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Oil and gas taxation in Canada

Deloitte taxation and investment guides

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Deloitte taxation and investment guides
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Oil and gas tax guide

Tax professionals of the member firms of Deloitte Touche Tohmatsu Limited have created the Deloitte International Oil and Gas Tax Guides, an online series that provides information on tax regimes specific to the oil and gas industry. The Guides are intended to be a supplement to the Deloitte Taxation and Investment Guides, which can be found at www.deloitte.com/taxguides. For additional information regarding global oil and gas resources, please visit our website:www.deloitte.com/oilandgas

1.0 Summary

The taxes which companies doing business in Canada in the oil and gas industry are generally subject to are:

• Federal Corporate Income Tax	15%
• Provincial Corporate Income Tax (Varies by Province)	10% to 16%
• Crown Royalties	Up to45%
• Capital Gains*	50% x Marginal Tax Rate
• Goods and Services Tax ("GST")	5%
• Provincial Sales Tax ("PST")	Up to 7%
• Harmonized Sales Tax ("HST")	Up to 15%
• Withholding taxes	
• Interest, dividends, royalties**	25%

* Only applicable to realized capital gains. Unrealized capital gains are not taxed.

** May be reduced by an applicable tax treaty

2.0 Corporate income tax

2.1 In general

Corporations that are resident in Canada are subject to a federal income tax on their worldwide income at a base rate of 38%. This rate is generally reduced by 13% if the corporation is not subject to any other exemptions and a further 10% if the corporation has a permanent establishment in a Canadian province. The reductions to the base rate generally result in a corporation being subject to a 15% federal income tax for the majority of circumstances, as indicated in the rate provided in the above summary.

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Generally, a corporation will also be subject to provincial or territorial tax in a province or territory if it has a permanent establishment in that province or territory. If a corporation has permanent establishments in more than one province, the allocation of taxable income to a particular province is generally determined by the weighted average of revenues and salaries/wages apportioned by province[1]. Provincial income tax rates range from 10-16%, and provincial taxes are not deductible in the determination of federal taxable income. Thus, the overall combined federal and provincial income tax rate can vary between 25% and 31%.

For most major centers in Canada there are not municipal income taxes.

Residency is determined primarily based on place of incorporation or place of central management and control. Companies incorporated outside of Canada can be regarded as tax residents in Canada.

Canada does not allow corporate groups to file consolidated tax returns.

Tax returns are normally due six months after the end of the fiscal year. There is the ability, after incorporation, to choose any year end date for the fiscal period.

1 Normally the allocation is based on salaries and revenues, however certain industries (i.e. pipeline businesses) have allocations based on different methods

2.2 Taxable income

Corporation tax is imposed on a company's profits, which consist of business income, property income and capital gains. Normal business expenses may be deducted in computing taxable income.

2.3 Deductions and allowances

General deductions

Allowable deductions ordinarily include expenses to the extent that they are incurred for the purpose of gaining or producing income from a business or property unless they are capital in nature (see notes below on capital cost allowances and intangible resource expenditures).

Royalties

Effective since January 1, 2007, crown royalties (generally royalties paid to a provincial government) are fully deductible for tax purposes.

Abandonment/Site Restoration/Asset Retirement Obligation ("ARO") Costs

ARO costs are generally only deductible in the period in which they are paid.

2.4 Capital allowances

CCA is taken on all tangible oil and gas well equipment which generally includes all above ground equipment and recoverable down hole equipment. Assets are allocated to a particular class and CCA is generally calculated on a declining balance basis at the specified rate for the particular class. CCA is an optional deduction, and a claim can be made in respect of certain classes at less than the maximum amount permitted for the year in respect of a particular class, with any unused balance in the class remaining available for deduction in a future year, subject to the maximum deduction available for that particular year.

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The following is an overview of some of the more common classes of depreciable equipment in the oil and gas industry:

- Class 1 (4% declining balance) – Oil or gas transmission pipelines
- Class 6 (10% declining balance) – Downstream oil storage tanks (i.e. tank farms)
- Class 7 (15% declining balance) – Pumping or compression equipment
- Class 41 (25% declining balance) – Gas or oil well equipment
- Class 49 (8% declining balance) – Pipelines acquired after February 22, 2005 that are not part of gathering systems

In the year of acquisition, only 50% of the cost of capital is included in the calculation of the available CCA claim for the year. CCA claims are generally prorated for short taxation periods.

CCA claims are only available for tangible assets that are available for use subject to special rules for longer term projects.

2.5 Intangible resource expenditures

Intangible expenditures comprise expenditures incurred in acquiring properties or conducting seismic, drilling, or perforating activities, etc. These expenditures are generally classified into one of the following categories:

Canadian Oil and Gas Property ("COGPE") – Deductible at 10%, declining balance

Generally, COGPE includes all intangible costs associated with the acquisition of a Canadian resource property, including the acquisition of rights to an undeveloped property, rights to drill or produce, or a right to a royalty or net profits interest. These expenditures also include a partner's share of such costs incurred by a partnership for the year in which the partnership's fiscal period ends.

Canadian Development Expense ("CDE") – Deductible at 30%, declining balance

Generally, CDE includes all intangible costs that are incurred in drilling and completing a well in Canada, unless the costs are a CEE, and includes drilling or converting wells for the disposal of waste liquids, injection, and monitoring wells. CDEs also include a partner's share of such costs incurred by a partnership for the year in which the partnership's fiscal period ends.

Canadian Exploration Expense ("CEE") – 100% deductible

Generally, CEE are intangible costs incurred in drilling and completing an exploratory well, geological, geophysical or geochemical costs, the cost of wells drilled and abandoned (i.e. a dry hole) within a year or six months after the end of the year without the well having produced other than for testing purposes, and costs related to a well that has not produced, other than for testing purposes, for 24 months following the completion of drilling. CEEs also include a partner's share of such costs incurred by a partnership for the year in which the partnership's fiscal period ends.

Foreign Resource Expense ("FRE") – Deduction depends on foreign resource income for the relevant country, but are at least 10%, declining balance

Generally, FREs are intangible costs incurred outside of Canada that are similar to the types of costs described above as COGPE, CDE or CEE, that are tracked on a country by country basis. FREs also include a partner's share of such costs incurred by a partnership for the year in which the partnership's fiscal period ends.

Eligible Capital Expenditures ("ECE")

Generally, ECE are intangible costs associated with pipeline rights of way, goodwill, and incorporation costs. 75% of the original cost can be depreciated at a rate of 7% per annum on a declining balance.

As with CCA, a deduction in respect of any of the foregoing intangible expenditures is optional, and except in the case of CEE, prorated for short taxation periods. Corporations in the oil and gas industry generally cannot make a claim for CEE in excess of their income for the year.

Claims for COGPE, CDE, CEE or FRE are generally restricted following an acquisition resulting in the control of a corporation.

2.6 Income tax losses and utilization

Each type of loss has its own characteristics with respect to utilization and carryover periods. The principal types of losses for income tax purposes are outlined below.

Non-capital losses may be carried back three tax years and carried forward twenty tax years, while net capital losses may be carried back three tax years and carried forward indefinitely.

Non-capital Losses

Non-capital losses are generally the amount by which the taxpayer's losses for a year from an office, employment, or business or property, exceed the taxpayer's incomes from these sources and any net taxable capital gains.

Net Capital Losses

Net capital losses are generally the amount by which a taxpayer's allowable capital losses for a year exceed their taxable capital gains for the year. The allowable capital loss is 50% of the actual capital loss and the taxable capital gain is 50% of the actual capital gain.

Loss Carryover and Utilization

Non-capital losses may be carried back three tax years and carried forward twenty tax years, while net capital losses may be carried back three tax years and carried forward indefinitely. Net capital losses are only deductible against the net taxable capital gains for a particular year.

On an acquisition that results in the control of a corporation, net capital losses expire, while non-capital losses may generally only be claimed against income from the same or similar business.

2.7 Foreign entity taxation

Subject to the provisions of an applicable tax treaty, non-resident companies that carry on business in Canada or are deemed to carry on business in Canada are subject to the normal income tax rate plus a branch tax of 25% (which may be reduced by an applicable tax treaty).

3.0 Other corporate income tax

3.1 Provincial

Natural resources in Canada are often owned by the Provinces, which makes the payment of royalties subject to provincial jurisdiction. Royalties vary greatly between provinces and can be up to 45% of net profit. The calculations that are used to determine the royalty tax rate between provinces also varies greatly in both type of calculation and type of resource being taxed. The quantity/type of variables used in the calculations and the different methods between provincial jurisdictions make royalty calculations very complex and difficult to summarize effectively within the scope of this document.

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4.0 Tax incentives

4.1 Scientific research and experimental development

The federal government provides investment tax credits to taxpayers as an incentive to carry on business in Canada and incur research and development expenses. Most Canadian corporations, proprietorships, partnerships, and trusts can earn an investment tax credit of 20%[2] for all qualified expenditures[3] for SR&ED that are incurred within Canada.

Investment tax credits are treated the same as non-operating losses for tax purposes, which means that they can be carried back up to three years and carried forward up to twenty years. It is important to note that many oil and gas research and development activities may qualify for the investment tax credit.

Additionally, many provinces provide separate SR&ED tax credits/incentives that can be claimed against provincial taxes payable.

5.0 Payments to related parties

5.1 Transfer pricing

When taxpayers conduct transactions with non-arm's length non-resident parties, the transactions are required to occur at a price that would have prevailed had the transaction been entered into by parties dealing at arm's length. Generally speaking, related persons are deemed to deal at non-arm's length. Related persons are defined to include, inter alia, a corporation (or a member of a related group of corporations) and a corporation which it controls, as well any two corporations which are under common control.

Where unrelated persons are dealing with each other, it is a question of fact whether the persons are dealing at arm's length or not. The Canada Revenue Agency ("CRA") has issued general guidelines regarding the criteria that it will consider in determining whether a transaction is at arm's length or not.

The Act does not specify the methods required to be used in determining transfer prices. However, the CRA has strongly stated its preference for the transfer pricing methods prescribed by the Organization for Economic Co-operation and Development: the comparable uncontrolled price method, the resale price method, the cost plus method, the profit split method, and the transactional net margin method.

Taxpayers are required to maintain "contemporaneous documentation" in respect of all transactions with related parties that are not resident in Canada to substantiate the transfer prices utilized. The documentation is required to be prepared or obtained by the taxpayer's filing due date.

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2 Recent Federal legislation has been enacted to reduce this amount to 15% for taxation years ending after 2013

3 Recent Federal legislation has been enacted to exclude capital expenditures from the definition of qualified expenditures

5.2 Thin capitalization

The thin capitalization rules limit the amount of interest on indebtedness owed to non-arm's length non-residents that may be deducted in computing the income of a Canadian resident corporation. In general terms, if the amount of outstanding debts to specified non-resident shareholders of the corporation exceeds 1.5 times the equity of the Canadian resident corporation, the portion of the interest paid in respect of the year to such non-residents may be limited.[4]

6.0 Transactions

6.1 Capital gains

Currently in Canada, 50% of realized capital gains (ie. proceeds less adjusted cost basis) are taxed at the income tax rate applicable for the year in which the amount is realized.

6.2 Asset disposals

Proceeds of Disposition Realized from the Sale of Canadian Resource Properties

The disposition of a resource property in Canada usually entails the disposition of two types of property (unless the property is undeveloped): intangible property (rights of the type referred to in the description of COGPE) and tangible property (well head equipment, field gathering lines, etc.).

Proceeds of disposition relating to intangible property reduce the seller's COGPE balance, and if the proceeds exceed the seller's COGPE balance, any remaining amount reduces the seller's CDE balance, after which any amount in excess of the seller's COGPE and CDE balance is included in the seller's income.

On the disposition of tangible property, the lesser between original cost and proceeds reduces the relevant CCA class of the seller and may result in income inclusion as a result of the recapture of previously claimed CCA, and/or a capital gain if proceeds exceed original cost.

The disposition of a resource property in Canada usually entails the disposition of two types of property (unless the property is undeveloped): intangible property ... and tangible property.

7.0 Withholding taxes

7.1 Dividends

Every non-resident person shall pay an income tax of 25% on every amount that a corporation resident in Canada pays or credits to the non-resident person as, on account, a taxable dividend. The rate of tax may be lowered if there is an applicable tax treaty.

7.2 Interest

Interest on most debts (excluding participating debt) paid to arm's length parties should be exempt from Canadian withholding tax, while interest paid to non-arm's length parties or in respect of participating debt should be subject to a withholding tax of 25%. The rate of tax may be lowered if there is an applicable tax treaty.

7.3 Rents and royalties

Oil and gas royalties are generally subject to withholding tax at a rate of 25%, which typically is not reduced by applicable tax treaties. Other royalties are also subject to withholding at a rate of 25%, but they may be reduced by an applicable tax treaty depending on the nature of the royalty.

7.4 Capital gains

Non-residents who trigger capital gains on the disposition of property situated in Canada should generally not be subject to Canadian tax unless the property is Taxable Canadian Property (ie. real property or interest in oil and gas rights).

4 Recent Federal legislation has been enacted to treat any interest that is not deductible as a result of the thin capitalization rules as a dividend that would be subject to withholding tax at a rate of up to 25% (potentially reduced by an applicable tax treaty)

7.5 Non-resident providing services in Canada

Every person paying a fee, commission or other amount to a non-resident of Canada in respect of services rendered in Canada is required to withhold and remit 15% of the gross amount paid. This fee is not a final tax but a pre-payment of tax. A nonresident has the ability to file a Canadian tax return, and depending on whether they have a permanent establishment in Canada, they may be eligible to apply for a refund.

In certain circumstances it may be possible to obtain a waiver of withholding by filing a request with the CRA well in advance of making any payments to which withholding would otherwise apply.

7.6 Employment withholdings

Employers are required to withhold and remit amounts in respect of an employee's income tax, as well as Canada pension plan and employment insurance premiums. Employee withholding requirements will also generally apply to non-resident employers whose employees perform any part of their employment services in Canada.

In certain circumstances it may be possible to obtain a waiver of withholding by filing a request with the CRA well in advance of making any payments to which withholding would otherwise apply.

8.0 Indirect taxes

8.1 Value added tax, goods and services tax, and sales and use tax

Canada's sales tax system is a combined landscape that encompasses a federal VAT known as the Goods & Services Tax/Harmonized Sales Tax ("GST/HST")[5], along with various provincially regulated, more traditional, sales and use taxes known as provincial sales taxes (PST).

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The GST/HST is a value-added tax subject to certain specific exemptions that generally applies to all supplies of property and services made in Canada. Generally speaking, GST/HST registrants are able to recover the GST/HST that they incur to the extent that the cost bearing the GST/HST in question relates to the registrant's "commercial activity". This GST/HST is recovered by the registrant through the claiming of input tax credits ("ITCs") on their GST/HST return. PST is generally unrecoverable once incurred.

8.2 Import, export, and customs duties

Goods imported into Canada can be subject to duty. In the oil and gas industry, duty rates typically range from 3% to 6% of the 'value for duty' value of the imported goods. However, goods imported into Canada from the United States and Mexico can qualify for relief from duty under the North American Free Trade Agreement ("NAFTA"). It is important to understand that even if goods are not subject to duty, there may still be compliance requirements imposed on the importer.

8.3 Excise tax

There are also a plethora of excise taxes that apply at both the federal, provincial and potentially regional levels. Taxes that specifically apply to the oil and gas industry are fuel and carbon taxes. Many provinces also impose land transfer taxes and most municipalities also impose property taxes (on real property ownership). Given the numerous types and levels of excise taxes, including fuel and carbon, it would be advisable to consult us to consider your current situation. Properly determining excise taxes that may be applicable can be very fact specific.

5 The current GST rate is 5%. Certain provinces have a higher rate of GST known as the HST. These provinces and their respective rates are: Prince Edward Island (14%), Ontario (13%), New Brunswick (13%), Nova Scotia (15%), and Newfoundland & Labrador (13%). The province of Quebec has a provincially administered VAT, referred to as the Quebec Sales Tax ("QST") that applies in addition to the GST

9.0 Other

9.1 Choice of business entity

Business can generally be conducted by corporations, partnerships, joint ventures, and trusts as well as individuals acting on their own behalf. Some of the Canadian income tax consequences of using certain types of business entities can be summarized as follows:

Partnerships

For income tax purposes, a partnership is recognized as a separate and distinct entity. The partnership is required to compute its income from various sources, as well as any net capital losses and non-capital losses (where applicable), for the fiscal period of the partnership as if it was a separate person. The partnership entity does not pay tax on its income. Instead, the income is allocated to the partners pursuant to the terms of the partnership agreement and each partner must recognize his share of partnership income on their own tax return for the year during which the fiscal year of the partnership ends. As noted above, COGPE, CDE, CEE and FRE are also allocated to partners pursuant to the terms of the partnership agreement as are the proceeds from the disposition of Canadian resource property (i.e. intangibles).

Joint Ventures

While the distinctions between a joint venture and a partnership may often be subtle from a legal perspective, the distinction between a joint venture and a partnership for income tax purposes is significant. In a joint venture, each member owns an undivided working interest in the properties of the venture. Each participant is responsible for their own (and only their own) share of expenses and liabilities in respect of the joint venture. In much the same way, each participant generally has the right to take his share of production and any revenue earned from the joint operations.

The distinction between a joint venture and a partnership for income tax purposes is significant. In a joint venture, each member owns an undivided working interest in the properties of the venture.

The business of a joint venture is proportionately carried out by the joint venturers; income and deductible expenses are calculated at the joint venture level and allocated to the joint participants. All capital expenditures are allocated to the participants – to be included in their respective notional tax accounts that include CCA.

9.2 Foreign currency

Functional currency

An entity in Canada may calculate their taxable income in a functional currency (which is different than the Canadian dollar) where their accounting records are kept predominantly in that currency.

10.0 Oil and gas contact information

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Designed and produced by The Creative Studio at Deloitte, London. 31176A