "subject to seeing what we can do to ease the conflict in Ottawa and the provinces over resources".

Finance Minister John Turner had earlier responded in less positive fashion to western criticism of his May 6 budget proposals relating to the resource industries. In an address in Calgary on June 21, he said that the provinces will still have the lion's share of oil and gas revenues, netting perhaps $2 billion in 1974 in taxes and royalties as opposed to $500 million expected to flow to the federal government. Mr. Turner's calculations do not include the huge federal revenues from the oil export tax, presumably because this is regarded as being offset by federal subsidies on oil imports. Federal estimates quoted by Mr. Turner indicate that under a mature tax system (after accumulated earned depletion is used up) the federal government would receive 19.8% of production income with 51.7% going to the provinces and 28.5% going to the producers. (Producers of course have to meet all costs and expenses out of their share.)

Mr. Turner rejected one argument advanced by the oil and gas industry in its plea to keep a larger share of oil and gas revenues for the resource operators; he explicitly denied that it was reasonable for resource producers to expect to recover capital cost of exploration and development programs out of current resource revenues. Mr. Turner did agree that a combination of the federal proposals and the provincial royalty increases in Alberta and more especially in Saskatchewan were creating taxation problems for western oil producers, but implied that the solution was for the provinces to reduce their tax and royalty rates.

Of course, the Western provinces have not been the only ones to express dissatisfaction with the federal resource changes. Ontario Treasurer John White was highly critical, in a speech to the Ontario Legislature on June 21, of the federal tax proposals affecting the resource industries, and said that the May 6 budget displayed a "lack of understanding" and was an unwarranted reversal of the previous federal policy arrived at in August 1970 to leave to the provinces the final determination of the total tax burden on the mining industry.

[29] *Globe and Mail*, July 10, 1974.

The later statement of Finance Minister Turner indicating some possible federal drawback on the resource taxation issue confirmed a previous statement of Prime Minister Trudeau that he was prepared to meet with the provinces to discuss a number of issues relating to federal-provincial conflicts concerning the control over and taxation of the resource industries in Canada, including the implications of the recent federal tax proposals. Immediately following the federal election, Premier Lougheed of Alberta indicated his willingness to meet with Prime Minister Trudeau to discuss energy issues, including taxation policies.

The possibility therefore exists that the recent tax and royalty increases on resource profits at both the federal and provincial levels will ultimately be the subject of federal-provincial discussions. It is encouraging from the viewpoint of the industry that the federal government has indicated some possible flexibility with respect to its May budget proposals; however, with the present government now having a clear majority in the House of Commons, it should not be anticipated that it will be possible to reach any general agreement on the issue without the provinces also displaying some degree of compromise.

Implications for Mining Industry

The adverse implications of the federal budget on the mining industry will only be felt gradually, and even then with different weight in different sections of the country. The key federal proposal—the disallowance of provincial resource taxes and royalties—will naturally bear heaviest on those companies subject to relatively high rates of provincial mining levies, such as the larger Ontario-based mining corporations without important processing facilities, and almost all B.C. companies. The other major change affecting mining — the abolition of automatic percentage depletion — will be largely offset in the short run by the availability of earned depletion (although at a lower rate) based on qualifying eligible expenditures since November 7, 1969, and by the lower effective federal tax rates on mining income.

The general increase in federal taxation of the mining industry consequent on all of the measures will really become fully effective only after mining companies begin to exhaust their present "earned depletion" bank built up since November 1969. Once this initial bank has been used up (and many mining companies will go through it in a year or two) the earned depletion allowance will prove to be of substantially less benefit to the mining companies than the old percentage depletion. Indeed, most established mining companies will probably, after a short transitional period, have a relatively insignificant amount of earned depletion under the federal rules unless they are embarked on major development projects. Even then, the tax benefits under the earned depletion rules will not be nearly as favourable as under the previous provisions.[30]

The provincial changes in the taxation of mining income are extremely difficult to assess in terms of general incidence for two reasons. First of all, the legislation or proposed legislation in several of the provinces is new, complex, and frequently contains features to be determined by regulations not yet available. In addition, mining tax legislation such as that enacted in British Columbia and proposed in Manitoba would provide for a basis of taxation which is unrelated in part to mining profits and hence cannot be measured as a percentage of mining income.

[30] For example, an Ontario mining company could reduce its effective tax rate by 17 percentage points through percentage depletion under the previous system: the maximum reduction under the revised rules will be 6 percentage points, and very few will achieve anything like this saving in the long run.

Indeed, one of the most important facts to recognize in any discussion of average effective rates of total tax on the mineral industry under these recent developments is that there will be no such thing as average effective rates of tax that mean very much. Under the new federal tax proposals and the revised provincial rules the rates of tax applicable to mining profits will vary tremendously with a number of factors such as investment in processing equipment, degree of processing carried out, expenditures on exploration and development, metal prices and, of course, the particular province in which the company operates.

Some of the more important of these variables are as follows.

Mining companies which carry out a substantial degree of domestic processing will achieve significantly lower effective tax burdens than those which do not, primarily because of provincial processing and other incentives. Companies with substantial exploration and new mine and processing developments will also benefit to a degree from the federal earned depletion rules.

The progressive rate schedule of the Ontario mining tax will impose heavier tax burdens on the larger and more profitable companies, but the Ontario provisions contain extraordinary incentives for mining companies to expand their processing facilities.

The B.C. and Manitoba mining royalty systems will take a higher proportion of mining profit as the price of the metal increases. In both provinces up to 50% of "excess" profits will be taken by provincial royalties in addition to normal provincial mining taxes, royalties, and corporate income taxes.

The relative weight of provincial mining taxes in the total tax mix will become much more important, because of rate increases and their non-deductibility for income tax purposes. This will give increased importance to the particular features of such taxes (including for example the possible disallowance of interest expense). Correspondingly, income taxes, and especially federal income taxes, will become a less significant part of the total tax burden. Tax planning will become much more difficult because of the differing tax systems involved.

Implications for Oil and Gas

The implications of the May 1974 federal tax proposals on the oil and gas industries will be much more immediate and drastic. The disallowance of provincial royalties will mean that perhaps two-thirds of the total operating costs of most oil and gas producers will not be allowed as an expense, and will result in overall tax rates on the industry which will approach astronomic levels and which will certainly inhibit future exploration and development efforts. In a large number of cases, a combination of the federal proposals and the provincial royalty increases will mean that federal and provincial levies will take all or almost all of recent increases in the posted wellhead price of oil leaving the industry with little net benefit from the price rise.

Implications on Resource Development

The attempts by both federal and provincial governments to obtain a share of the supposed "bonanza" from higher resource profits, and the acrimonious conflict between the two levels of government as to how this windfall should be shared, have created a crisis for the resource industries in Canada. There is of course no scientific way of determining an appropriate level of taxation for the resource industries, any more than there is for other activities, and the appropriateness of a particular level of taxation for the industry must always rest on personal judgment, with the opinion of the industry eager for expan-

sion and profits, naturally diverging from that of governments, anxious for additional revenues. It can, however, be conservatively concluded that marginal tax rates on new resource developments approaching and even exceeding 100% will prove somewhat inhibiting of future investment.

There are three general points which could be made about the higher tax burden to be faced by the mining industry in Canada.

First, a large part of the higher tax burden discussed in this article has arisen not because of some deliberate and coordinated policy decision by governments but rather because of the unseemly dogfight between provincial and federal governments for a share of resource profits. Each level of government has imposed new taxes without regard for the position of the other, and in some cases in an obvious effort to "pre-empt" the tax field.

Indeed, the resource sector in Canada appears to be the ham in the sandwich, pressed on each side by governments anxious not only to gain increased resource revenues but also to exclude the other level of government from increasing its revenues from, and its control over, resource developments. The federal-provincial squabble over resource taxation is more than a fight over tax revenues—it is a struggle for power by governments who to date seem more interested in constitutional strategy than the future of resource developments.

Secondly, the structure of the new federal and provincial rules can, in some circumstances, have a particularly adverse impact on new resource developments, through imposing especially high marginal tax rates on new resource developments. To give just one example, while the average tax burden on a large integrated Ontario mining producer can still be less than 50%, additional income obtained from operating economies or the expansion of existing mines will be taxed at a marginal rate of 73%.

Thirdly, the taxation of natural resources in general is in a total state of confusion. New proposals for the taxation of the industry have been rattling out of federal and provincial budgets far too rapidly for the industry to absorb or tax practitioners to assess, and in any event many of the new tax schemes grant wide discretion to the taxation authorities to determine—and change—the rules. The current situation is one of almost total uncertainty, and that uncertainty may prove at least in the short run every bit as harmful to future investment as the higher tax rates themselves.

While it has been true that the reported profits of resource companies have climbed substantially over the past year or so because of higher oil, gas and metal prices, it should be remembered that this increase in profitability comes about in part because resource companies are now measuring the current selling price of their products against the amortization of capital and development costs which were incurred many years ago at much lower price levels. If regard is had to the current cost of exploring for and developing new oil, gas and mineral production, including taking into account the fact that the newer projects tend to be of high cost (because of lower mineral content or increased inaccessibility) then there may be justification for allowing the industry to have a reasonable share of higher resource prices in order to encourage the development of these higher cost new resources.

The practical effect of governments attempting to tax away virtually the entire "windfall profit" or economic rent[31] attributable to higher resource prices will not be the closing down of existing production facilities—in most cases, these involve heavy sunk costs and production will be continued as long as there is any positive cash flow. However, the long-term implications on future developments can be much more adverse unless special efforts are made, beyond those now taken, to provide incentives and reasonable rates of return on future high-cost resource developments.

[31] The question of why windfall profits in the resource sector deserve higher taxation than other windfall profits might warrant further consideration.

Conclusion

Leaving aside any particular question as to the appropriateness of the general increase in the level of taxation of resource profits, it can be concluded that the way in which these proposed increases have occurred has been unfortunate from the point of view of the long-term interests of the industry and the Canadian economy.

The increased taxation of the industry has been imposed without any coordination between the governments involved. Instead, the provinces and Ottawa have been tumbling over one another in their anxiety to obtain an increased share of resource profits and control of resource developments before other governments pre-empt the situation. Open conflicts between federal and provincial governments; complex, arbitrary and frankly inept legislation; and extraordinarily high marginal rates on new income have meant that these tax changes can be even more damaging to the industry than even the enormous amounts of additional revenues demanded by governments would indicate.

One bright spot in this situation has been the recent indications of the willingness of the federal government, and certain of the provinces, to discuss the overall taxation of the resource industries on a more rational basis. With both levels of government laying claim to an important share of the tax revenue from the industries, some coordination of federal and provincial tax policies and rationalization of tax objectives is essential if a tax jungle entirely inhibitive not only to the future growth but even to the present levels of production and employment is to be avoided.

Quaker's Claim of Three Billion Dependents Was No Crime

A Quaker was wrongfully convicted of supplying false withholding information, the U.S. Court of Appeals at Richmond has held, when he claimed three billion dependents although entitled to only four. This conduct could not have been intended to deceive since there was no chance it could adversely affect the government from the withholding standpoint. (The Quaker claimed all men were brothers as a means of war protest.)

On another point, a conviction for contempt in not rising on the entrance and departure of the trial judge was upset. This was not misbehavior that obstructed the administration of justice.

District Court reversed. One dissent.

Snider, CA-4, 9548

PART III—
SPECIAL STATUS TAXPAYERS

PROFESSIONS AND ACCRUAL INCOME

Under the former rules, the only taxpayers who were permitted to compute their income on a cash basis were farmers, fishermen and taxpayers engaged in professional practice. Although this special tax treatment continues in respect to farmers and (presumably) fishermen, taxpayers in the professions are now obliged to compute their income for tax purposes on a modified accrual basis.

For taxation years ending in and after 1972, a taxpayer in professional practice, whether a sole practitioner, partner or corporation, must use this accrual basis of reporting both income and expenses for tax purposes.

This computation of accrual income differs in one important respect from that of other taxpayers on the accrual basis. Taxpayers in the professions may elect to exclude from income the value of work-in-progress at the end of the year.

Special rules have been introduced to bring into income over a period of years a taxpayer's "1971 receivables" (accounts receivable at the end of the taxpayer's 1971 taxation year, which have not previously been brought into income because the taxpayer reported his income for tax purposes on a cash basis). These rules also provide that a taxpayer's "1971 payables" may be deducted in full in the 1972 taxation year. ("1971 payables" are those which would have been deductible in the 1971 taxation year, if they had been paid in that year.)

A more comprehensive discussion of the taxation of accrual income of taxpayers in the professions will be incorporated in a separate booklet entitled "Partnerships and the Professions".

MINING AND PETROLEUM

A number of major changes in the taxation of the mining and petroleum industry have been incorporated in the Act. The Government's stated intention is to subject the industry to a higher level of taxation, where projects are profitable, whilst ensuring that certain incentives should be permitted in order to recognize the inherent risks involved in the industry and the competition for international capital.

The new federal legislation provides as follows:—

- Expansion of deductible exploration and development expenses to include costs of all resource properties, with sale proceeds being included in income.
- More favourable treatment of Canadian exploration and development expenses for taxpayers not primarily in the mining or petroleum industry.
- More favourable treatment of foreign exploration and development expenses for all taxpayers.
- Substitution of "earned" depletion for automatic depletion after 1976.
- Removal of shareholder depletion on dividends received.
- Withdrawal of the three-year exemption for new mines on December 31, 1973 and introduction of accelerated capital cost allowance on certain depreciable assets acquired for a new mine or a major expansion of an existing mine.
- Increase in the federal tax credit from 10% to 25% of mining income after 1976, with provincial mining taxes no longer being deductible from income.

Since the mining industry is subject to provincial mining taxes, as well as federal and provincial income taxes, the full burden of tax that the industry will have to bear will depend on the level of income and mining taxes that each province will decide to assess.

Canadian Exploration and Development

PRINCIPAL-BUSINESS CORPORATIONS

Under the former Act, a "principal-business" corporation was permitted to deduct mining and petroleum exploration and development expenses to the extent of income from any source. A principal-business corporation was defined as a corporation whose principal-business was, amongst other things, exploring for minerals or petroleum.

A corporate taxpayer other than a principal-business corporation was only permitted to deduct such expenses from income from the particular mineral or petroleum source. Individual taxpayers were further restricted in that the deduction was only applicable to petroleum costs, which could only be deducted from petroleum-source income. In all cases, the cost of mineral properties was not deductible.

The new definition of Canadian exploration and development expenses, covering costs incurred after 1971, has been expanded to include the cost of all rights, rental and royalty interests in relation to mining properties as well as petroleum properties. In other respects, the deductible expenses are substantially the same as under the former legislation and include a taxpayer's share of any partnership exploration and development expenses. 66(15)(b)

A principal-business corporation can continue to deduct all such expenses to the extent of income from any source, and transitional rules permit the carry-forward of pre-1972 expenses in a separate pool for deduction before any post-1971 expenses.

TAXPAYERS OTHER THAN PRINCIPAL-BUSINESS CORPORATIONS

Under the old rules, taxpayers which were not principal-business corporations could not generally deduct exploration and development expenses from non-resource income and therefore might be prohibited any deduction for their costs unless they were successful in their exploration activities. The new provisions permit, for the first time, taxpayers in this category a limited deduction of post-1971 exploration and development expenditures against other income on an immediate basis. Although transitional rules provide for the carry-forward in a separate pool of expenses which qualified before 1972, deduction of these expenses after 1971 will be subject to the same restrictions that applied at the end of 1971, and, where possible, they must be deducted before post-1971 expenses. Subject to the foregoing comments, the new rules provide that the amount deductible is the greater of:–

a). 20% of aggregate expenses incurred before the end of the taxation year and not previously deductible, or

b). Income from the resource, including royalties and proceeds from disposal of resource property.

Where pre-1972 expenses are also deductible in a year, the amount deducted will reduce the deduction for post-1971 expenses, as calculated under the above formula. 66(3)

Example of Deduction by Taxpayer other than a Principal-Business Corporation

	1974	1975	1976
Aggregate unamortized Canadian exploration and development expenses at the end of each year, before deduction for the year	$11,000	$8,000	$6,400
Canadian resource income	$ 3,000	$ 500	$7,500
Other income	1,000	1,500	500
	4,000	2,000	8,000
Maximum Canadian exploration and development expenses deductible (See Notes)	3,000	1,600	6,400
Net income	$ 1,000	$ 400	$1,600

Notes:–

1. In 1974, the maximum deduction equals the resource income, since this exceeds 20% of $11,000.
2. In 1975, the maximum deduction amounts to 20% of the unamortized expenses, since $1,600 exceeds the resource income for the year.
3. In 1976, the deduction is limited to the balance of unamortized expenses remaining on hand, since this is less than the resource income for the year.
4. The example presupposes that there were no further exploration and development expenses incurred in 1975 or 1976.

The overall effect of the above rules is that resource income will not be taxed until all Canadian exploration and development expenses have been deducted, and, if insufficient resource income is available, a limited deduction may be taken against other income.

Foreign Exploration and Development

Under the former legislation, taxpayers were only permitted a very restricted deduction for certain petroleum exploration costs outside Canada and no recognition was given to mining exploration costs. The new rules define foreign exploration and development expenses to include the cost of foreign resource properties and permit a deduction to all taxpayers along lines comparable to those described above in relation to Canadian expenses of taxpayers other than principal-business corporations. The only difference is that the minimum percentage deduction is 10% rather than 20%. 66(4)

Example of Deduction by any Taxpayer for Foreign Exploration and Development Expenses

	1974	1975	1976
Aggregate unamortized foreign exploration and development expenses at the end of each year, before deduction for the year	$11,000	$8,000	$7,200
Foreign resource income (including royalties and proceeds from disposal of foreign resource property)	$ 3,000	$ 500	$7,500
Other income	1,000	1,500	500
	4,000	2,000	8,000
Maximum foreign exploration and development expense deductible	3,000	800	7,200
	$ 1,000	$1,200	$ 800

These rules effectively ensure that foreign resource income is not taxed until all foreign exploration and development expenses have been amortized and that a limited deduction from other income may be taken, if insufficient resource income is generated.

Since foreign exploration and development is almost invariably carried out through a subsidiary corporation incorporated in the foreign jurisdiction, the parent will not be able to obtain a deduction for such expenses since it did not incur them. As a consequence, the opportunities to take advantage of the new deduction will normally be severely limited.

Transferability of Exploration and Development

ACQUISITIONS

With certain modifications, the former rules are continued whereby a principal-business corporation (the "successor" corporation) that acquires all or substantially all of the Canadian resource properties of another principal-business corporation (the "predecessor" corporation) is permitted to deduct the unclaimed Canadian exploration and development expenses previously incurred by the predecessor corporation, but only to the extent of the aggregate income reasonably attributable to production from the specific properties acquired from the predecessor corporation. If all or substantially all of the resource property of the successor corporation is acquired by another principal-business corporation (the "second successor" corporation), the second successor corporation is entitled to a deduction within the same limitations. 66(6)&(7)

The Act now also permits the deduction of foreign exploration and development expenses acquired by a successor or second successor corporation, subject to similar limitation as above. 66(8)&(9)

The former rule continues whereby a principal-business corporation, which was formed as a result of an amalgamation of two or more corporations, is permitted to deduct qualifying Canadian expenses incurred by a predecessor corporation, but only from income attributable to production from properties acquired from that predecessor corporation. The rule is now extended to include foreign expenses, with similar restrictions as to the income from which they may be deducted.

RENUNCIATION OF EXPENSES

The Act also continues to allow a "joint exploration corporation", which is defined as a principal-business corporation that has never had more than ten shareholders, to renounce Canadian exploration and development expenses in favour of any shareholder corporation. However, this election has not been extended to include foreign costs. 66(10)

> **TAX PLANNING TIP**
>
> The use of a joint exploration corporation is not without potential tax problems. First, renounced expenses can cause a reduction in the cost base (for purposes of determining capital gains) of the shareholder corporation's investment in the joint exploration corporation. Secondly, any expenses renounced will not be included in the joint exploration corporation's pool of expenditures which earn depletion, and it is not altogether clear whether such expenditure would be included in the shareholder corporation's pool. "Earned depletion" is discussed shortly.

CHANGE OF CONTROL

Where a corporation has ceased active business and control of the corporation has subsequently changed, a new rule has been introduced which precludes the corporation from being able to deduct Canadian or foreign exploration and development expenses incurred in the period prior to the change of control. The restriction only applies to expenses incurred after 1971. Change of control, by itself, will not cause the loss of deductibility of such expenses. Cessation of business may prove difficult to define. In circumstances where a corporation has accumulated substantial exploration costs, it may prove advantageous to maintain some active business operations if change of control of the corporation is a possibility in the future. 66(11)

Disposal of Resource Properties

In line with the new deduction permitted in relation to all rights and interests in mining or petroleum properties, provisions have been introduced to tax in full or in part the proceeds of any disposition of a resource property. 59

Under the former Act, principal-business corporations were required to bring into income proceeds from disposal of Canadian petroleum rights, irrespective of when they were originally acquired. Other taxpayers were also required to recognize proceeds from such rights as income, but only in relation to properties acquired after April 10, 1962.

The new rules require that proceeds of disposal after 1971 of all Canadian or foreign resource property must be brought into income in full, subject to some transitional relief for properties owned on December 31, 1971. (This transitional relief does not, however, apply to disposal of resource property that would have been taxable under the former rules.) For all other resource property, if a sale is made in 1972, only 60% of the proceeds need be brought into income and this percentage increases by five percentage points each calendar year until 1980, when 100% of the proceeds must be recognized.

A special rule applies to non-arm's length disposal of resource property, whereby the purchaser is only deemed to have a cost equal to the amount which the vendor is required to bring into income. The non-arm's length purchaser, in these circumstances, will also be able to obtain the transitional relief if he disposes of the acquired property before 1980.

After 1971, if adverse tax consequences are to be avoided, all transfers of resource properties between related parties must be carried out at fair market value. The

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few exceptions to this rule are where a tax-free "rollover" is permitted in the case of:—

1. The winding-up of a wholly-owned Canadian subsidiary, 88
2. The amalgamation of two or more Canadian corporations, and 87
3. The transfer of property into a Canadian partnership. 97

TAX PLANNING TIP

Where a corporation is considering the joint development of one of its resource properties, it could consider using a subsidiary joint exploration corporation and transferring the property into that corporation. Although the transfer would be made at fair market value and would give rise to income in the hands of the transferor corporation, the joint exploration corporation may renounce its exploration and development expenses to the shareholder corporation. Since, for tax purposes, the cost of the property to the joint exploration corporation will be equal to the amount that the shareholder corporation must recognize as income, and since such cost is included in the exploration and development expenses which may be renounced, there will be no overall tax cost to the shareholder corporation. Other corporations could then acquire an interest in the joint exploration corporation (through incurring eligible expenditures on the property) without adverse tax consequences to any of the parties involved. Note, however, previous comments on the tax difficulties which can arise with respect to a joint exploration company.

Where disposal proceeds are not all receivable in the year of disposal, the amount receivable at the end of any year may be deducted from income, in which case it must be included in income in the following year. A reserve is no longer deductible in the year or in the immediately preceding year if the taxpayer becomes exempt from tax, ceases to be resident in Canada or, if non-resident, ceases to carry on business in Canada.

It should be noted that:—

a). The amount brought into income by reference to a sale of resource property is the proceeds, as distinct from the profit, on disposal.

b). The income does not qualify for percentage or maximum earned depletion, and

c). For taxpayers other than principal-business corporations, the income is considered to be resource income for the purpose of deducting Canadian exploration and development expenses.

Transitional Provision for Resource Property owned on December 31, 1971 and disposed of after 1971 (other than property, disposals of which would have been also taxable under the former Act)

Calendar Year of Disposition	Percentage of Proceeds		
	To Be Included in Vendor's Income	To Be Added to Exploration and Development Expenses of	
		Non-Arm's Length Purchaser	Arm's Length Purchaser
1972	60%		100%
1973	65%		
1974	70%		
1975	75%		
1976	80%		
1977	85%		
1978	90%		
1979	95%		
1980 (and subsequent years)	100%		

New Mine Exemption/Accelerated Capital Cost Allowance

The three-year tax-exempt period for new mines expires with respect to income earned after December 31, 1973. To replace this tax holiday, provision has been made for accelerated depreciation for specified depreciable assets acquired for the purpose of producing income from a new mine or a major expansion of an existing mine in Canada. TR28

The specified assets:—

1. Must be acquired after November 7, 1969, but before the new mine comes into production in reasonable commercial quantities or before the expansion of an existing mine is completed (in which case, they must also be acquired for the purpose of the expansion itself);
2. May be new or used, except that non-arm's length acquisitions of used property will not qualify; and
3. Will be placed in a separate capital cost allowance class or classes. (A separate class is prescribed for property acquired for the purpose of producing income from each mine or each group of mines.)

For a new mine, qualifying assets include:—

- Buildings, other than office buildings not situated on the mine property.
- Structures, mining machinery and equipment.
- Electrical generating or distributing equipment for the purpose of providing power to the mine.
- Community and transportation facilities for the operation or servicing of the mine, or for the community, such as an airport, dam, dock, fire hall, hospital, house, natural gas pipeline, power line, recreational facility, school, sewage disposal plant, sewer, street lighting system, town hall, water pipeline, water pumping station, water system, wharf, road, sidewalk, runway, parking area, storage area, but not a railway unless it is situated on the mine property.

For a major expansion of an existing mine, which is considered to have taken place when the greatest designed milling capacity has been increased by at least 25%, qualifying assets will include all the above property with the exception of community and transportation facilities.

Qualifying assets acquired after November 7, 1969 but before the end of the taxpayer's 1971 taxation year may be transferred into the new class or classes at their undepreciated capital cost.

The rules provide that a taxpayer may claim capital cost allowance on qualifying assets to the full extent of the income from the new mine or mines, or 30% of the undepreciated capital cost of those assets, whichever is the greater.

ILLUSTRATION

	NEW MINE A	NEW MINE B	NEW MINE C	TOTAL
Undepreciated capital cost of qualifying assets of each mine	$300,000	$200,000	$1,000,000	
Income from each new mine	$100,000	$250,000	$ 100,000	$450,000
Capital cost allowance deductible	100,000	200,000	300,000	600,000
Income (loss) after capital cost allowance	$ Nil	$ 50,000	$ (200,000)	$(150,000)

If all three mines above are owned by one company, the aggregate loss of $150,000 is deductible from income from existing mines or from any other source.

A new mine which began its three-year tax-exempt period before November 7, 1969 obtains the full benefit of the exemption, but is not permitted to use the accelerated capital cost allowance provisions. Such assets would still be subject to capital cost allowances at the normal rates. A new mine coming into production between November 7, 1969 and December 31, 1973 may, if it wishes, treat the appropriate income as exempt. At the end of its tax-exempt period, it can then claim capital cost allowance at normal rates on otherwise qualifying assets or, if it so elects, can claim accelerated allowances. However, if the election is made, the undepreciated capital cost of the qualifying assets must be reduced by the amount of the exempt income, in which case the only advantage is through deferral of tax.

Since this election need not be made until the taxpayer files his return for the year in which the exempt period ends, there would normally be sufficient information on which to base a decision. Factors affecting the choice would include:—

a). The total assets subject to the accelerated write-off, and

b). The total income in the exempt period.

Depletion-Operators

The former system of allowing an operator of an oil or gas well, a base or precious metal mine, a depletion deduction of 33⅓% of production profits continues until the end of 1976, as will the separate rates applicable to gold and coal. After that date, several important changes come into effect:—

- A deduction of up to 33⅓% of qualifying profits will continue but will have to be "earned" on the basis of $1 of depletion for each $3 of expenditure on specified activities or assets
- The qualifying profits on which the deduction will be taken after 1976 are referred to as "resource profits" and have been expanded to include resource royalties
- The mining of gold and coal will be subject to the new earned depletion rules

EARNED DEPLETION

After 1976, a taxpayer will be permitted a deduction of $1 for every $3 of eligible expenditures incurred after November 7, 1969, up to a maximum of 33⅓% of resource profits, which consist of:—

1. Petroleum production profits from Canadian resources
2. Mineral production profits, up to the prime metal stage, from Canadian resources
3. Profits from custom processing in Canada of minerals up to the prime metal stage
4. Income from an interest either in a resource or in the sale of products from the resource
5. Rental or royalty income, where computed by reference to production from a resource

Regulation 1205(1977) to the Income Tax Act provides that the following expenditures incurred after November 7, 1969 are eligible for inclusion in a taxpayer's earned depletion pool:—

a). Cost of assets acquired for new mines or major expansions of existing mines which are eligible for accelerated capital cost allowance, other than community and transportation facilities (These costs were discussed earlier)

b). Canadian exploration and development costs other than

(i) Interest capitalized where borrowed to finance exploration and development

(ii) The cost of resource properties

(iii) Expenses in the vicinity of the mine after commencement of production

(iv) Where the corporation is a joint exploration corporation, expenses renounced to a shareholder corporation

c). Cost of processing assets for processing in Canada minerals to the prime metal stage, provided they are acquired for a new mine or the expansion of an existing mine

d). Cost of processing assets used to process in Canada minerals beyond the stage to which the particular minerals had been processed before in Canada.

In addition to the above costs incurred after November 7, 1969, eligible expenditures include the cost of all processing assets acquired after May 8, 1972 for processing ore in Canada up to the prime metal stage, including assets acquired by custom processors. From the above total, any interest costs capitalized in depreciable assets would be excluded.

As under the former rules, the profit on which depletion is taken is calculated after deducting capital cost allowances and exploration and development expenses. It is worth noting that although the cost of acquisition of resource properties after 1971 is included in exploration and development expenses and is therefore deducted in arriving at depletable income, the sale of a resource property is not included in resource profits and therefore does not give rise to depletable income. As a consequence, a purchase and sale of a resource property at the same price could give rise to an aggregate net tax cost.

Since the accumulation of costs which constitute eligible expenditures includes those incurred after November 7, 1969 and since the draw-down of earned depletion will not commence until 1977, it is possible that taxpayers may build up a substantial pool of earned depletion before 1977, with the result that the full impact of the new provisions may not be felt for some years after that date.

Depletion—Non-Operators

The former 25% depletion deduction available to non-operators will continue until the end of 1976. After 1976, royalty or rental income will be classified as "resource profits", as defined earlier, and will be eligible for earned depletion along the same lines as for operators of a resource.

Depletion—Shareholders

In recognition of the fact that resource properties are wasting assets, shareholders were allowed under the former rules, a deduction for depletion ranging from 10% to 20% of gross dividends received. With the cost of resource properties being deductible under the new system and with the introduction of the capital gains concept whereby a shareholder will receive some relief on any loss he may realize on disposal of his shares in a resource corporation, the rules now provide that no depletion is deductible by shareholders in respect of any dividends received after 1971.

Prospectors and Grubstakers

Under the former Act, prospectors and grubstakers were generally exempt from tax in respect of proceeds from sale of mining properties or shares received in exchange for such properties. Under the new rules, preferential treatment is still extended to such taxpayers in certain cases, but by means of tax deferment and capital gains treatment, and not by total exemption from tax. 35

If the mining property acquired by prospectors or grubstakers is sold for shares, they are not required to bring any amount into income at that stage, but the shares are deemed to have a nil cost to the recipients and the property will have a nil cost to the corporation. The corporation will therefore be entitled to no deduction and will be taxable in full on any disposition of the property. The shareholder will have a capital gain, of which 50% will be taxable, on any subsequent disposition of the shares. (It seems possible that the sale of shares could be looked on as an income transaction in certain circumstances.)

Any consideration other than shares received on the sale of a resource property by a prospector or grubstaker will be included in his income.

Provincial Mining Taxes

The former legislation permitted a corporation to deduct from income the lesser of mining taxes paid or that proportion of the mining taxes paid that mining income computed under federal rules was of mining income computed under provincial rules. This deduction will cease at the end of 1976. In addition, all corporations continue to be allowed a provincial tax credit—deductible from federal tax—of 10% of taxable income.

After 1976, provincial mining taxes will no longer be deductible in computing income. Instead, a corporation may take a further tax abatement of 15% of the lesser of:—

a). Taxable mining production profits earned in a province, or

b). Such part of its taxable income that consists of active business income taxed at the full rate. 124

Federal tax payable on mining profits earned after 1976 will therefore be at a minimum rate of 21% (46% less 25% abatement) and, assuming no increase in provincial mining taxes, after-tax income will be either greater or less than under the former system, depending on the amount of earned depletion that the corporation is able to deduct.

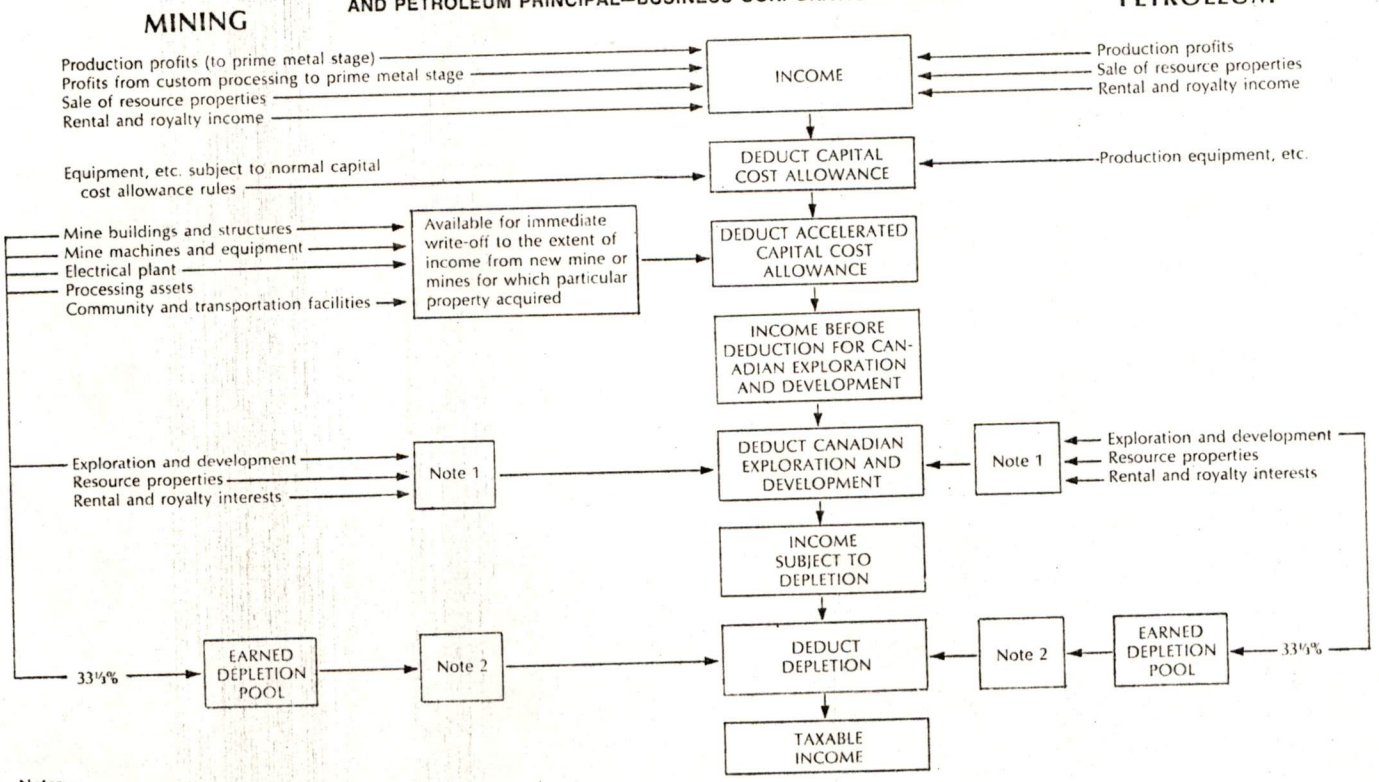
		After 1976	
	Former Act	Maximum earned depletion available	No earned depletion available
Mining income	$300	$300	$300
Less: mining taxes (assumed to be deductible in full)	45	-	-
Depletable income	255	300	300
Depletion	85	100	-
Taxable income	$170	$200	$300
Total taxes			
Provincial mining taxes at 15% (Note 1)	45	45	45
Federal income tax			
$170 at 36% (assumed rate)	61		
$200 at 21%		42	
$300 at 21%			63
Provincial income tax (Note 2)			
$170 at 10%	17		
$200 at 10%		20	
$300 at 10%			30
	$123	$107	$138
After-tax income	$177	$193	$162

Notes:–

1. As discussed earlier, the full impact of taxation for the mining industry will depend on the provincial income and mining tax rates that each province will decide to apply.
2. If a Provincial income tax rate in excess of 10% is assumed the after-tax income under the new system would be reduced proportionally more than under the former Act.

The following table shows, in chart form, the calculation of income and taxable income of principal-business corporations in the mining and petroleum industries after 1976, and indicates the types of assets which are eligible for accelerated capital cost allowance treatment, the costs included in exploration and development and those which rank for inclusion in the earned depletion pool.

CALCULATION OF TAXABLE INCOME OF MINING AND PETROLEUM PRINCIPAL—BUSINESS CORPORATIONS AFTER 1976



Notes:—

1. Deductible in full from income from any source.
2. Amount deductible is lesser of:
   a) 33⅓% of income subject to depletion
   b) Earned depletion pool.
3. Subject to provincial income and mining taxes.

FARMERS AND FISHERMEN

The former Act (together with Department of National Revenue practice) granted farmers or fishermen special tax treatment in four main areas:–

a). Cash basis–farmers, and by Department practice fishermen, were permitted to compute their income for tax purposes on a cash basis.

b). Basic herd–a livestock farmer could elect to treat part of his herd as a capital asset, so that the cost of its acquisition was not deductible and the proceeds of its sale were regarded as capital gains and therefore not included in income.

c). Straight-line depreciation–both farmers and fishermen could, if they so wished, claim capital cost allowance on depreciable assets on a straight-line basis and were not subject to recapture when such assets were disposed of, nor were they permitted a terminal loss.

d). Averaging–both farmers and fishermen (individual or corporate) were entitled to average their income in five-year blocks.

Under the new rules, the averaging provisions have been modified and, with capital gains now constituting part of the tax base, basic herds and straight-line depreciation will be phased out.

Cash Basis

Farmers can continue to use the cash basis for computing income, if they wish. The Act still does not specifically allow fishermen to use the cash basis but it is understood that past Department practice will continue in this regard. 28

The former rules are also continued whereby:–

1. Partners in a farming or fishing business must make a joint election to be taxed on the cash basis, or otherwise they will have to follow the accrual basis, and

2. Amounts received on disposal of inventory or accounts receivable after cessation of business are taxable when received or, in the case of a taxpayer becoming non-resident, at the time he ceases to be resident, whether the proceeds have been received or not.

Basic Herds

A basic herd cannot be created or increased after 1971. For 1972 and subsequent years, a cash basis taxpayer who has an existing basic herd must report all proceeds of sale of animals as ordinary income. However, he may elect each year to deduct a portion of the fair market value of his basic herd as at December 31, 1971 in accordance with the following rules:–

a). He may deduct an amount not exceeding the least of:–

–the basic herd value of animals sold during the year;

–10% of the value of the basic herd as at December 31, 1971; and

–the undeducted 1971 value of the basic herd at the beginning of the year.

b). Whenever the actual number of animals in the basic herd is less than the basic herd remaining after making the above deductions, the taxpayer must claim an additional deduction to reduce the basic herd to the number of animals actually on hand in the class at the end of the year.

The change in the law concerning basic herds means that, in future, the taxpayer who has chosen to follow the cash basis of reporting income must deduct the cost of acquisition of new animals purchased during a year and must report the proceeds of all sales of animals during the year subject to a deduction for a portion of the December 31, 1971 value of any established basic herd which he may have had. 29

Chapter 10

EARNED DEPLETION OF MINING AND PETROLEUM CORPORATIONS

GENERAL DESCRIPTION

If a corporation in the extractive industries makes an expenditure of a specified nature, the corporation will receive an allowance of $1 for each $3 spent, which is called 'earned depletion'. The allowance is in addition to the right under tax law to write off the expenditures made. After 1976, 'earned depletion' will be allowed as a deduction from income, subject to limitations similar to those which now apply to percentage depletion. 'Earned depletion' replaces percentage depletion which will not be allowed after a transitional period expires. 1

It should be recognized that the allowance is misnamed when called "depletion". (The Act does not use the term depletion and the relevant definitive regulations have not yet been published.) It has few of the characteristics associated with depletion. In the accounting sense, depletion is the amortization of the cost of the resource and the basis for the amortization is usually related to the consumption of the resource. This is sometimes referred to as cost depletion. These costs prior to 1972, with the exception of the purchase price of a mining property, were deducted for tax purposes in the allowances for exploration and development costs. Percentage depletion (or in certain cases an alternative allowance based on production volumes) which 'earned depletion' will replace for tax purposes, encompasses, in an economic sense, an allowance for the diminishment of the discovery value of the resource. It may fail to cover the cost of the property or it may exceed that cost many times over. 2

On the other hand, 'earned depletion' is a potential deduction from income granted because funds have been expended on qualifying expenditures. The expenditures may be made for the exploitation of a resource. When the allowance relates to exploration and development expenses, it may have some elements of depletion. However, even there the deduction may be made against the profits from another resource. There must be production profits, etc. before the allowance is deductible but these need not be related to the expenditures in any way other than they were made by the corporation. These are not the characteristics of depletion. 3

'Earned depletion' is expenditure oriented, in that no deduction is possible without eligible expenditures, but it is also profit oriented because no deduction 4

is possible without production profits. However, the latter need not be related to the expenditures.

5 The accounting problems presented by the provision include: identifying the nature of the allowance; determining how and when it should affect income; and determining what disclosure should be necessary.

DESCRIPTION OF TAX PROVISION

6 The technical provisions are made by regulations under Sec. 65 of the Income Tax Act. Final regulations have not been issued. Proposed regulations were issued on July 6, 1971.

7 A taxpayer will earn the right to $1 depletion for every $3 of 'eligible expenditures' made after November 7, 1969. This will be in addition to the normal deductions permitted in respect of the $3. The present percentage depletion allowances carry on until the end of 1976. After that time, 'earned depletion' accumulated to the end of 1976 and that earned subsequently will be deductible to the extent of 33⅓% of the income derived from production profits after some specified deductions and from royalty income derived from Canadian resources.

8 'Eligible expenditures' will include:

1. Canadian exploration and development expenses in the mining and petroleum industries except for the acquisition costs of Canadian resource properties, community and transportation facilities, exploration and development in the vicinity of the mine after it comes into production, and interest related to exploration and development costs.
2. Buildings, machinery and equipment and electrical plant costs related to a new mine or a major expansion of an existing mine.
3. Expenditures on new building and machinery, to the extent that they are to be used to process ore from Canadian mineral resources beyond the stage to which they were previously processed in Canada, up to but not beyond the prime metal stage or its equivalent.

9 Where there has been a statutory amalgamation of mining or petroleum corporations, or where one mining or petroleum corporation has taken over all or substantially all of the resource property of another such corporation, 'earned depletion' of a predecessor corporation which has not been absorbed against its production income may be assumed by the continuing corporation to be claimed against production income from the properties which were taken over. 'Eligible expenditures' do not include the purchase price of resource properties.

ANALYSIS OF ACCOUNTING PROBLEMS

The nature of the allowance

10 *Rate reduction.* Percentage depletion is effectively an indirect rate reduction since there is no way to relate it to the cost of past expenditures nor is there any

limit to it except that inherent in the capacity of the resource to produce profits. While it has been stated at the beginning of this chapter that 'earned depletion' is not really depletion, there is no doubt that percentage depletion is its predecessor. It may be argued that the reduction of taxes from 'earned depletion' is a rate reduction since it does not come from the amortization of costs. It is a reduction granted for having made 'eligible expenditures' in the past.

The concept of rate reduction places heavy emphasis on the fact that the deduction requires production profits, etc. and is not in any way related to the amortization of the costs on which the 'earned depletion' is based. Had the primary emphasis been on the 'eligible expenditures' instead of the production profits, etc., the tax provision could have been written to provide a deemed cost for 'eligible expenditures' of 133⅓% of actual cost. This would have permitted the tax savings to have been accounted for as a permanent difference in tax allocation at the time the expenditures were charged to income. However, because percentage depletion is to be retained until the end of 1976, while 'earned depletion' allowances are retroactive to November 1969, and because the new method is the successor to percentage depletion, the actual deductibility is primarily tied to production profits, etc. rather than 'eligible expenditures'. 11

The concept of rate reduction will lead to fewer problems than alternatives discussed below. Income is not affected until the tax saving or reduction occurs. No virtual certainty tests have to be applied. Every corporation involved can be treated the same way. It is similar to the current practice. 12

'Earned depletion' deductions available for future years should be disclosed in a note to the financial statement. The note should state that the amount can be used only subsequently to 1976. Corporations which do not have production profits, etc. should have a more comprehensive note indicating the circumstances necessary for 'earned depletion' to produce a tax reduction for the corporation. 13

Immediate recognition of tax savings. Even if it is virtually certain that a corporation will eventually be able to claim full deduction of the 'earned depletion' credits, these should not be used to reduce the income tax provision in the year of the expenditure, or thereafter, except to the extent that they effect the rate of tax under the rate reduction concept or have been charged against income under the tax credit concept outlined below. It is a well established accounting principle that the mere expenditure of money does not create income. Rather it is the use of the assets acquired by such expenditure that creates income. 14

Grants. Since 'earned depletion' arises from specific types of expenditures, the position may be taken that the tax reduction is the equivalent of a government grant. However, a tax incentive or concession is not usually considered to be a grant. In the extractive industries, it would be peculiar to have a grant dependent upon production profits. Many corporations will derive no tax saving from the provision because they will not produce the kind of income necessary; for others, the benefit or degree of benefit will be uncertain. Before the matter could even be seriously considered as possibly giving rise to a grant, the advan- 15

tage would have to be certain for all taxpayers who made 'eligible expenditures'. There would appear to be no justification for accounting for the tax saving as a grant. A variation of the grant concept, i.e. a tax credit, is discussed below.

16 *Tax Credit.* 'Earned depletion' allowances may be considered the equivalent of tax credits granted for making 'eligible expenditures'. This conclusion may be reached by placing the emphasis on the expenditure and de-emphasizing the fact that no benefit is derived unless and until production profits, etc. are earned. The 'earned depletion' is a mixed concept in that it seeks to continue percentage depletion but to limit its application by the requirement that depletion-earning expenditures be made. The result is neither percentage depletion nor tax incentives certain of realization.

17 Under the tax credit concept, the tax saving is recorded at the time the expenditure is made. It would be improper to reflect that saving in income in the year of acquisition because income arises from the use of the assets acquired rather than from the acquisition itself. The Accounting Principles Board of the AICPA in dealing with the investment credit (deductible from income taxes payable and arising from the acquisition of certain depreciable assets), recommended (prior to the intervention of the U.S. Government) that the investment credit be reflected in income over the productive life of the acquired property and not in the year in which it was placed in service. This is similar to the conclusion reached in paragraph 3065.14 of the *CICA Handbook* with respect to grants where the availability of the grant influenced the decision to acquire the asset.

18 Under the tax credit concept, the estimated tax saving (this would be based on the rates in effect in the year the property was acquired) would be deducted from the cost of the assets acquired and the offset set up as a deferred item. In the years in which taxes were reduced because of the 'earned depletion' allowances, appropriate transfers would be made from the deferred debit to the tax liability account. The income would be affected in the years in which the 'eligible expenditures' were depreciated or amortized because the accounting charges would be based on original cost less the deferred tax debit. In this way the benefits would flow into income over the productive life of the assets. The tax saving deducted from the cost of the acquisition would give rise to a permanent difference rather than a timing difference.

19 The following is an illustration of the tax credit concept. Assume an expenditure of $3,000,000 on 'eligible expenditures' which is written off at 30% per annum and that the write-off for tax purposes is at the same rate. Assume also that the tax value of the $1,000,000 'earned depletion' is $500,000. The $3,000,000 expenditure would be recorded as follows:

Assets	$2,500,000	
Deferred tax	500,000	
Cash		$3,000,000

20 The accounting income, in the first year, would compare with the taxable income, less tax, as follows:

	Tax Credit Method	Tax	Rate Reduction Method Note 4
Production profits before write-off	$1,200,000	$1,200,000	$1,200,000
Less 30% write-off – see note (1)	(750,000)	(900,000)	(900,000)
	450,000	300,000	300,000
Depletion ⅓		(100,000)	
		200,000	
Tax – see notes (2) and (3)	(150,000)	(100,000)	(100,000)
Add depletion		100,000	
Income after tax	$ 300,000	$ 200,000	$ 200,000

Notes:

1. Tax deduction of 30% based on actual expenditures of $3,000,000 whereas accounting deduction based on $2,500,000.
2. There is a permanent difference between the accounting basis and the tax basis arising from the difference in 1. The difference in the year is $150,000 ($900,000 minus $750,000) which results in a tax provision of $75,000 less than it would otherwise be.
3. The tax provision would be recorded as follows:

Tax provision	$150,000	
Taxes payable		$100,000
Deferred taxes		50,000

The deferred taxes are reduced by $50,000 because 30% of the depletion credits has been used.
The tax credit method puts the tax reduction in the years in which the expenditures are written off in the accounts rather than in the years in which the 'earned depletion' credits are used to reduce taxes.

4. If, instead of the tax credit method, the rate reduction method was used, the company's income in the first year (assuming post-1976) would be $200,000 which is the same as the tax basis.

The concept is subject to the criticism accorded net of tax accounting since the taxes shown as such in the income statements over the entire period would be greater than the actual taxes. The tax saving from 'earned depletion' would appear in the income statement netted with depreciation and amortization, etc. 21

However, if the position that the incentive is for the purpose of making certain expenditures (rather than carrying on the percentage depletion incentive in modified form) can be supported, then the effect of the method on inter-period income determination is reasonable because on that assumption it gives better income measurement. The quarrel, if any, is with the initial assumptions. 22

A further problem with the method lies in the uncertainty of the amount of the tax credit. While the potential reduction in taxable income may be certain, the tax rate to be applied to determine the amount of tax credit to be deducted from the 'eligible expenditure' is very uncertain. The earliest date for obtaining benefits from the provision is 1977. The Government has suggested that at that time, the abatement for provincial taxes be increased to 25 percentage points. The rates and the tax base for provincial income taxes for 1977 and subsequent years are unknown and the present law is not a reasonable guide in the circumstances brought about by Tax Reform. 23

Any error made in estimating the credit carries over in determining the cost of the 'eligible expenditures' for accounting purposes. Through depreciation and amortization, the error is carried into the income statements. 24

The objection may be raised that, if the tax credit method is used prior to 1977 while percentage depletion is still in effect, the corporation gets two deductions for depletion in its accounts while it is entitled only to one during 25

that period under tax law. The objection is not relevant as long as the contention can be supported that 'earned depletion' is expenditure oriented and that therefore the tax saving should be recognized in the accounts as and when the expenditures are amortized for accounting purposes.

26 The major criticism of the tax credit method lies in the difficulty of determining the amount of the credit, although this will be a minor factor after 1976. Its validity rests on the assumption that the incentive has been basically changed to an expenditure oriented incentive rather than a continuation of percentage depletion (i.e. a profit-oriented incentive) modified by the addition of a limitation factor.

27 *Choice between rate reduction or earned credit method.* This Study does not conclude as a generality that one method is clearly preferable to the other. For many corporations the earned credit method would be clearly inappropriate because of the uncertainty that the 'earned depletion' credits could ultimately be used.

28 In all other cases, either method may be appropriate depending on the circumstances. The principal factor to be considered would be which approach will give the most reasonable income measurement. The two methods should not be considered interchangeable.

29 The accounting policy disclosure note should set out the method of accounting for 'earned depletion' credits adopted by the corporation together with reasons for adopting the particular method.

Application of tax allocation – post 1976

30 At present in determining the tax provision related to timing differences it is customary to take the effect of percentage depletion into account in determining the tax rate to be applied.

31 After 1976, where the rate reduction method is used, it cannot be assumed that, because there are production profits, the rate will be reduced by a depletion factor. The reduced rate to be applied to the timing difference would be justified only to the extent that there were unused 'earned depletion' credits on hand to support the assumptions made. This would suggest that a pro forma record should be maintained of depletion credits on the basis of the utilization for such a calculation.

32 The problems will not arise where the tax credit method is used because the tax saving related to 'earned depletion' is taken into income as the expenditures which gave rise to 'earned depletion' are written off in the accounts. The rate applicable to other timing differences would be the full rate.

Transfer of earned depletion allowances

33 Where a corporation takes over substantially all the property of another corporation, it can acquire the unused 'earned depletion' allowances of that corporation. The credits so acquired, however, can be applied only against income derived from the properties acquired. Such restricted 'earned depletion' allow-

ances should be shown separately with appropriate explanation in the note to financial statements dealing with 'earned depletion' allowances.

Under the rate reduction concept, it is not necessary to ascribe any value to 'earned depletion' allowances acquired since any value attributed to them would be included in the cost of the resource properties acquired. These costs would be charged to income as the gains or earnings arose which permits deduction of the 'earned depletion' allowances. 34

Cost of resource properties

The purchase cost of any Canadian resource property is now included in exploration and development expenses whereas formerly only such properties related to oil and gas were so included. This raises the question as to what accounting is appropriate in respect of the tax saving arising from the deduction of the cost for tax purposes where the corporation has adopted a policy of not providing for depletion of the cost of such resource properties. While the matter is extraneous to the Chapter on 'earned depletion' it should be raised for consideration. 35

It would seem that the situation is potentially analogous to the conclusions reached in Chapter 8 on 'eligible capital expenditures' where the corporation's accounting policy does not countenance amortization of goodwill. There it was concluded that a tax provision should be made in the income account with the credit deducted from the asset. 36

CONCLUSIONS

The following conclusions have been reached about the accounting implications of the provisions related to earned depletion of mining and petroleum corporations: 37

1. 'Earned depletion' may be considered to effect rate reductions which are reflected in income in the years in which the allowances are claimable in relation to accounting income. This method has the advantages of being similar to current practices, applicable to all corporations, and simple in determination. (Paragraphs 10 to 12)

2. Unapplied 'earned depletion' allowances should be disclosed in an explanatory note to the financial statements. 'Earned depletion' acquired from other corporations should be segregated and the note should indicate the restrictions applicable. (Paragraph 13)

3. An alternative treatment would be the tax credit concept. This method is logical if it can be accepted that the new incentive is expenditure oriented. It is more difficult to apply. The calculation of the tax credit may lack precision until after 1976. It is not suitable for corporations where there is uncertainty about the ability to use the 'earned depletion' credits. (Paragraphs 16 to 26)

4. In circumstances where either method may be appropriate, the Study does not indicate a preference. The choice is left to the corporation to determine which is the more appropriate in the circumstances. The method adopted and the reasons for the choice should be included in a note to the financial statements. (Paragraphs 27 to 29)

Turner Budget

CORPORATION INCOME TAX

10% SURTAX

A 10% surtax is imposed on corporate profits, effective for that part of a corporation's tax year which falls within the period from May 1, 1974 to April 30, 1975. This surtax will not apply to manufacturing or processing profits, to natural resource profits, to any small Canadian-controlled private company which is eligible for a small business deduction, or to investment corporations. Instalments of corporate tax due after May 6, 1974 will have to be adjusted to reflect the surtax (Income Tax Resolution 6).

SMALL BUSINESS INCENTIVE

The small business 25% tax rate on the first $50,000 of business income is extended to the first $100,000 of business income and the overall limit of $400,000 taxable income for this benefit is extended to $500,000. This amendment is applicable to the 1974 and subsequent taxation years (Income Tax Resolution 5).

As part of the special incentives available to manufacturers and processors, the low rate for Canadian-controlled private corporations in this sector has been reduced to 20%. The new annual and cumulative limits would also be available to these corporations.

MINING, PETROLEUM AND GAS CORPORATIONS

Tax rates. The basic rate of corporation tax for production profits from minerals, oil and gas is increased immediately to 50%. This compares with a general corporate rate established by the Income Tax Act of 48% in 1974, 47% in 1975 and 46% in 1976 and thereafter. The basic rate is subject to a standard provincial abatement of 10 percentage points.

As part of tax reform, the net federal rate for mining corporations was to be reduced to 25% in 1977, at the same time as the deductibility of provincial mining taxes and certain other similar payments was to be terminated. The Budget proposes for both mining and petroleum corporations a special resource profit abatement which will effectively reduce the net federal tax rate to 30% on Canadian petroleum profits and to 25% on Canadian mineral profits. It would apply as follows:

		Mineral profits		*Petroleum profits*
Basic tax rate		50%		50%
Less: Provincial abatement	10		10	
Resource profit abatement	15		10	
Total abatements		25		20
Net federal tax rate		25%		30%

Deductions. Effective immediately, no deduction would be allowed for mining taxes, royalties, or other arrangements with similar effects on amounts allocated to or paid to or derived by a government body in respect of the production from a resource operated by the taxpayer.

Earned depletion. Under tax reform, the existing system of "automatic depletion" was to have been replaced by earned depletion in 1977, with a maximum rate for earned depletion of 33⅓%. The "earned depletion" system for resource operators would be made effective for income earned after budget day, and would be deductible at a reduced rate of 25% of production profits.

No change is proposed in the existing formula under which $1 of depletion is earned by every $3 of eligible expenditures (on Canadian exploration and development, capital assets for a new mine or mine expansion, and certain ore processing facilities).

Canadian exploration and development expenditures. Expenditures incurred after May 6, 1974 are to be deductible at a rate of 30% of the unclaimed balance for *all* taxpayers. These expenditures were previously deductible by taxpayers who qualified as "principal-business" operators in the resource field against any income in the year incurred or in any subsequent year, and by other taxpayers from income from the resource or 20% of the unclaimed balance, whichever was greater.

(Income Tax Resolutions 7 to 11, 41, 46, effective May 6, 1974.)

FINANCIAL INSTITUTIONS

Reserves. Tax-free reserves which financial institutions may claim against potential losses are to be reduced to 1% from 1½% on eligible assets of over $2 billion. These reserves permit banks, trust companies, life insurance companies, mortgage investment corporations, credit unions and some other lenders to set aside amounts to meet abnormal losses from doubtful or bad loans or debts, declines in the value of marketable securities held as investments, or declines in the value of certain other assets.

Eligible assets for purposes of computing reserves generally include bonds and mortgages; loans are also included for banks and credit unions. It is proposed to permit trust companies to include bonds and certain debentures for the first time in their eligible assets, which will put them on a similar footing with banks and insurance companies.

At present asset levels, only the largest institutions have eligible assets in excess of $2 billion and will therefore pay higher taxes immediately as a result of the new rule which is applicable to taxation years ending after May 6, 1974 (Income Tax Resolutions 13 and 14).

Interest income. For 1972 and subsequent taxation years, interest accrued and interest receivable in the year, to the extent that it was not included in computing the corporation's income for a previous taxation year shall be included in the corporation's income. For credit unions or financial corporations that have not included accrued or receivable interest in taxation years ending before 1972, this rule may not become effective until the 1975 taxation year (Income Tax Resolution 18).

Lorne Swenson

MEMORANDUM FROM JURGEN ROHWEDDER

TO Mr. J. S. Poyen
Director
ECONOMICS & PLANNING DIVISION

THE DEPARTMENT OF
MINES AND PETROLEUM RESOURCES
PARLIAMENT BUILDINGS, VICTORIA, BRITISH COLUMBIA V8V 1X4

DATE May 11/76

RE: MINING TAXATION

The Northern Miner, April 22, 1976, contained an article which is appended and should be read.

According to this article, a mine operating in Quebec could increase net income by 4 per cent of exploration expenditures doing exploration work in Quebec (see appended Example 1). In Manitoba, net income would not be reduced at all and in Ontario it would be reduced only by 4 per cent. Under present British Columbia tax legislation a company operating a mine in British Columbia would only have to contribute 19.3 per cent of exploration expenditure and this would be reduced to 7.0 per cent if the mining tax is increased to 25 per cent.

If one views these figures, the argument that the mining industry supplies the risk money for mining does not stand up, as exploration is the investment of the higher risk and that is nearly totally supplied by the taxpayer.

J. Rohwedder

Jurgen Rohwedder

JR:ps

Encl.

cc: Mr. Gordon Bell
Mr. Phil Olson

EXAMPLE I

EXPLORATION EXPENDITURE AND ITS EFFECT ON NET INCOME IN QUEBEC

	Without Exploration Expenditure	With Exploration Expenditure
Net Revenue	1,000.0	1,000.0
Operating Expenses Excluding Exploration	600.0	600.0
Operating Income	400.0	400.0
Exploration Expenses	0	200.0
Pretax Income	400.0	200.0
Federal Tax (36%)		
Pretax Income	400.0	200.0
Less 25% Resource Tax Allowance	100.0	100.0
Less 25% Depletion Allowance	0	66.7
Taxable Income	300.0	33.3
Federal Income Tax (36%)	108.0	12.0
Quebec Provincial Income Tax (12%)	36.0	4.0
Quebec Mining Tax (30%)	90.0	10.0
Total Tax	234.0	26.0
Net Income	$166.0	$174.0
Taxes as Per Cent of Pretax Income	59%	13%
Net Cost (gain) of Exploration to Company as Per Cent of Exploration Expenditure		(47%)

earned depletion = 33⅓% of exploration outlay.

EXAMPLE 2

EXPLORATION EXPENDITURES AND ITS EFFECT ON NET INCOME IN BRITISH COLUMBIA

Revenue and exploration expenditure, same as in Example 1.

	Without Exploration Expenditure	With Exploration Expenditure
Federal Income Tax (36%)	108.0	12.0
Provincial Income Tax (15%)	45.0	5.0
Provincial Mining Tax (12.75%, no depletion allowance)	38.2	12.8
Royalty (5%)	50.0	50.0
Total Tax	241.2	79.8
Net Income	$158.8	$120.2
Taxes as Per Cent of Pretax Income	60%	40%
Net Cost of Exploration to Company as Per Cent of Exploration Expenditure		19.3%

EXAMPLE 3

EXPLORATION EXPENDITURES AND ITS EFFECT ON NET INCOME IN BRITISH COLUMBIA ASSUMING INCREASE IN MINING TAX RATE TO 25%

Revenue and exploration expenditures, same as in Example 1.

	Without Exploration Expenditure	With Exploration Expenditure
Federal Income Tax (36%)	108.0	12.0
Provincial Income Tax (15%)	45.0	5.0
Provincial Mining Tax (25%, no depletion allowance)	75.0	25.0
Total Taxes	228.0	42.0
Net Income	$172.0	$158.0
Taxes as Per Cent of Pretax Income	57%	21%
Net Cost of Exploration to Company as Per Cent of Exploration Expenditure		7%

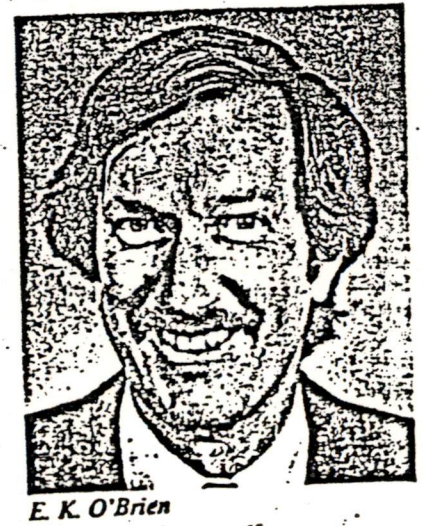
Mining taxation problem in Canada becomes less ominous as time goes on

By E. K. O'BRIEN
Chief tax advisor
Inco Limited

Let's face it. The biggest problem facing mining companies in Canada today is low metal prices, not high taxation. The major exceptions, of course, are British Columbia and Saskatchewan whose royalties are computed without regard to net profit. In Saskatchewan, taxation has almost become secondary in the case of many of the operators. It is hoped that Saskatchewan will assume a more rational position in taxing the producers that remain after Saskatchewanization. If not, that province will be a dust bowl insofar as potash miners, present and future, are concerned. Uranium miners seem to have other, brighter ideas about investing in Saskatchewan, and continue to conduct active exploration programs there.

In British Columbia, excessive tax rates have resulted by virtue of the fact that tax is levied on gross profit rather than net profit but recently the new government announced its intention to revert back to a tax on net profit and may cast its eyes in the direction of Ontario and Quebec. It is hoped that British Columbia will legislate a flat rate of tax or at least lower marginal rates which would eliminate the need to have generous processing allowances.

Ignoring Saskatchewan and assuming an optimistic posture in respect of British Columbia, the tax systems in place in the various provinces and in Ottawa, while unusual and complex, seem to be fairly workable. Unfortunately, tax systems have been changing with such rapidity that industry has lost confidence in the government's ability to choose a rational, stable course of tax policy. The past two years have been real shockers for mining companies in terms of taxation. Federally, the special privileges enjoyed by mining companies — 3-year new mine exempt income, automatic depletion, deductibility of mining royalties, were all swept away and in their place, greatly modified incentives with rigid limitations were legislated.



E. K. O'Brien

Accelerated capital cost allowance and an earned depletion concept provided little encouragement to mining companies compared to those of the past. Provincially, governments noted soaring metal profits and prices, especially gold and copper which hit spectacular heights. The soaring price of oil also brought into focus the need for provinces to maximize their returns on provincially controlled non-renewable resources.

Additionally, many provinces had enacted expensive social welfare programs, incurred substantial deficits and were desperately looking for additional tax revenue. The mining companies, whose provincial income taxes had remained relatively stagnant for decades, were an extremely attractive source of income. The subsequent tax legislation introduced in Canada by both levels of governments affecting mining companies was at times irrational and vindictive.

In three provinces, British Columbia, Manitoba, Saskatchewan, legislation was introduced, and in B.C. and Saskatchewan royal assent given, to levy provincial taxes, which when combined with federal taxes, produced a marginal tax rate in excess of 100% under very attainable circumstances. Companies were obviously discouraged from selling their product — copper and potash — above certain levels even though world prices were much greater. In the case of potash, U.S. brokers were realizing profits that should have been made in Canada. While the top marginal rates were eventually adjusted to be less than 100% in both of these provinces. B.C.'s rate is 92% when the super royalty tax is applicable, and Saskatchewan has an effective rate of roughly 85% when K_2O is $72 per ton. At the moment, because of extremely low copper prices, the B.C. effective rate can easily exceed 100%. This is shown in Schedule 1. Hopefully, this tax system will be replaced by a tax on net profit.

The marginal rates in other provinces, although never having approached the dizzy heights of those of B.C. and Saskatchewan are still ridiculously high. Manitoba, which did not pass its original variable volumetric tax bill, ended up with a top marginal rate of 72%. Ontario, 75%, and Quebec 67%. Many provincial changes were coming very fast and very furious in early 1974. At that time, the federal government found itself picking up one quarter of the cost of industry's increased tax bill by virtue of the fact that mining taxes were deductible by mining companies in the determination of federal income tax payable.

Lack consultation

Provincial actions were made without consultation with the federal government and without regard to the high resulting marginal rates which would affect industry. The graduated rate structures in Ontario and Quebec represent a tax on bigness not necessarily a tax on excess profitability. However, to some degree, these very high marginal tax rates are offset by processing allowances and credits. High marginal tax rates do not encourage efficiencies in operation or as incentives to reduce costs. As noted below in Schedule 2, an operator could lose three quarters of any cost reductions to the various levels in governments. Obviously, workers, realizing that if companies are in this position, will obviously ask for higher wages because it is not costing the company all that much after tax and, in fact, the bulk of his wages are being born directly by the two levels of government. The "suggestion box" could become a thing of the past.

While the provinces forged ahead to become the senior taxing jurisdiction relative to the mining industry, the federal government was hopping around like a little boy about to wet his pants. The reader will recall that the federal government spent millions of dollars on a royal commission, commons hearings, senate hearings, etc., to determine how mining and other companies should be taxed. As a result of this enormous effort of time and money, a timetable of tax reform was set out for the mining industry.

Schedule 1
B.C. copper mining company
1976 effective tax and royalty rate

	65¢	70¢
International copper price (LME)	$650	$700
Revenue	180	190
Less: smelting, refining and ocean freight	470	510
"gross value"	15	15
Less: inland freight and handling costs	455	495
"net value"	450	450
Less: operating costs	$ 5	$ 45
Income before royalties and taxes		
Royalties and taxes		
Basic royalty — 4%	$ 19	$ 20
Super royalty	—	—
Mining tax — 12.75% of income	—	3
Provincial income tax — 9.75% of income	—	2
Federal income tax — 27% of income	1	12
Total	$ 20	$ 37
Effective tax/royalty rate (before depletion)	400%	82%

Notes:
1. Super royalty = 50% of "gross value" — (64.7¢ × 120%)
2. Mining tax rate assumes minimum processing allowance
3. Royalties are deductible for mining and provincial income tax purposes
4. Income tax rates are shown net of resource allowance
5. Basic royalty is normally 5% except where gross value is less than $540.

phasing out incentives, the last of which was to disappear December 31, 1976. This timetable was derailed and abandoned on May 6, 1974, further changes were made in the budget of November 18, 1974 and still more changes in the budget of June 23, 1975 giving the mining industry the distinct impression that the federal government not only did not know what it was doing, but was sincerely intent on proving it. Needless to say, the mining industry's confidence in investing in this country was and is shaken, rather severely.

Lack of leadership

The federal government's inability to provide leadership or for that matter, to know its own mind, did nothing to reassure the industry.

Schedule 2
Marginal tax rates
Assuming maximum mining tax rates

	Que.	Ont.	Man.
Federal income tax*	27%	27%	27%
Provincial income tax	9.75%**	8%**	9.75%**
Provincial mining tax	30	40	35
	67%	75%	72%

*net of resource allowance
**net of automatic depletion

Notes:
The above table depicts rates assuming processing allowance neither at the maximum nor the minimum. The marginal rates in these instances would be as follows:
Maximum: Quebec — 47%, Ontario — 49%, Manitoba — 54%
minimum: Quebec — 63%, Ontario — 69%, Manitoba — N/A
Assumes operator operates only in one province.

To explore, discover and develop a new mine takes an enormous amount of lead-time, approximately 6-8 years. Tax rules, which have changed as drastically and as often as the ones we have seen recently in Canada will obviously work against future investment in Canada until such time as stability and confidence returns to the mining scene.

Inasmuch as little or no thought has gone into the long-range tax planning picture by either level of

Schedule 3
Canadian Mine Operator
Exploration Expenditures
Corporate Income Tax Relief

Exploration expenditures			$100
Deduction permitted		133-1/3%*	
Federal income tax relief	36%	48%	
Provincial income tax relief (except P.Q. or Ontario) 10-13% say 12%		16%	
Total income tax relief			64%
Net tax cost			36%

*Assumes depletion earned on expenditure.

Note:
The tax cost depicted above relates only to corporate income tax relief. An operator would obtain additional relief through deductibility of this expenditure from provincial mining income if it were incurred in that province. Otherwise, he could explore in any part of Canada at the cost shown.

government, it is possible that the tax systems we have now may be no better or worse than those which could have been devised by a dozen committees or commissions studying taxation of the mining industry. It is suggested, with the exception of British Columbia and Saskatchewan, that governments stop tinkering with their systems and announce that, with minor exceptions, the tax systems recently enacted will be given a fair chance of working. In other words, the governments should assure industry that the existing laws have a degree of permanence about them, and then industry could get on with the job of assessing the viability of various potential mining projects in Canada.

Schedule 4
Quebec mining company
Exploration tax relief
Assuming maximum mining tax rates

Exploration expenditure			$100
Total deduction permitted		133-1/3%	
Federal income tax relief		48%	
Quebec corporate tax relief	12%	16%	
Quebec mining tax relief	30%	40%	
Total tax relief			104
Net tax cost (credit)			(4)%

Notes:
Assumes operator operates and explores only in Quebec.
Assumes processing allowance is neither at the maximum nor the minimum. The net tax cost in these instances would be as follows: maximum — 22%, minimum — 2%.

Living with high marginal rates is no picnic but they do have certain advantages. Exploration in parts of Canada by a Canadian operator is now virtually free of corporate risk. Effective January 1, 1976, the federal government has bonused exploring in Canada to an extent that has never been done before. As shown on Schedule 3, an operator can obtain corporate income tax relief of roughly 60% depending in which province he is operating. This does not include mining tax relief that he will be granted in the province of operation.

Schedule 4 depicts the net tax cost to a Quebec operator assuming that that operator has a substantial mining operation in the province of Quebec and operates only in that province. Exploration expenditure relief is shown at 104%.

Schedule 5 shows the potential exploration relief that a large On-

tario producer could obtain if his operations were in the province of Ontario.

Schedule 5
Ontario mining company
Exploration tax relief
Assuming maximum mining tax rates.

Exploration expenditure			$100
Total deduction permitted		133-1/3%*	
Federal income tax relief	36%	48%	
Ontario corporate tax relief	(net)	8%	
Ontario mining tax relief	40% net	40%	
Total tax relief			96
Net tax cost			4%

*Federal income tax only

Notes:
Assumes operator operates and explores only in Ontario.

Assumes processing allowance is neither at the maximum nor the minimum. The net tax cost in these instances would be as follows: maximum — 30%, minimum — 10%.

Corporate risk is less

Schedule 6 illustrates the exploration relief that a Manitoba operator could attain if his base of operations is in the province of Manitoba.

The essence of the foregoing is that corporate risk of exploration is virtually eliminated due to the combination of the federal encouragement to explore, and relief at the high marginal rates existing in these provinces. The oil companies, due to the incentives offered and tax relief granted, are in a similar position with respect to exploring in Alberta, i.e., no cost to the operator. The discovery of an ore deposit is done at virtually no cost to the mining company which can then, using its own investment criteria; eg., discounted cash flow, determine whether, under existing tax rules, a deposit can be profitably mined.

One of the interesting conclusions that one can draw from the fact that exploration is no longer a high corporate risk proposition is that the existing Canadian operators have been granted a virtual monopolistic position in the Canadian mining industry. However, from a non-operator's point of view, various studies that have been made comparing the various mining tax systems in Canada with those of other countries, show that most parts of Canada are still very competitive insofar as taxes are concerned. Certainty is another question. The obvious levelling effect is that the high effective and marginal rates are levied on the existing mining operations. Another way of looking at it would be that there exists a penalty for not exploring.

To a large degree, the same holds true with respect to processing in Canada. The high marginal rates in Ontario are, in effect, a tax on bigness. However, if a company mines, concentrates, smelts and refines in Northern Ontario, processing allowances are available to negate some of the effect that the high marginal rates would otherwise have had. Even if that company were to refine its ores to prime metal anywhere in Canada, it is still able to obtain the 20% processing allowance, which is by far the highest processing allowance granted by any provincial taxing jurisdiction in Canada.

Nearly all provinces permit the deduction of a processing allowance from mining and processing profits to eliminate that portion pertaining to the processing activity in order to determine profits subject to mining tax. Normally, an annual deduction

Schedule 6
Manitoba mining company
Exploration tax relief
Assuming maximum mining tax rates

Exploration expenditures			$100
Total deduction permitted		133-1/3%*	
Federal income tax relief	36%	48%	
Manitoba corporate tax relief	13%	17	
Manitoba mining tax relief	35% net	35	
Total tax relief			100
Net tax cost			0

*Does not apply to mining tax deduction

Notes:
Assumes operator operates and explores only in Manitoba

Assumes processing allowance is neither at the maximum nor the minimum. The marginal rates in these instances would be as follows: maximum — 17%, minimum N/A.

equal to 8% of the original processing asset cost is permitted. Similarly, the British Columbia Mineral Royalties Act provides for a remission of one percentage point of royalties levied under that Act if a mining company's product is smelted in British Columbia.

Quebec is encouraging processing within that province as well, and new processing facilities attract an investment allowance of $1 for every $3 spent on processing facilities which can be deducted from mining and processing income and a 15% processing allowance where product is smelted or refined in the province. Ontario and most provinces limit the processing allowance deduction to 65% of the mining and processing income.

Ontario leads processing bonuses

Ontario has gone further down the processing path by providing a processing allowance on a manufacturing plant built in Northern Ontario utilizing feed from mining operations. A processing allowance of 35% has been granted on the original cost of assets to be used in such a facility. The processing allowance limitation may be waived with respect to these assets. One caveat is that the profits generated by such a facility must be subject to mining tax. It should be noted that they will also be taxed as manufacturing profits without benefit of the federal resource allowance which could add up to an 88% marginal tax rate. On the whole, however, judging by the announcements made by Texas Gulf and Inco, substantial investments are being contemplated in this area.

The message being brought home seems to be three-fold: (1) The provinces are seeking and indeed demanding a greater share of the resource industry's profits, (2) mining companies are being encouraged, as never before, to get out and explore and (3) mining compaies are being encouraged to build maximum processing facilities in Canada, particularly in the provinces in which they mine and to the extent that processing allowance can be utilized.

Need stability in tax policies

There are a few reasons why aggressive pursuit of these policies is not forthcoming at this point in time — industry is not firmly convinced that the tax systems presently imposed in this country have any degree of permanence, the demand for additional processing capabilities in Canada is not overwhelming, and companies may lack profits to provide funds with which to explore and build new plants.

Assuming some stability in respect of the present taxing systems and acknowledging that the high marginal rates do not encourage efficiency in day to day mining operations, investing in Canada is still no less attractive than investing in many of the other countries in the world.

Canada tax law.

a. There is depletion allowed (tho it must be "earned.") It is limited to $\frac{1}{3}$ of "production income".

b. Even though land acqu. costs have already been either expensed or amortized.

October 14 1975

Professor Andrew Thompson,
Chairman,
B. C. Energy Commission,
1177 West Hastings Street,
Vancouver, B. C.

Dear Andy:

On 4th of February 1974 you wrote to Mr. Jonathan Rowe among other things, "The Federal Income Tax law offers a package of incentives... including... full write-off of exploration and development expenses including land acquisition costs". The inclusion of land acquisition costs is unlike the U. S. law and I am writing to inquire if this is indeed deductible under Canadian law. Under U. S. law the depletion allowance is regarded as an alternative to deduction of land acquisition costs and is not additive.

Do I assume correctly that you include bonus bid payments?

I'm sending you, within a day or two, a copy of my paper for Michael Crommelin's book, which includes a small point based on the assumption that land acquisition costs may not be written off. So if you don't get around to answering this letter at least please flag this in the manuscript before it goes to press. Thank you.

Cordially,

Mason Gaffney
Executive Director.

MG:jm

Prof. Andrew Thompson

7: Commelin paper

ALL COMMUNICATIONS TO BE ADDRESSED TO THE REGISTRAR

IN REPLY PLEASE QUOTE

University of Melbourne

Law School

Parkville 3032, Victoria

January 21, 1976

Dr. Mason Gaffney,
Executive Director,
British Columbia Institute for
Economics Policy Analysis,
37771 Haro Road,
VICTORIA, BRITISH COLUMBIA,
CANADA, V8P5C3

Dear Mason,

Thank you for your letter of January 14, which arrived today (the postal service has definitely improved!). I am pleased to hear that the press is ready to move ahead quickly with the publication of the mineral leasing papers.

I have a couple of responses to make to your comments upon my comments. Let me take them in turn.

depletion allowance is a % of current value.

With regard to my comment five, I was referring to the half paragraph on the top of page thirteen. By "revised value" I meant the value including accruals. I am surprised to learn that this value is deductable for tax purposes. (Although by now I should have ceased being surprised about the tax benefits enjoyed by the mineral industry). However, accepting that this value is deductable, I still have trouble with your sentence which commences on page twelve and continues on to page thirteen - particularly with the phrase "and he deducts it as a depletion allowance". I would have thought that the deduction was by way of depreciation, not by way of depletion allowance. In other words, the depletion allowance in Canada is conceived very narrowly, to include only the specified percentage of net profits. Deduction for depreciation of capital assets is in addition to this depletion allowance (not in substitution for it as in the U.S.). I think our difference here is only one of terminology - you are using the expression "depletion allowance" in the sense that it is understood in the U.S. whereas I do not think that it is used this way in Canada. However, I may well be wrong and perhaps the best thing to do is to check with Andy.

(? Not of gross volume?

Concerning the variation of Alberta royalty rates with depth of well, I have read the extract from Campbell Watkins' paper that you sent me. This paper deals with calculation of allowables under the prorationing scheme - that is, production quotas for pools and wells. My understanding is that the Crown royalty is applied quite separately from the operation of the prorationing scheme. In other words, the prorationing scheme determines the rate at which a well may produce and the royalty is calculated according to the rate of production, without any direct link to the well depth. I concede, of course, that if well depth affects production rates, then it indirectly affects royalty rates as well. However, there is no more direct link than this - the royalty regulations contain a formula which makes the royalty rate vary principally with rate of production (and now also with the selling price of oil).

I accept your point regarding the "Crown land provinces", but wonder whether you could make it a little clearer in the text. I was certainly misled upon a first reading.

And now to the more important things in life. I am delighted to hear that the Gaffneys have continued their involvement in the children business - the Crommelins are likewise doing their bit for Australia, with a new one due for late March.

Kindest regards,

Yours sincerely,

Michael Crommelin,
Senior Lecturer in Law.

January 14th, 1976

Professor Michael Crommelin
Senior Lecturer-in-Law
University of Melbourne Law School
Parkville 3032, Victoria
Australia

Dear Michael:

My paper to you was mailed sometime before the mail strike began, so I am puzzled that it took so long to arrive. However, I am glad that it did and I appreciate your comments which are well taken. I will make revisions as suggested, although I have not yet received the paper itself on which you have indicated revisions. The press appears to be ready to move ahead with the publication so I will get to this promptly.

In your comment five, are you referring to my first full paragraph or the half paragraph on the top of page 13. What do you mean by "the revised value"? If you are questioning the nondeductibility of land acquisition under Canadian tax law, you are correct. Andy and I have already corresponded about that, although I found it hard to believe, land acquisition under Canadian law is deductible.

Concerning the variation of Alberta royalty rates with depth of well, I have checked this out pretty carefully, and there is such a variation still in the law although it is a minor aspect of the whole picture. Before 1964 it was evidently quite important and is described in Eric Hansen's book Dynamic Decade. The present arrangement is discussed in the paper by Campbell Watkins, "Regulation and Economic Efficiency", Discussion Papers Series No. 32, Dept. of Economics, University of Calgary, 1975, pp. 4-9; I enclose a copy for your delectation.

As to the "Crown land provinces", this is merely a reference to the fact that crownland is relatively much more important in the western than the eastern provinces.

..... 2

A Crommelin

We do not think the election will affect the Institute's activities. At least there is no sign of it yet. However, when the axe strikes us, we may have reason to change our minds. Otherwise, everything looks rosy. I hope all is well with you and Roslyn and family. A new Gaffney is scheduled for August, 1976.

All the best.

Cordially,

Mason Gaffney
Executive Director.

MG/am

Encl.

F. Crommelin Master

ALL COMMUNICATIONS
TO BE ADDRESSED TO
THE REGISTRAR

IN REPLY PLEASE QUOTE

University of Melbourne

LAW SCHOOL

Parkville 3032, Victoria

5th January, 1976.

Dr.
~~Doctor~~ Mason Gaffney,
Executive Director,
British Columbia Institute for
Economic Policy Analysis,
3771 Haro Road,
VICTORIA, British Columbia,
Canada.

Dear Mason,

I was delighted to receive your paper shortly before Christmas; unfortunately it must have been caught up (along with a good deal more), in the Great Canadian Mail Strike. However, I have now read it closely and have made a few minor editorial changes. I have sent you a copy of the paper, including the changes noted therein, under separate cover. This letter is simply to raise a few questions and explain my reasons for the very few changes of substance.

1. I feel the paper would benefit tremendously from a few additional footnote references. I have indicated on the paper the places where these seem to be desirable. I hope you will not think that I am trying to turn your paper into a Harvard Law Review publication (definitely not the objective) - but the additional references would be particularly useful in the case of readers outside British Columbia (unfamiliar with events in that province).

2. Page 5. The sentence deleted appears to be repetitive.

3. Page 11. In your discussion of expensing, I had difficulty with the sentence "Later he recovers the same percentage of the cash flow". What clearly is intended is that the investor recovers the same percentage as he invested. However, the way you expressed it left the possibility open that the investor may recover the tax-rate percentage of the cash flow. The redrafting is an attempt to overcome that.

Page 11 (final paragraph). I have difficulty with your discussion of the depletion allowance. Are you referring to it in its Canadian or American form? In its Canadian form (calculated as a percentage of net profits) it would not seem to me to speed up the use of rentable deposits.

Whether it had this effect or not would depend upon whether marginal costs (of additional production in any time period) were rising faster than the rate of interest. It is on this basis that I have altered the paragraph. If I am wrong, please let me know.

5. Page 13. Again I am in some doubt regarding the correctness of your first paragraph dealing with production of the revised value of mineral deposits. I was not aware that this was the position under Canadian tax law. However, I am unable to check on this here. Would you mind satisfying yourself that this indeed is the case in Canada? If it is, perhaps a reference to the relevant provision of the Income Tax Act may be useful.

6. Page 25. I had trouble with the sentence beginning "The armour of the Crown land provinces". It seems to me to suggest that some provinces do not control Crown land - this has not been the case since the early 1930s.

I have also revised my introduction, to take account of the content of your paper. I shall send you a copy of the introduction as soon as it is typed.

I hope you had a Merry Christmas, and that 1976 is a vintage year for you.

With kindest regards,

Yours sincerely,

Michael Crommelin,
Senior Lecturer-in-Law.

P.S. The first two weeks of December were certainly inhospitable to reigning governments - in New Zealand, British Columbia and Australia! Will the change affect the Institute's activities?

P.P.S. I see now that I overlooked a comment on the first paragraph of your page 15. It is my understanding that the royalty rate does not vary with depth of wells in Alberta - although I do not have a copy of Watkins paper to which you refer. It is the case that the size of allowables under the prorationing formula did (and still does to some extent) vary with well depth. Could this be what you are referring to?