RECENT DEVELOPMENTS IN PETROLEUM TAXATION AND THE CANADIAN OWNERSHIP RULES UNDER THE NATIONAL ENERGY PROGRAM

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This paper examines the recent changes in federal oil and gas taxation, with particular focus upon the new Canadian ownership rules arising from the National Energy Program.

I. INTRODUCTION

To date, Canada's energy resource wealth has moderated the problems that confront us as they do other industrial nations. However, from the preceding discussion, it is clear that there are grounds for concern about Canada's energy outlook. Despite our strengths, the nature of our energy use and trade leaves Canada unwisely and unnecessarily vulnerable to the vagaries of the world oil market. An immediate start must be made on measures to achieve sustained energy security.

The current fiscal system concentrates petroleum wealth within Canada to a highly undesirable extent, and leaves the federal government seriously short of the revenue it requires to manage the Canadian economy, reduce regional disparities, and develop an effective national energy policy. Also, while there is an important and entrepreneurial Canadian presence in the oil and gas sector, the involvement of Canadians through private and public sector corporations is still unacceptably low. The challenge is to effect the changes required to alleviate these problems.

The National Energy Program is the federal government's response to these energy challenges. It is an energy package that includes pricing regimes, fiscal measures, expenditure programs, and direct federal action to achieve the goals of energy security, opportunity, and fairness. The specific elements of the National Energy Program, which are detailed in the following pages, will restructure Canada's energy system to balance domestic oil supplies with domestic demand by 1990, achieve an equitable sharing of energy benefits and burdens among Canadians, lead to a high level of Canadian ownership and control of the energy sector, expand the role of the public sector in oil and gas, and ensure greater industrial benefits from energy development.[1]

With this introduction, the Government of Canada launched the National Energy Program on October 28, 1980. The Program outlined proposals relating to energy pricing, Canadian ownership and control of energy resources, and methods by which a greater degree of public participation is to be achieved through participation of state-owned corporations. The purpose of this paper is to review, to the extent of the legislative amendments enacted prior to and the information released by the federal government as of the date of writing, the amendments to the income tax legislation and the proposals relating to the measurement of the Canadian ownership and control of the petroleum industry. In the latter context, the paper deals specifically with the Canadian ownership rules on which the Petroleum Incentives Program grants will be based.

Certain of the proposals have become law. The amendments to the *Income Tax Act*[2] (the "Act" or "ITA") were enacted on February 26, 1981 by S.C. 1980-81 c. 48 (also referred to herein as "Bill C-54"). Proposed amendments to the Income Tax Regulations (the "Regulations" or "ITR") were released on February 4, 1981. The rules relating to the Petroleum Incentives Program have been described in papers released by the federal government but at the time of writing draft legislation had not been released to the public.

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1. Canada. Energy, Mines and Resources, *The National Energy Program 1980*, 23.
2. R.S.C. 1952, c.148, as am..

II. AMENDMENTS TO FEDERAL INCOME TAX LEGISLATION

A. *Changes in CEE*

1. *Changes in the definition of CEE*

The definition of "Canadian exploration expense" ("CEE") is contained in paragraph 66.1(6)(a) of the Act. Several changes to the provisions which determine whether an expense incurred for the ultimate extraction of petroleum qualifies for CEE treatment were introduced by the enactment of Bill C-54. These amendments contained in Bill C-54 were not identical to those proposed in the October 28, 1980 Budget. The Budget proposals, which were intended to restrict the CEE treatment to expenses incurred after 1980 which were regarded as truly "exploratory", were modified for the purposes of Bill C-54 in the face of vociferous protests from the oil industry. One modification is that expenses incurred in drilling dry holes will continue to qualify for CEE treatment whereas the original Budget proposals would have restricted exploration expenses to dry holes drilled in an area where a commercial accumulation of oil or gas had not been previously discovered.

The result of the enactment of Bill C-54 is that, except for a few immediate changes, the present definition of drilling costs relating to petroleum activities which qualify as CEE will remain in effect until and including December 31, 1981.[3] Drilling expenses *incurred after that date* will qualify as CEE if they meet one of two tests:

(a) Expenses incurred in drilling or completing a particular oil or gas well in Canada (or in building a temporary access road to, or preparing the site in respect thereof) that are incurred in the year will qualify as CEE if the drilling of the well is completed within six months after the end of the year and the well is abandoned within six months after the end of the year and within twelve months after the drilling of the well is completed.[4] It is still the case that if drilling of the well is not completed or the well is not abandoned, within six months after the end of the year, then the expenses incurred will qualify as a Canadian development expense ("CDE") but may be reclassified as a CEE in a subsequent year if the drilling of the well is completed within six months after the end of that year and the well is abandoned within six months after the end of that year and within twelve months after the drilling of the well is completed. The reference to six months coincides with the requirement of a corporation to file its federal tax return within six months after the end of its taxation year. If the drilling of the well is not completed on or before, and it has not been abandoned on or before, the last day for filing the return, the expense will be a CDE subject to recharacterization as a CEE in a subsequent year. As a result of the introduction of the reference to an abandoned well, all dry hole costs will qualify as a CEE regardless of whether the well is drilled to explore for oil or gas or to produce from an already discovered and developed field.

(b) Expenses incurred in drilling or completing an oil or gas well in Canada (or in building a temporary access road to, or in preparing

3. *Id.*, s.66.1(6) (a) (ii).
4. *Id.*, s.66.1(6) (a) (ii.1).

the site in respect thereof) will qualify as a CEE provided that the well is not drilled for the purpose of producing from, or delineating or determining the extent or quality of, an accumulation of petroleum or natural gas capable of being produced in commercial quantities that was known to exist at the time drilling of the well commenced.

This test is intended to ensure that the drilling costs of wells that are truly exploratory in nature and that are drilled to find oil or gas or to delineate or determine the extent or quality of an accumulation known to exist will qualify as a CEE up to the point of determining that it is capable of commercial production. A variation to this general treatment is that a delineation well drilled in a "prescribed frontier exploration area" will qualify for CEE treatment not only up to the point of determining that the accumulation drilled on is capable of commercial production but also up to the point that production in commercial quantities of any petroleum or natural gas from the particular accumulation actually commences.[5]

By virtue of Bill C-54 an "oil or gas well" is now a term defined by paragraph 66(15)(g.1) of the Act. An "oil or gas well" is a well drilled for the purpose of producing petroleum or natural gas or for determining the existence, location, extent or quality of an accumulation of petroleum or natural gas. At the same time, subparagraph 66.1(6)(a)(i) of the definition of CEE, which includes geological, geophysical or geochemical expenses and all other expenses incurred for the purposes of determining the existence, location, extent or quality of an accumulation of petroleum or natural gas in Canada, was amended so as to exclude expenses incurred in drilling or completing an oil or gas well (or in building a temporary access road to, or preparing a site in respect of any such well). The combined effect of these amendments is that test wells drilled to determine the existence of, or to delineate the extent of, an accumulation must qualify for CEE treatment under subparagraph 66.1(6)(a)(ii) before 1982. Thereafter they must qualify under tests (a) or (b) set out above (contained in subparagraphs 66.1(6)(a)(ii.1) and (ii.2) respectively).

Pursuant to paragraph 66(15)(g.2), an "outlay" or "expense" made or incurred before a particular time by a taxpayer now does not include any amount paid or payable as consideration for services to be rendered after that time, or as, on account, or in lieu of payment of, or in satisfaction of, rent in respect of a period after that time. This amendment effectively crystallizes the Department of National Revenue's policy of denying CEE or CDE treatment to prepaid drilling expenses which a taxpayer had paid or become liable for in a taxation year where the services for which he paid were not provided until a subsequent taxation year.[6]

5. *Id.*, s.66.1(6) (a) (ii.2). "Prescribed frontier exploration area" has not yet been defined.

6. The suggestion that a taxpayer would be considered as having incurred an expense by becoming liable to pay an amount notwithstanding that no cash outlay may have been made and that the activity resulting in the expense may not yet have taken place appears to find support in the jurisprudence. *See Federal Commissioner of Taxation* v. *James Flood Proprietary Limited* (1953) 88 C.L.R. 492 (High Court of Australia); *King and Another* v. *Commissioner of Inland Revenue* [1974] 2 N.Z.L.R. 190 (Supreme Court of New Zealand); *Mayor, Aldermen and Burgesses of West Ham* v. *Grant* (1889) 40 Ch. D 331 (Chancery Division). [*But see Edmonton Liquid Gas Limited* v. *The Queen* [1981] CTC 223, decided subsequently to the time of writing].

But for the change noted above, subparagraph 66.1(6)(a)(i) remains unaffected and continues to allow the deduction of exploration costs such as seismic expenditures.

2. *Changes in CCEE Deduction*

Several modifications to the determination of a taxpayer's cumulative Canadian exploration expense ("CCEE") were effected by the enactment of Bill C-54. The 1982 sunset date for the 100% deduction of CEE incurred by individuals and corporations which are not principal-business corporations (a "PBC") has been removed by an amendment to subsection 66.1(3). Subsection 66.1(2) has also been amended so that a PBC can make an optional deduction of its CCEE, in addition to the mandatory deduction of its CCEE up to its income for the year (as defined in subparagraph 66.1(2)(a)(ii)), up to the amount included in its income for the year by new subsection 59(3.3). This subsection includes in income a percentage of amounts receivable where a portion of the original cost of the item, to which the receivable relates, was previously added to the taxpayer's earned depletion base, supplementary depletion base or frontier exploration base.

In calculating its income for the purposes of its mandatory CCEE deduction, a PBC must now make a "prescribed deduction" by virtue of an amendment to subparagraph 66.1(2)(a)(ii). On February 4, 1981 the Department of Finance released draft amendments to the Regulations which proposed that the prescribed deduction would be the earned depletion allowance claimed by a successor corporation under subsection 1202(2) or by a second successor corporation under subsection 1202(3) of the Regulations. This change is intended to allow the PBC to have a residual amount of income, after the mandatory CCEE deduction, in order to facilitate the deductions provided for under subsection 1202(2) or (3) of the Regulations relating to earned depletion bases inherited from predecessor corporations under the successor corporation rules. Without this provision the mandatory CCEE deduction could (and often does) reduce the PBC's income to nil. This would effectively preclude a deduction for any such inherited earned depletion allowance which may be claimed only against resource profits. Although this is always the situation with respect to a taxpayer's self-generated earned depletion base, it was considered desirable that the earned depletion base inherited from a predecessor corporation should be deductible before self-generated CEE.

The final legislative change affecting the deductibility of CCEE derived from the October 28, 1980 Budget proposals is that the CCEE account is to be reduced by the amount of any government assistance received or receivable in respect of any CEE incurred after December 31, 1980. Previously CCEE was not reduced by the amount of any related government assistance. Although this amendment was designed to reduce the exploration expense deduction to the extent it is subsidized by Petroleum Incentives Program grants, it will also apply to provincial incentives such as drilling and seismic credits.

B. *Changes in CDE and COGPE*

The introduction of the "Canadian oil and gas property expense" ("COGPE") has correspondingly narrowed the ambit of the expenses qualifying for CDE treatment. The costs of acquiring Canadian oil and gas resource properties incurred after December 11, 1979 will be treated as

COGPE and not as CDE. Proceeds of disposition of Canadian oil and gas properties, regardless of when they were acquired (except oil and gas properties acquired prior to January 1, 1971 and not described in subsection 83A(5a) of the pre-1972 Act), operate to reduce the taxpayer's cumulative Canadian oil and gas property expense ("CCOGPE") account. To the extent that the CCOGPE account becomes negative, the CCDE account will be reduced by the negative amount and the CCOGPE account will be returned to a nil balance. With the enactment of Bill C-54, a taxpayer's CCDE or CCOGPE account will be diminished to the extent of any government assistance received or receivable with respect to any CDE or COGPE incurred after December 31, 1980.

C. *Changes in the Calculation of the Adjusted Cost Base of Partnership Interests*

Prior to the amendments effected by the enactment of Bill C-54, it was possible for a taxpayer who owned an interest in a partnership which in turn owned a Canadian resource property to have an adjusted cost base in his partnership interest which differed from his true underlying tax cost basis in the resource property. This discrepancy was attributable to the inclusion in, and deduction from, income of certain non-cash items, namely, the inclusion in income of non-deductible Crown royalties and the deduction of the 25% resource allowance from production and royalty income.

Consider the situation where a taxpayer invests $10,000 in units of a limited partnership and this amount is spent on Canadian exploration expenses by the limited partnership. The taxpayer could claim $10,000 as a deduction and thereby reduce his adjusted cost base in the partnership interest to nil. Should the drilling with respect to which the CEE was incurred prove to be successful, the partnership would presumably earn production income and would be liable to pay Crown royalties thereon. If it is assumed that this was the taxpayer's only resource-related activity in the year and the taxpayer's share of the gross production received by the partnership was $1,000, $600 of which he received as a cash payment and $400 of which constituted Crown royalties, the partner's income for the year for tax purposes would be $750 (the $600 cash received plus the $400 non-deductible Crown royalties minus the 25% resource allowance). The taxpayer's adjusted cost base of his partnership interest would thus be increased by $750 and decreased by $600 in respect of the cash distribution.[7] Although all of the production income in the year has flowed through in the year to the taxpayer, he will enjoy an accretion to his adjusted cost base of his partnership interest of $150. Alternatively, had the taxpayer owned the resource property directly without the interposition of the partnership, he would still have had a taxable income of $750 and $600 cash before tax, but would have enjoyed no increase in his adjusted cost base of the resource property. This artificial inflation of the taxpayer's adjusted cost base of his partnership interest would continue in each year that production income was received.

Conversely, if the partnership owned a royalty on Canadian production, which royalty did not bear any portion of the Crown royalty, an artificial erosion of the partner's adjusted cost base would take place. The

7. Income Tax Act, *supra* n.2, ss. 53(1) (e) (i) and 53(2) (c) (v) respectively.

taxpayer would receive $1,000 cash and would pay income tax on only $750 (after the resource allowance[8]). The taxpayer's cost base would accordingly be reduced by $250 to negative $250.

The proposals in the October 28, 1980 Budget to correct this situation were crystallized in the provisions of Bill C-54 which require the calculation of the positive and negative adjusted cost base adjustments of a partnership interest to be made without reference to the provisions relating to the non-deductibility of Crown royalties and without reference to the resource allowance. This treatment is extended also to the deemed fair market value provisions under subsections 69(6) and (7). These correcting provisions are now found in clauses 53(1)(e)(i)(B) and 53(2)(c)(i)(B) of the Act.

One further amendment to the calculation of a partner's adjusted cost base of his partnership interest, which is contained in paragraph 53(1)(e)(ix), is that the taxpayer's share of any government assistance that the partnership has received or become entitled to receive after 1971, with respect to a Canadian resource property or an exploration or development expense incurred in Canada, is added to the partner's adjusted cost base.

The above-noted amendments will apply in determining the adjusted cost base of a partnership interest after October 28, 1980 and in determining the adjusted cost base of a partnership interest disposed of by a person after 1976 and before October 29, 1980, where that person so elects before 1982.

D. *Changes to the Resource Allowance*

Paragraph 20(1)(v.1) of the Act provides for an allowance to be established by regulation in respect of oil or gas wells or mineral resources in Canada. The amount of this allowance, which is referred to as the resource allowance, is prescribed by section 1210 of the Regulations. Generally, the resource allowance is equal to 25% of resource profits, as calculated in accordance with the Regulations.

The draft amendments to the Regulations released by the Department of Finance on February 4, 1981 would amend section 1210 of the Regulations. For the purposes of ascertaining the resource allowance, resource profits would be reduced by "Canadian exploration and development overhead expenses" incurred in the relevant taxation year by the taxpayer. The definition of "Canadian exploration and development overhead expense" is added to subsection 1206(1) of the Regulations by the draft amendments to the Regulations. These expenses are defined to include CEE or CDE incurred after 1980 in respect of the administration, management or financing of a business (including remuneration and related benefits paid to a person whose duties were not all or substantially all directed towards Canadian exploration or development activities), and the upkeep, maintenance, taxes and insurance costs with respect to property other than property all or substantially all of the use of which was for the purposes of Canadian exploration or development activities. The definition also includes CEE or CDE incurred after 1980 with respect to the utilization of services or property supplied by a person not dealing at arm's length with the taxpayer, to the extent that the expenses exceed

8. Assuming s. 80.2 of the Income Tax Act was not applicable.

the direct costs to the non-arm's length contractor. The proposed amendment, read literally, could lead to an artificially high figure for Canadian exploration and development overhead expense with respect to the use of property supplied by a non-arm's length person or persons. It would appear that where several non-arm's length persons have an interest in a property which is rented by the taxpayer, the Canadian exploration and development overhead expense in relation to this transaction would be equal to the expense to the taxpayer minus the least of amounts, each of which was the cost incurred by a non-arm's length party in respect of the property. Thus the overhead expense could be based on the taxpayer's expense less the cost in respect to the property of a person with a 1% interest in the property.

A proposed amendment to paragraph 1204(1)(b) of the Regulations would add to a taxpayer's resource profits for the year, as calculated for the purposes of determining the taxpayer's resource allowance and depletion allowance, the income derived by the taxpayer in the year from the processing in Canada of heavy oil recovered in Canada to the crude oil or equivalent stage. This amendment would parallel the completed amendment to subparagraph 125.1(3)(b)(iv) of the Act which precludes income from processing heavy oil to the crude oil or equivalent stage from qualifying for the manufacturing and processing profits deduction.

E. *Changes to the Earned Depletion Allowance*

A major aspect of the National Energy Program is the replacement of the depletion allowances with a system of grants under a program known as the Petroleum Incentives Program. The government's reasoning behind the introduction of the direct incentive payments and the phasing out of the depletion allowances is stated in the National Energy Program:[9]

> As part of the National Energy Program the provisions that relate to depletion allowances are to be modified, for oil and gas exploration and development activities, effective January 1, 1981. Depletion and other incentive deductions have reduced the effective federal tax rate in the oil and gas sector to some 10-12 per cent. These incentives have primarily benefitted [sic] large established corporations which are generally foreign-owned or controlled. They have been of little use to the smaller Canadian-owned corporations which do not have sufficient income to benefit from tax incentives. The National Energy Program provides a new incentive in the form of direct incentive payments for exploration and development. This new system will provide important support for oil and gas exploration and development, particularly for corporations that are not in a taxable position. The rates of incentive payment will be higher for Canadian-owned firms and accordingly will promote Canadian ownership. This new system will significantly reduce the need for the tax-based incentives and as a result depletion allowances for the oil and gas sector are to be modified . . .

Generally, pursuant to section 1201 of the Regulations, as amended by the draft amendments released February 4, 1981, a taxpayer may deduct an amount in respect of an earned depletion allowance equal to the lesser of:

(a) 25% of his resource profits for the taxation year, plus 100% of all amounts included in his income in the year pursuant to paragraphs 59(3.3)(a) or (b) of the Act; and

(b) his earned depletion base at the end of the year.

Paragraphs 59(3.3)(a) and (b) were added to the Act with the enactment of Bill C-54. These provisions add into the taxpayer's income the fraction of the amounts which became receivable after December 11, 1979 by the taxpayer in respect of the proceeds of disposition of property or in

9. Canada. Department of Finance, *Budget Papers*, (October 28, 1980), 87.

respect of payment for services equal to the fraction of the cost to the taxpayer of the property or services which was originally added to the taxpayer's earned depletion base when the cost was incurred. As these provisions increase income with respect to the particular amounts receivable after December 11, 1979, paragraph 1205(g) of the Regulations is to be amended by the draft amendments to provide that the reduction of the earned depletion base with respect to the particular amounts receivable by the taxpayer applies only to those amounts receivable before December 12, 1979. These rules do not apply to property that is a Canadian resource property or a share of a corporation, as the proceeds of disposition of such properties already operate to reduce deductions or increase income.[10]

Resource profits, as calculated for the purposes of determining the earned depletion allowance, are similar but not identical to the resource profits used in determining the resource allowance.

A taxpayer's ability to deduct his earned depletion base has not been significantly affected by the recent amendments to the Act (apart from the increase of the potential deduction by reference to the paragraph 59(3.3)(a) and (b) amounts). The major change is the extent to which a taxpayer's ability to add to his earned depletion base has been limited. These limitations are contained in the February 4, 1981 draft amendments to the Regulations. The changes do not generally affect the mining sector.

The earned depletion base is calculated pursuant to the rules contained in section 1205 of the Regulations. Essentially, it is one-third of all CEE and CDE incurred on oil and gas or mining properties after November 7, 1969 and prior to January 1, 1981 plus one-third of CEE incurred after 1980 that relates to mining properties plus a percentage of certain expenses related to oil and gas activities incurred by a corporate taxpayer after 1980. Individuals will no longer be entitled to add to their earned depletion base any amount with respect to expenses incurred after 1980 in respect of oil and gas activities.

CEE incurred by a corporation with respect to oil and gas activities on "Non-Conventional Lands" will continue to increase the corporation's earned depletion base by one-third of these expenses. The draft amendments to the Regulations define "Non-Conventional Lands" as all lands, other than lands to be designated, owned by Her Majesty in right of Canada, or in respect of which Her Majesty in right of Canada has the right to exploit or dispose of the natural resources, which are situated in the Northwest Territories, the Yukon Territory or the submarine areas adjacent to the coast of Canada. CEE related to oil and gas activities incurred by a corporation on "Conventional Lands" in Canada (provincial lands) will increase the earned depletion base by one-third of such costs incurred in 1981, by one-fifth of such costs incurred in 1982, by one-tenth of such costs incurred in 1983 and by no amount thereafter.

Oil and gas related CDE incurred by a corporation will not increase the earned depletion base where the expenses are incurred after 1980 except where the CDE is incurred in respect of an oil well the production from which is to be subject to incentive prices such as wells drilled in respect of

10. Proceeds of disposition of Canadian resource properties reduce the CCOGPE and possibly the CCDE tax accounts and s.66.3 of the Act concerns itself with shares issued as consideration for expenses that increase the earned depletion base.

heavy oil projects. In these cases, one-third of the CDE will continue to be added to the earned depletion base.

One-third of the capital costs of machinery and equipment used in certain tertiary recovery projects and heavy oil projects will also be added to the earned depletion base where the machinery and equipment was acquired after 1980.

CEE that was a "Canadian exploration and development overhead expense" (as defined with respect to the resource allowance above) will no longer qualify for addition to the earned depletion base pursuant to the proposed amendments to the Regulations. The earned depletion base will be reduced by the fraction of the amount of government assistance received with respect to CEE or CDE incurred after 1980 equal to the fraction of the CEE or CDE that was added to the earned depletion base.

F. *Supplementary Depletion*

One of the proposals contained in the October 28, 1980 Budget was that the provisions allowing supplementary depletion to be earned at the rate of 50% of the cost of enhanced oil recovery machinery and equipment and 33⅓% of the cost of bituminous sands equipment, deductible up to 50% of total income, would continue up to the end of 1980. After 1980 it was proposed that such expenditures would earn depletion at the rate of 33⅓% if they were incurred in respect of a prescribed project entitled to incentive prices. Machinery and equipment acquired for a facility to upgrade heavy oil to a crude oil equivalent were also to earn depletion at a 33⅓% rate. These items are dealt with by adding the relevant costs to the earned depletion base as noted above.

Accordingly, the effect of the February 4, 1981 draft amendments to the Regulations is that section 1210 of the Regulations is to be amended such that no amounts can be added to a taxpayer's supplementary depletion base in respect of expenses or costs incurred after 1980. The supplementary depletion allowance may still be claimed to the extent of the quantum of the supplementary depletion base on December 31, 1980 less allowances claimed after that time.

New paragraphs 59(3.3)(c) and (d) operate to the same effect with respect to the supplementary depletion allowance as paragraphs 59(3.3)(a) and (b) do with respect to the earned depletion allowance, as described above.

G. *Dispositions of Canadian Resource Property*

1. *Changes of general application*

The enactment of Bill C-54 modified the treatment of the proceeds of disposition of Canadian resource property retroactively to December 12, 1979. Prior to that date the proceeds of disposition of a Canadian resource property operated as a negative adjustment to the CCDE account. As at present, if that account became negative, the negative amount was included in income and the CCDE account returned to a nil balance.

Pursuant to subsection 59(1.2), which was added to the Act with the enactment of Bill C-54, the proceeds of disposition of all Canadian resource properties, with one exception, operate to adjust negatively the disposing taxpayer's CCOGPE account. This will be the case whether the resource properties were acquired on, before or after December 11, 1979. The exception to this treatment relates to property disposed of by a taxpayer which he owned continually since December 31, 1971 that would be a Canadian resource property but for the fact that it was acquired before 1972, but not including property described in paragraph 59(1.2)(b) (a right, licence or privilege referred to in section 83A(5a) of the pre-1972 Act). An example of this type of property would be an oil or gas royalty acquired by the taxpayer prior to 1972 and owned by the taxpayer continuously since December 31, 1971. The proceeds of disposition of such property will operate as a negative adjustment to the taxpayer's CCDE account by virtue of the combined effect of subsection 59(3.1) and clause 66.2(5)(b)(v)(A), to the extent the proceeds became receivable in the relevant taxation year.

Where the negative adjustments to a taxpayer's CCOGPE account for a taxation year exceed the positive balance at the beginning of that year plus the positive adjustments for the year, the negative balance is carried over and becomes a negative adjustment to the taxpayer's CCDE account for the year. Should that account have a negative balance at the end of the year, the negative balance is included in income pursuant to paragraph 59(3.2)(c). Any negative balance in either account returns to zero at the beginning of the following year.[11]

The Act allows a taxpayer to claim a reserve with respect to the proceeds of disposition of a Canadian resource property which are due over a period of time. With the introduction of the CCOGPE account, the reserve with respect to Canadian oil and gas properties operates pursuant to the provisions of subsection 64(1.2) of the Act. In order to be entitled to claim a reserve under subsection 64(1.2), there must have been a negative balance in the CCOGPE account which was transferred over to the CCDE account, which in turn became negative resulting in an income inclusion pursuant to paragraph 59(3.2)(c) of the Act. This reserve is equal to the lesser of:

(a) the amount of the paragraph 59(3.2)(c) income inclusion in excess of any reserve deducted under paragraph 64(1.1)(a) (paragraph 64(1.1)(a) relates to a reserve with respect to the disposition of mining properties and pre-1972 oil and gas properties that are not subsection 83A(5a) properties),
(b) the amount by which the CCOGPE account was negative, and
(c) the amount of the proceeds of disposition not due until after the taxation year end.

The amount of the reserve claimed is added back to income in the following year by virtue of subsection 59(2.1) and a new reserve may be claimed in the following year. The reserve may not be claimed by a taxpayer who, at the end of the particular tax year or at any time in the following tax year, is exempt from Part I tax or is not resident in Canada and did not carry on a business in Canada.

The fact that a reserve may not be claimed unless there is, and only to the extent of, an income inclusion under paragraph 59(3.2)(c) as the result of a negative CCDE account, can work hardship. The taxpayer must reduce his cumulative account balance by the proceeds of the disposition even if not due until a later year. For example, if a taxpayer has a

11. For a more detailed analysis, *see* D.H. Watkins, "Recent Developments in Petroleum Taxation", *1981 Prairie Provinces Tax Conference*, Canadian Tax Foundation.

CCOGPE balance of $1,100 and he sells a Canadian resource property for $1,000 payable as to $100 per year for ten years, his CCOGPE deduction at the end of the year of sale will be $10 being 10% of $100. To use another example, if the taxpayer had no balance in his CCOGPE account prior to a sale for $1,000 payable as to $100 per year for ten years, but intended to purchase another Canadian resource property in the same year at a cost of $1,500, he would be well advised to postpone the acquisition until the next year so that his CCOGPE pool will become negative in the year of sale. To the extent this also creates a negative balance in his CCDE account, a reserve will be available. He can then claim 10% of $1,500 or $150 in the next year in respect of the acquisition.

It is interesting to speculate as to the reason behind and the meaning of the reference in the definition of "Canadian resource property" in paragraph 66(15)(c) to any right to or interest in any Canadian resource property, including a right to receive proceeds of disposition in respect of a disposition thereof, found in subparagraph 66(15)(c)(vii). Does this mean that a vendor of a Canadian resource property disposes of a Canadian resource property but also acquires a Canadian resource property, being his right to be paid? If so, and if the right to be paid is a right to be paid over a period of time, it would seem to follow that the taxpayer disposes of a portion of this right to be paid — and therefore disposes of a Canadian resource property — each year that he receives an amount on account of the sale price. For example, if a resource property is sold for $100 payable in equal instalments over ten years, has the taxpayer disposed of a Canadian resource property for proceeds of $100 in the initial year and acquired a Canadian resource property, being the right to receive proceeds of $90 in subsequent years? If this is correct, the result is a negative adjustment to the CCOGPE account of $100 and a positive adjustment of $90 resulting in a net negative adjustment of $10. Each year during which a payment is received, arguably the taxpayer disposes of a Canadian resource property — being a portion of the right to receive proceeds — equal to $10 giving a negative adjustment equal to that amount. The effect is that a reserve is available without the use of the specific reserve provisions and the consequential limitations contained in subsection 64(1.2) which require, *inter alia*, that there be income from a negative CCDE account before a reserve can be claimed and that the taxpayer be subject to Part I tax in the following year.

2. *Dispositions of Canadian resource properties by non-residents*

Where a non-resident disposes of resource properties, new rules relating to withholding requirements of the purchaser have been introduced through amendments to section 116 of the Act. Subsection 116(5.2) has been added to the Act and provides that where a non-resident person has, in respect of a proposed disposition of a Canadian resource property or a depreciable property that would be a taxable Canadian property, paid an amount that is "acceptable to the Minister", or furnished security in lieu thereof, the Minister will issue a clearance certificate to the non-resident. The stipulation that the vendor pay an amount "acceptable to the Minister" rather than a specified percentage of the proceeds, results from the fact that the amount of income resulting from the disposition of a Canadian resource property or a depreciable property cannot be determined simply by comparing the proceeds of disposition to the cost of the property as the purchase and sale of both these types of property are dealt with, for tax purposes, on a cumulative account basis. The practice of the Calgary District office seems to be that a certificate will be issued where the taxpayer can show that an accretion to income is not likely to arise solely as a result of the disposition. Where an accretion to income does arise, the practice seems to be that, to obtain the certificate, the taxpayer will be required to pay an amount approximating his expected marginal tax rate multiplied by that amount of income.

If a certificate is not issued under subsection 116(5.2), subsection 116(5.3) requires the purchaser to pay the Receiver General 50% of the amount payable by the purchaser for the property acquired. The purchaser is entitled to withhold or otherwise recover this amount from the vendor.

If a certificate has been issued under subsection 116(5.2), subsection 116(5.3) requires the purchaser to pay the Receiver General 50% of the amount payable by the purchaser for the property acquired in excess of the amount fixed in the certificate.

It should be noted that subsection 116(5.2) contemplates only certificates issued with respect to "proposed dispositions". If the Minister issues a certificate after the disposition by a non-resident (as is frequently the case with respect to the disposition of non-depreciable capital property under subsection 116(3)) it is therefore not clear that the certificate has been issued "under subsection (5.2)". In this situation the obligation on the purchaser imposed by subsection 116(5.3) could, very technically, require a withholding by the purchaser notwithstanding the issuance of the certificate.

H. *Successor Corporation Rules*

Prior to Bill C-54, on an amalgamation of two corporations, the cumulative expense accounts of both corporations were streamed against income from the properties of each of the predecessors. If Corporation A and Corporation B amalgamated, Corporation A's cumulative accounts could only be deducted by the amalgamated corporation against income from properties owned by Corporation A prior to the amalgamation. The same treatment was accorded Corporation B's cumulative accounts with respect to income from pre-amalgamation property of Corporation B. Subsection 87(1.2) now provides that this treatment does not apply where a corporation and a subsidiary wholly-owned corporation (as defined in subsection 87(1.3)) amalgamate. Provided that the amalgamated corporation elects in its income tax return for its first taxation year ending after October 28, 1980, only the cumulative expense accounts of the subsidiary wholly-owned corporation are streamed. The cumulative accounts of the parent corporation may be applied against income generated from pre-amalgamation property of either amalgamating corporation. This change was implemented to put an amalgamation of a parent and a subsidiary on the same footing as the liquidation of a subsidiary.

III. MEASUREMENT OF CANADIAN OWNERSHIP AND DETERMINATION OF CONTROL UNDER THE PETROLEUM INCENTIVES PROGRAM

A major aspect of the National Energy Program is the introduction of a system of grants under the Petroleum Incentives Program relating to exploration and development activities carried on in Canada. The purpose of the Program is to provide assistance, through cash grants, to individuals who are Canadian citizens ordinarily resident in Canada or who are permanent residents of Canada, as defined, and to corporations which are controlled by Canadians and have a sufficient degree of Canadian ownership, in respect of petroleum exploration and development activities carried on in Canada by such individuals or corporations. The government's goal is to give Canadians and Canadian-owned and controlled corporations a competitive advantage by making the grants available only to such entities, thereby placing non-qualified players in the petroleum industry at a disadvantage. Whether or not the goal is a desirable one, in light of the cost of achieving it, is beyond the scope of this paper.

Grants will be paid to qualified applicants based on the amount of their eligible exploration and development expenditures. The amount of a grant depends upon the place where the activity takes place, whether the activity is of an exploration or development nature or relates to the acquisition of certain capital assets, and the Canadian ownership rate of the applicant.

At the time of writing, legislation enacting the Petroleum Incentives Program had not been introduced into Parliament nor had a draft of proposed legislation been released to the public. The only written indicia of the details of the proposals have been contained in papers and press releases issued by the Department of Energy, Mines and Resources, some of which are referred to below. Naturally, a careful examination of the ultimate legislation will be in order to determine the final rules of the game.[12]

On November 21, 1980, a paper was released by the Department of Energy, Mines and Resources outlining the initial details of the proposed rules for measuring the Canadian ownership and control of investors in Canadian resource activities.[13] This was followed, on December 19, 1980, by a document summarizing the method by which qualified investors would apply for and receive grants under the Petroleum Incentives Program.[14] Both papers were released to allow the petroleum industry to review and react to the proposals. A number of press releases were subsequently issued announcing changes to the proposals following consultation between the industry and the government.

On April 22, 1981, a revised paper was released by the Department concerning the Canadian ownership and control proposals.[15] A revised paper relating to the method of applying for and receiving grants was to be released by the end of June, 1981.

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12. There is little doubt that the legislation first enacted will be subject to numerous amendments as the industry and the government begin work within the framework of the Program. Notwithstanding this, the federal administration will likely be given a broad degree of discretion in dealing with certain portions of the Program. Indeed, as will be seen, this will clearly be the case as far as anti-avoidance measures are concerned.

13. Canada. Petroleum Monitoring Agency, *Measurement and Determination for Canadian Ownership and Control: A Proposal.* November 21, 1980.

14. Canada. Department of Energy, Mines and Resources, *Petroleum Incentives Program 1981.*

15. Canada. Petroleum Monitoring Agency, *Method for Measurement of Canadian Ownership and Determination of Control Under the National Energy Program.* April 22, 1981.

Originally, it was contemplated that this paper would examine both sets of rules, i.e., the method of measuring Canadian ownership and control and the rules governing receipt of the grants once control and the degree of Canadian ownership had been determined. At the time of writing, the release of the revised paper relating to the grants was still pending. Accordingly, the paper restricts itself to the rules relating to the measurement of an investor's Canadian ownership rate and the determination of control. The paper of April 22, 1981 (the "April 22nd Paper") and discussions the writer has had with the Petroleum Monitoring Agency (the "PMA") form the basis of the comments below. For a review of the basic concepts of the grant Program, the reader is referred to the December 19, 1980 paper and press releases from the Department of Energy, Mines and Resources which have been issued since then.

A. *Measurement of Canadian Ownership Rate and Determination of Control*

One of the factors determinative of the amount of a grant payable to an applicant therefor is that person's Canadian ownership rate ("COR") and whether or not, in the case of a corporation, partnership or trust, the applicant is controlled by Canadians.

The administration of the COR rules will be handled by a new tribunal known as the Petroleum Monitoring Agency. The Petroleum Incentives Board (the "Board") is to be in charge of the receipt of applications for and the payment of the grants with the amount thereof to be dependent on the COR of the applicant as certified by the PMA.

In order to be entitled to receive a Petroleum Incentives Program ("PIP") grant, an applicant must have received a certificate from the PMA certifying the applicant's COR or its control status or both. Such a certificate will then be used by the applicant in applying to the Board for a PIP grant.

1. *Who can apply for a certificate?*

Qualified applicants include the following:

(a) An individual who is a Canadian citizen ordinarily resident in Canada or an individual who is a permanent resident within the meaning of the Immigration Act[16] who has been ordinarily resident in Canada for no more than one year after the time when he first became eligible to apply for Canadian citizenship. A permanent resident who has been ordinarily resident in Canada for more than one year after the time when he first became eligible to apply for Canadian citizenship will remain a qualified applicant provided he applies for Canadian citizenship within five years of the coming into force of the enabling legislation.

An individual who is a Canadian citizen does not lose his status as a qualified applicant if he has been ordinarily resident outside of Canada for less than five consecutive years prior to the date of application for a certificate. A Canadian citizen will also not lose his status if he serves in an official or other capacity outside Canada as: a full time employee of a Canadian government or a Crown corporation; a full time employee engaged in the conduct of a Canadian

16. S.C. 1976-77, c.52, as am..

business or a branch, associate or affiliate thereof, at the direction of that Canadian business; a full time student if the period of residence outside Canada is less than ten consecutive years; or, an employee in an international association of which Canada is a member. Furthermore, a Canadian citizen does not lose his status if he was ordinarily resident in Canada when he reached his sixtieth birthday and has been ordinarily resident outside Canada for a period of less than ten consecutive years or if his residence is governed by an income tax treaty.

(b) A corporation incorporated under the laws of Canada or of a province. If the corporation was incorporated outside of Canada and prior to October 29, 1980, it will be "presumed" to be a qualified applicant provided its activities are conducted primarily in Canada and it is a subsidiary of a qualified applicant.[17] In the case of a corporation that issues shares to investors under circumstances whereby the investors are entitled to a deduction in respect of Canadian exploration expenses or Canadian development expenses under circumstances described in subparagraph 66.1(6)(a)(v) or 66.2(5)(a)(v) of the Act (sometimes referred to as a "flow-through share corporation"), it is the corporation and not the investor that is to apply for and receive a COR certificate.

(c) A partnership established under or subject to the laws of a province. A COR certificate issued to a partnership applies to all partners of that partnership but only in respect of the activities carried on by that partnership. [At the time of writing the Petroleum Incentives Board was considering the possibility of treating certain partnerships with a low number of partners as joint ventures such that each partner would apply for his grant separately using his own COR level and COR certificate.] For other oil and gas activities that may be carried on by the individual partner, that partner must apply for its own COR certificate. Members of a joint venture that is not a partnership are to apply for their PIP grants separately and therefore must each have their own COR certificate.

(d) A trust resident in Canada. This includes tax-exempt pension trusts or corporations referred to in paragraphs 149(1)(o), (o.1) and (o.2) of the Act, and a trust constituted pursuant to a deferred profit sharing plan as defined in section 147 of the Act.

(e) A self-administered registered retirement savings plan ("RRSP"), provided the individual owner of the plan could himself qualify as a qualified applicant. In such a case, the RRSP is deemed to have a 100% COR.

(f) Certain financial institutions that administer funds in which deposits, savings or assets of two or more investors are comingled in a single portfolio investment. These financial institutions include Canadian banks, Canadian trust companies, mutual fund corporations incorporated in Canada, Canadian life insurance companies, and credit unions incorporated under the laws of a province.

(g) Certain other legal entities to be prescribed by regulation.

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17. It is not clear from the April 22nd Paper under what circumstances the "presumption" may be rebutted by the government. Perhaps the presumption will ultimately be a conclusive one, i.e. the corporation is deemed to be a qualified applicant.

2. *Presumptions concerning 100% Canadian ownership.*

An individual who is a qualified applicant is presumed to have a COR of 100%. This also applies to a corporation that is a special status corporation. At the time of writing, it was proposed that three corporations would so qualify, namely, Alberta Energy Company Limited, the British Columbia Resources Investment Corporation, and the Canada Development Corporation.

A pension trust or corporation in respect of a defined *contribution* pension plan and a trust under a deferred profit sharing plan will be deemed to have a 100% COR provided certain tests are met. These tests include requirements that the plan be registered under the Income Tax Act, that at least 90% of the active members of the plan have Canadian addresses, and that the administrators of the plan have no reasonable grounds to believe that at least 90% of the members of the plan would not themselves be qualified applicants. Also, if the plan is trusteed by individuals, three-quarters of them must be able to qualify as qualified applicants. A pension trust or corporation in respect of a defined *benefit* pension plan will have a COR of 100% if it meets the same tests as above and the plan has at least fifty active members.[18]

Life insurance corporations and co-operative corporations will be presumed to have a 100% COR if certain tests are met.

A Canadian charitable organization as defined under the Act will be presumed to have a COR of 100%, although this is only relevant when the charity is an investor in a qualified applicant.

A fund referred to in 1(f) above, i.e. a pooled fund, will be deemed to have a 100% COR if the management has reasonable grounds to believe that at least 90% of the value of the assets of the fund are held on behalf of individuals that would be qualified applicants or on behalf of self-administered RRSP's where the beneficiary of the RRSP would be a qualified applicant.

The 90% test which can result in a plan or fund being treated as having a 100% COR and the other "deemed 100% COR" rules referred to above are designed to allow large pools of Canadian capital to invest in the equity of Canadian corporations and other types of qualified applicants (such as partnerships) in order to increase the Canadian ownership of such corporations and applicants. This proposal is consistent with the growing desire of the managers of pension funds and other pooled investment funds to invest in the petroleum industry.

3. *Measurement of a qualified applicant's COR*

In determining a qualified applicant's COR, it is necessary to identify and measure the COR of its "formal equity". "Formal equity" is essentially

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18. If a defined benefit or defined contribution pension plan is one where less than 90% of the plan members have Canadian addresses, the COR of the plan is equal to:

$$\frac{\text{Plan Members With Canadian Addresses}}{\text{Total Members of Plan}}$$

If a defined benefit pension plan has less than fifty active members, the COR of the plan is equal to:

$$\frac{\text{Pension Plan Liabilities to Canadian Citizens Ordinarily Resident in Canada}}{\text{Total Pension Plan Liabilities to all Plan Members}}$$

the applicant's classes of beneficial ownership. In the case of a corporation, its formal equity consists of shares of its capital stock. In the case of a partnership or a trust, the formal equity is the right to the income of the partnership or trust owned by the partners or beneficiaries or the right to the capital of the partnership or trust owned by the partners or beneficiaries.

Formal equity represents the rights or claims of investors to the income or capital of the applicant. The COR rules attempt to identify and define separate classes of these rights or claims and then measure the degree to which these rights or claims are owned and controlled by Canadians.

The types and classes of formal equity are defined in the following manner:

(a) Each class of shares of common stock and, subject to the comments in the following sentences, preferred stock of an applicant that is a corporation, is treated as a class of formal equity. Any series of shares of a class also appear to be treated, initially, as a separate class. Preferred shares of a corporation are not treated as a class of formal equity except where the preferred shares are convertible into common shares (in which case the preferred shares may be excluded from the calculation and the common shares into which the preferred shares are convertible are treated as if they were issued and owned by the preferred shareholders: see the discussion below), or participate in the profits of the corporation beyond a defined rate, or are redeemable for an amount in excess of their par value or their redemption value, or the rate of dividend on the preferred shares permits the shareholder to participate to a "disproportionate" extent in the future revenues of the corporation. The intention is to exclude non-convertible preferred shares from the COR calculation unless they represent a participation in revenue or profits above what is considered "normal".

(b) Formal equity includes shares of a class of a corporation that are issuable on the conversion of a convertible preferred share or a convertible debenture if the COR level of the applicant would increase if all the shares were issued. This type of convertible security is referred to as "forward equity". The conversion feature must meet certain conditions specified in Schedule A to the April 22nd Paper. These conditions essentially operate to include forward equity in formal equity for the COR measurement purposes where there is a reasonable likelihood that the convertible securities will be converted into common shares within a specified time frame. Otherwise, the beneficial ownership of the convertible security is not to be included in the COR determination of the class of common shares into which the convertible security may be converted. The exception to this rule, as stated below, is where the forward equity would operate to reduce the COR.

It seems clear that it is the common shares into which the convertible security may be converted that are included (or not included) in the COR measurement. The convertible security itself is not treated as a class of formal equity.

Schedule A provides that convertible preferred shares and convertible debentures (in registered form)[19] will add to the COR of the class of common shares into which they may be converted provided that any resulting increase in the COR of the applicant cannot exceed 10 percentage points and provided the following conditions are met:

(i) The convertible security is sold to arm's length parties and the underlying common shares are traded publicly.

(ii) The maximum conversion price is not more than 20% above the mid-market price of the common shares as quoted on a recognized Canadian stock exchange. It is presumed that a premium in excess of 20% makes it unlikely that the conversion will take place. Mid-market price of the common shares is:

(aa) The average of the closing prices during the last 30 business days that the stock traded *unless* there is evidence that the price determined in this way does not reflect actual market value. The applicant will be required to obtain from its underwriter and, somewhat curiously, also from its legal counsel, a statement that to the best of their knowledge there is no evidence that the market value so determined is an unreasonable one.

(bb) In the case of an issue where a final prospectus is available, the mid-market price will be the mean between the bid and the ask as quoted on a recognized Canadian stock exchange at the close of trading on the day of signing of the prospectus.

(cc) In the case of an issue where no public prospectus is available, the mid-market price will be the mean between the bid and the ask at the close of trading on the date prior to the formal closing.

(iii) The convertible securities will be taken into account for COR measurement purposes only during the first five years from the date of issue, even if the date of that issue is prior to October 29, 1980. In other words, if conversion has not occurred by the fifth anniversary of the date of issue, further recognition of the forward equity in the COR determination ceases.

(iv) In the event that the common shares of the applicant fall in price during the five-year measurement period, the April 22nd Paper states, in language that suffers from lack of clarity, that the convertible securities are excluded from the COR measurement if the conversion price exceeds the weighted average price of the common shares during the twelve months preceding the COR measurement by more than 20%, provided that convertible securities may be included in an annual COR calculation if the premium exceeds 20% but not 30%, and provided this proviso is exercised only once in the five year period.

Where the convertible securities do not meet the conditions set out above, the applicant will be given the opportunity to convince the PMA that the forward equity should be included in the COR

19. Convertible debt in bearer form will not normally be included in the calculation of forward equity for purposes of increasing COR but it is indicated that such a security may be included if it can be formally certified as being Canadian-owned.

measurement. The example given is the case where there is a high probability of a conversion within a short period of time after issuance of the convertible security.

(c) Warrants, rights and options to acquire a class of common shares are not, at the time of writing, to be included in the COR measurement process if the exercise of such instruments would increase the applicant's COR.

(d) Formal equity includes shares of a class of a corporation that are issuable on the exercise of a warrant, right, option or similar instrument or are issuable on the conversion of a convertible preferred share or a convertible debenture *if the COR level of the applicant would decrease* if all such instruments were exercised or converted, as the case may be. As might be expected, there is no 10% limitation on the potential COR reduction.

In the case of convertible preferred shares and debentures that would reduce the COR level, the common shares into which they may be converted will be *automatically* included in the COR calculation if the maximum conversion price is not more than 20% above the mid-market price of the common shares and the convertible securities were issued not more than 5 years prior to the date of the COR application. If the common shares should fall in price during the 5 year measurement period, the convertibles would be excluded from the COR measurement in the same manner as described above for the purposes of increases in COR level on such conversions. Convertible securities that reduce the COR level and *are not automatically* included in the COR calculation will nevertheless be included in the COR measurement unless it can be shown why they ought not to be included. This may be the case where the period remaining for the conversion is relatively short and the premium is relatively high.

In the case of warrants, rights or options, the common shares which would be issued upon their exercise will be *automatically* taken into account where they have a *negative* impact on the applicant's COR and the exercise price is not more than 20% above the mid-market price of the common shares and there is at least 5 years remaining in the term of the warrant, right or option. Where the shares to be issued on exercise *are not automatically* included in the COR calculation, they will nevertheless be taken into account if they reduce the COR, unless the PMA can be satisfied that there is a good reason why they should be excluded.

(e) Shares that are issuable by a corporation in consideration for exploration or development expenses pursuant to an agreement described in subparagraph 66.1(6)(a)(v), 66.2(5)(a)(v) or 66.4(5)(a)(iii) of the Act are to be treated as formal equity of the corporation if the COR of the corporation would increase if the shares were issued and where it is reasonable to presume that the shares will be issued within twenty-four months of the date of the agreement. If the COR of the corporation would decrease if the shares were issued, the shares must be treated as formal equity. Forward equity of a flow-through share corporation will also be included in measuring the COR of the corporation.

(f) An interest in a partnership or trust which is an interest in the net income of the partnership or trust is a separate class of formal equity. An interest in the capital of the partnership or trust under the terms specified in the partnership or trust agreement or on dissolution is also a separate class. Where the partnership interest or interest in the trust does not distinguish between or combines income and capital rights, the interest will be treated as one class. If Canadian partners or beneficiaries are entitled to a higher proportion of equity in the future, pursuant to the terms of the partnership or trust agreement, than at the time of the COR certificate application, then the partnership or trust may submit argument to show that this forward equity should be included in the COR calculation. The PMA must be convinced that there is a high probability that the beneficial Canadian ownership in the partnership or trust will be raised before it will take this form of forward equity into account for COR measurement purposes. The COR of the applicant may not be increased by more than 10 percentage points in this manner.

Conversely, where foreign partners or beneficiaries are entitled to a higher proportion of equity in the future, the formal equity will be presumed to have been issued at the time of the application unless the applicant can satisfy the PMA that there is a low probability that the forward equity will be exercised or converted.

A qualified applicant must always measure its formal equity.[20] In cases where the existence of informal equity results in a materially different distribution of revenues or benefits between a party having a COR level which entitles it to PIP grants calculated as a certain percentage of expenditures and a party having a COR level which entitles it to PIP grants calculated as a *different* percentage of expenditures than would result solely from the formal equity, then informal equity *may* be taken into account.[21] "Informal equity" means an arrangement between two or more persons that permits one person or group of persons to participate to a material extent in the future revenues or future benefits of the qualified applicant. "Arrangement" means a contract or similar understanding between a qualified applicant and any other person and specifically includes two or more such understandings where, *in the opinion of the PMA*, a principal consequence of their separate existence is the realization of a higher COR by the qualified applicant than would have been realized under one such understanding. The example given in the April 22nd Paper is of a royalty agreement under which the royalty holder has a share in the resource profits of a qualified applicant of such an extent that it amounts to a material interest in the future revenues of the applicant. Informal equity is discussed in more detail below but it obviously is intended to provide the PMA with discretion to prevent the implementation of schemes that are considered to constitute an abuse of the Program.

In determining an applicant's COR, the COR of each class of formal equity must be determined. The COR of the applicant is the weighted average of the CORs of the classes of formal equity, but only if it is prac-

20. Presumably this is not necessary where the applicant is presumed to have a COR of 100% as previously noted.

21. Under the National Energy Program, a person with a COR of 80% would be entitled to PIP grants equal to 80% of his exploration expenses incurred on Canadian lands. A person with a COR of 55% would be entitled to PIP grants equal to 35% (in 1981, increasing to 45% for 1982 and 1983, and 50% in 1984) of such expenses incurred by him.

ticable to calculate a weighted average. If it is not practicable to calculate a weighted average, the COR of the applicant is the lowest COR of the classes. No indication is given as to when it would or would not be practicable to calculate a weighted average. The PMA is at the present time grappling with this concept and it may ultimately end up as essentially a matter of discussion and negotiation with the PMA of methods of calculating an average.

In many cases it is possible to reduce the number of classes of formal equity by combining two or more classes into one class. Where two or more classes of formal equity can reasonably be combined, they will be so combined. Whether or not they can be combined depends upon the similarity of the rights and obligations of the particular classes. If a class cannot be combined because of a material difference in the rights and obligations of holders of such a class as compared to other classes of formal equity, but the particular class is insignificant in relation to the total formal equity of the applicant, then the particular class will be excluded from the COR measurement. In determining whether a class is to be combined with another class, voting rights are to be ignored. Where a class of formal equity may be issued only to Canadians (such as constrained shares) but the class is otherwise substantially similar to other classes of formal equity, the particular class will be combined with the other classes. Where classes are combined, they are jointly considered to constitute one separate class of formal equity for purposes of the COR measurement.

The purpose of the concept of informal equity is, as noted above, to prevent an applicant with a high COR measured by its formal equity from entering into an "arrangement" whereby a material portion of its gross or net income is siphoned off to a person or persons who have a lower COR. In fact, however, informal equity will only be taken into account in measuring the COR of a qualified applicant where it results in a material change in the distribution of the revenues or benefits of the qualified applicant between persons of different COR levels which entitle them to different PIP grants based on the same type of expenditures as measured only on the basis of formal equity. That is to say, informal equity held by another person within the same threshold levels will not, it appears, affect the COR measurement based on the formal equity only. Where informal equity is to be taken into account, the informal equity will be treated as a separate class as if it were formal equity. Where it is not practicable to relate the COR of a qualified applicant based on its formal equity to the COR based on its informal equity in order to do a meaningful weighted average of the two, the COR of the qualified applicant will be the lower of the COR measured on the basis of formal equity and the COR measured on the basis of informal equity. Alternatively, the PMA may make an adjustment to the COR of the applicant based on its formal equity rather than treat the informal equity as a separate class. The April 22nd Paper indicates that informal equity will not be taken into account if the PMA can be satisfied that the arrangement was not entered into in order to circumvent the rules and that the informal equity does not result in a substantial dilution of the COR measured on the basis of formal equity. It is indicated that interpretation bulletins or guidelines will be published by the PMA relating to the effect of informal equity on an applicant's COR. This type of subjective analysis emphasizes the discretion the PMA intends to retain to ensure the government's objectives concerning Canadian ownership are not avoided through "arrangements" between persons of different COR levels.

The determination of an applicant's COR where the applicant is a public corporation, a partnership, or a trust is made as follows. The first step is to identify the separate classes of formal equity (and any classes of informal equity to be treated as separate classes of formal equity) as described above. Once this has been done, the COR of each separate class must be determined. This requires knowledge of the following factors which enter into the calculation:

(a) Total number of units of the class issued ("T"). In the case of a public corporation where the class is its outstanding shares, this is the total number of shares issued and outstanding.

(b) Number of holdings with foreign addresses ("F"). In the case of shares of a public corporation, this is the number of shares in respect of which the registered owners are shown as having foreign addresses. If it can be established that shares held through a foreign address are beneficially owned by one or more Canadians, then that shareholding is to be excluded from F.

(c) The total number of small holdings ("S"). A small holding is a holding having *a Canadian address and a market value of under $50,000.* In the case of a public corporation, in determining the market value of the shares of the class, a day must be selected which is no more than 120 days prior to the date of application for the COR certificate whether that be the initial application or a subsequent application. This date is referred to as the "determinant date". The market value is determined as being the weighted average price of all shares of that class traded on a stock exchange during the 30 days preceding the determinant date. If the shares are traded on more than one exchange, the exchange with the largest volume of the applicant's shares traded during that 30 day period must be used. If the shares are traded over the counter, the market value is determined as above using the over the counter published trading lists from the exchange with the largest volume of shares of the applicant traded during the 30 day period. By dividing the market value of the shares by 50,000, the number of shares (rounded to the closest 5 shares) which will make up a small holding will be determined.

Small holdings are deemed to have a COR of 100%.

In the case of a partnership or a trust, if the applicant wishes to calculate the number of small holdings, it must do so by way of a method that is "appropriate to the circumstances".

(d) The number of Canadian addressed shareholdings that are not small holdings. This amount is referred to as "P".[22]

These factors are used to calculate the COR of the class as follows:

(1) List the large holdings of the class. A "large holding" is a holding having a Canadian address and representing at least 0.5% of the equity of the class. That is, in the case of shares of a public corporation, list shareholdings of the class that are large holdings.

(2) If the large holdings listed represent at least 50% of "P" (the number

22. $P = T - (F + S)$.

of Canadian addressed holdings that are not small holdings), then it is not necessary to list any more holdings.

(3) If the large holdings listed represent *less* than 50% of "P", then the intermediate holdings of the class must be listed *in descending order of magnitude* until the number of holdings listed (large and intermediate) represent at least 50% of "P". An "intermediate holding" is defined (in a very straightforward and clear manner) as being a holding with a Canadian address that is smaller than a large holding and larger than a small holding.

(4) Once the listed holdings of the class represent at least 50% of "P", it is not necessary to add any further intermediate holdings but the applicant may list as many further intermediate holdings as it wishes provided they are listed in descending order of magnitude. An applicant may want to list further intermediate holdings if they are beneficially owned by persons having high COR levels.

(5) The total holdings that have been listed are referred to as "A". The total holdings not listed are referred to as "R".

(6) The COR of each listed holding must be determined. In the case of shares of a public corporation, this requires the identification of the COR of the beneficial owner of each listed shareholding. The COR of each holding is multiplied by the number of shares making up the holding and the aggregate of the products of these calculations is referred to as "B".

(7) The COR of the class is then determined as follows:

$$\text{COR of Class} = \frac{B + (B/A \times R) + S}{T}$$

Fractions of less than 1% are rounded off with .5% being rounded up.

Mathematically the formula can also be expressed as follows:

$$\text{COR of Class} = \frac{B}{T} + \frac{(B/A \times R)}{T} + \frac{S}{T}$$

Essentially, the formula calculates the COR of the class contributed by the listed holdings as B/T, i.e. the total net Canadian ownership of the listed holdings divided by the total number of holdings. It then assumes that the average Canadian content of the listed holdings only, i.e. the net Canadian ownership of the listed holdings divided by the gross number of listed holdings, B/A, is also the average of the unlisted Canadian addressed holdings R. Therefore, R is multiplied by B/A and divided by T to calculate the net addition to the COR of the class. Finally, because small holdings are deemed to have a COR of 100%, the net addition to the COR of the class contributed by the small holdings, S/T, is added. The fraction generated by this formula is the COR of the class.

If the applicant desires, it need not determine the number of small holdings "S" (which could be a rather time consuming task) in which case S is equal to nil. In many cases, however, applicants will want to take advantage of the rule that deems the COR of the small holdings to be 100%.

Where there is more than one class remaining after various classes have been combined or eliminated from the calculation, as referred to above, then the COR of the applicant will be the weighted average of the classes where it is practicable to calculate a weighted average. If it is not so practicable, the COR of the applicant will be the lowest COR of the measured classes.

In the case of a public corporation, an additional five percentage points will be added to the COR of the qualified applicant otherwise determined, provided that its COR otherwise determined is at least 50%, it is Canadian controlled, and that the special rule referred to below (by which a secondary investor which owns 5% or more of the ownership interests in the qualified applicant is deemed to have a COR of 100%), is not used. The 5% boost appears to be an allowance partially to mitigate the possible loss of COR content through the practical inability to apply the various rules with complete accuracy. It is unlikely that the COR of all listed holdings will be accurately identified or that all small holdings will be identified.[23] The 5% rule gives a certain benefit of doubt to the public corporation.

In the case of a partnership or trust, the formula noted above is to be followed in respect of the classes of equity of the partnership or trust. This would include a class relating to the rights to, and claims of the holder on, the income of the partnership or trust and a class consisting of holders of rights to, or claims on the capital of, the partnership or trust. It would appear that these classes may be combined into one where the interests in income and capital are relatively the same.

In the case of shares of a private corporation, the above formula is not used. Instead, a simpler calculation is made available. A private corporation that is not a "small business" must determine the COR of all its individual and other shareholders and multiply the COR of the shareholders by the number of shares held. This calculation is to be done in respect of each separate class of equity. The aggregate beneficial Canadian ownership of the shareholders, being the aggregate of the products of the multiplications carried out, is then divided by the total number of shares outstanding to arrive at the COR level of the private corporation.

Where a qualified applicant is a "small business", a special rule will deem the small business to have a COR of 100%. A "small business" means a qualified applicant with total assets of less than $5,000,000 *and* annual gross revenues of less than $10,000,000 including total assets and gross revenues of any persons not at arm's length with the applicant. The 100% deeming rule will be applied where the small business is Canadian controlled, at least 50% of the outstanding shares have holders with Canadian addresses, and, if its shares are listed for trading on a stock exchange, the shares are listed on a Canadian exchange only.

The following is the example found on page 23 of the April 22nd Paper. In the example, it is assumed that there are 1,000,000 units (say, shares of a public corporation) outstanding, that 100,000 units have foreign addresses, and that 200,000 units are small holdings having a fair market value of $50,000 or less. Therefore T = 1,000,000, F = 100,000, S = 200,000 and P = T − (F + S) or 700,000.

Holder	Number of Units		COR of holding	Beneficial Canadian ownership
Pension fund "C"	200,000	x	1.00	200,000

23. Some holdings of a value of under $50,000 may have foreign addresses yet be beneficially owned by Canadians.

Corporation "D"	60,000 x	0.75	45,000
Corporation "E" (unidentified)	50,000 x	0.00	—
Individual "I"	20,000 x	1.00	20,000
Trust company equity fund "J"	4,500 x	1.00	4,500
Corporation "K" (unidentified)	4,000 x	0.50	2,000
Individual "L"	4,000 x	0.00	—
Individual "M"	4,000 x	1.00	4,000
Insurance company Fund "N"	4,000 x	1.00	4,000
Total	350,500		279,500
	"A"		"B"

Large holdings are holdings of 5,000 units or more. In the calculation, it is necessary to list 50% of P (350,000 units), but 350,500 have been listed. The holdings have been listed in descending order of magnitude. The foreign addressed holdings have been excluded. The number of units listed is 350,500; therefore, the remaining Canadian addressed units not listed which are not small holdings ("P") is equal to P − A = 700,000 − 350,000 = 349,500.

The COR of this particular applicant is calculated as follows:

$$\text{COR} = \frac{B + (B/A \times R) + S}{T}$$

$$= \frac{279{,}500 + (279{,}500/350{,}500 \times 349{,}500) + 200{,}000}{1{,}000{,}000}$$

$$= 76\%$$

Assuming the applicant is a public corporation, the COR is increased by 5% to 81%.

The key to the formula is the determination of the COR of the holders of the equity of the class. If the holder is an individual who beneficially owns the holding, the matter is simple, assuming the relevant facts relating to the individual such as residence and citizenship are known: if the individual is one who would himself qualify as an applicant, his COR is 100%; otherwise it is 0%. In the example, Individual I had a COR of 100% because he could qualify as a qualified applicant. Individual L could not and therefore had a COR of 0%.

In the case of a holder of equity where the holder is a corporation, partnership or trust, a series of rather complex rules have been established, the purpose of which is to look behind the corporation, partnership or trust and determine who are the individuals behind the corporation, partnership or trust and what is their status. If, after looking behind two arm's length relationships to the third level behind the applicant, there is still a corporation, partnership or trust, then it is not necessary to look through the third level; instead rules are set out to test the status of the third level.

In certain cases, a holding is deemed to have a certain COR. As noted above, a small holding is deemed to have a COR of 100%. An intermediate holding in a public corporation, partnership or trust that is not identified as to its beneficial owner is deemed to have a COR of 50% provided that it does not have a foreign address, the holding is listed in the formula for determining the COR of the applicant, and a reasonable effort has been made to determine the beneficial ownership of the holding. This is the case of Corporation K's holding in the example: its 4,000 shares are an intermediate holding as they constitute under 0.5% of the total number of units outstanding and are therefore not a large holding and are assumed in the example to be larger than a small holding. An intermediate holding with a Canadian address that is listed in the formula will be deemed to have a COR of 0% if no reasonable effort has been made to identify its beneficial holder. A large holding that is not identified is deemed to have a COR of 0%. This is the case of Corporation E in the example.

An investor who owns under 50% of the voting rights of a qualified applicant and does not control the qualified applicant, either alone or as a member of a group, is referred to as a passive investor. A passive investor with a COR of at least 90% will be deemed to have a COR of 100%, provided that where the passive investor owns under 10% of the ownership interest in a qualified applicant, the COR of the passive investor is measured as if it were a primary investor (see below); otherwise the COR of the passive investor is measured as if it were a qualified applicant.

The importance of identifying the addresses of small holdings cannot be overstressed as the difference between a Canadian address and a foreign address in respect of a small holding is the difference between a COR attributable to that holding of 100% and 0%. As holdings each of a value of under $50,000 can account for a considerable percentage of the outstanding holdings of widely-held corporations, the accuracy of recording shareholder addresses is important.

(a) *Arm's length chain measurement*

The COR measurement rules contemplate a qualified applicant looking through no more than two arm's length investors to the third arm's length entity in determining the true ownership of the applicant. That is, if a shareholder of a corporate applicant is an individual, there is no need to look behind him (except in the case of a nominee). If the shareholder is a corporation, it is necessary to look behind it to see who are the various owners of that corporation. If they are in turn corporations, it is not necessary to look further, provided this corporation is the third link in an arm's length chain. "Arm's length" means arm's length as contemplated in the Income Tax Act.

A "primary investor" is a beneficial owner of a class of formal or informal equity of a qualified applicant with whom the primary investor deals at arm's length. A "secondary investor" is a beneficial owner of a class of formal or informal equity of a primary investor with whom the secondary investor deals at arm's length.

The COR of a primary investor is determined using the same formula as if the primary investor was an applicant, except that the primary investor is required to list only a minimum of 25% of its total holdings instead of 50%, and is required to include in the list all holdings greater than or equal to 5% rather than 0.5% (this is referred to below as the 5%/25% basic system).

The COR of the secondary investor is calculated as follows:

(i) For applications received in 1981, if the secondary investor is not a "non-eligible person" as defined for the purposes of the Foreign Investment Review Act[24] ("FIRA") (i.e. it is Canadian-controlled), its COR is 100%. Otherwise, it must calculate its COR as if it were a primary investor.

(ii) For applications received in 1982, if the secondary investor has an indirect ownership in the qualified applicant (through the primary investor) of 20% or less and is not a "non-eligible person", its COR is 100%. Otherwise, it must calculate its COR as if it were a primary investor.

(iii) For applications received in 1983, the rule in (ii) applies as if "20%" was replaced with "15%".

(iv) For applications received in 1984 and subsequent years, the rule in (ii) applies as if "20%" was replaced with "10%".

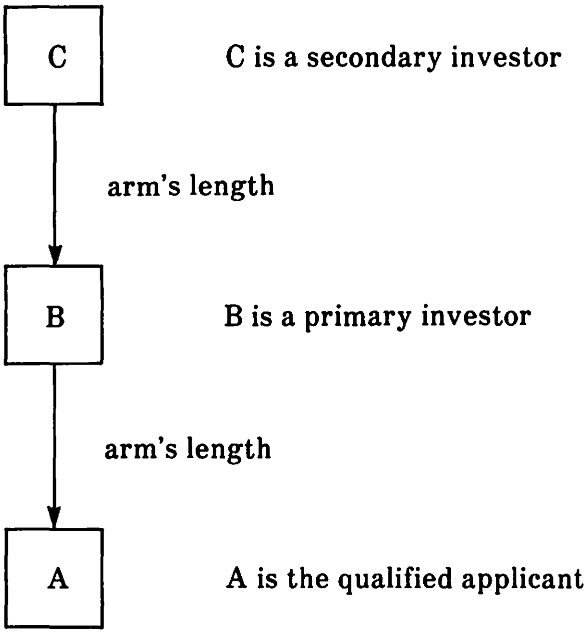
If the COR of a secondary investor is deemed to be 100% under the rules above and the applicant is a public corporation, the applicant cannot increase its COR otherwise determined by 5% under the rule described above relating to Canadian controlled public corporations.

In any case where a primary or secondary investor has also been a qualified applicant in the same calendar year, its COR as an investor is its COR as an applicant (less the five percentage points that may have been added as described earlier with respect to a Canadian controlled public corporation). If a secondary investor has been a primary investor in the same calendar year but has not also been a qualified applicant, its COR as a secondary investor will be the same as its COR as a primary investor.

It is interesting to note the difficulty that would arise under these rules relating to secondary investors who, because they do not meet the requirements in (i) to (iv) above, which would give them a deemed COR of 100%, must determine this COR as if they were primary investors. This would require the examination of the status of the investor or investors behind the secondary investor who would themselves become secondary investors. If these fourth level investors must in turn calculate their COR as if they were primary investors, the fifth level investors must be examined. In theory, all members of the arm's length chain could be subject to examination as a result of these rules which is contradictory to the general intent of proceeding only to the third level in an arm's length chain.

Rules will be provided to give the PMA the power to deem relationships between applicants and investors not to be arm's length relationships for the purposes of COR measurement where the PMA believes that an applicant and/or its investors have arranged or organized their affairs in order to obtain a higher COR than otherwise would be obtainable.

24. S.C. 1973-74, c.46, as am..



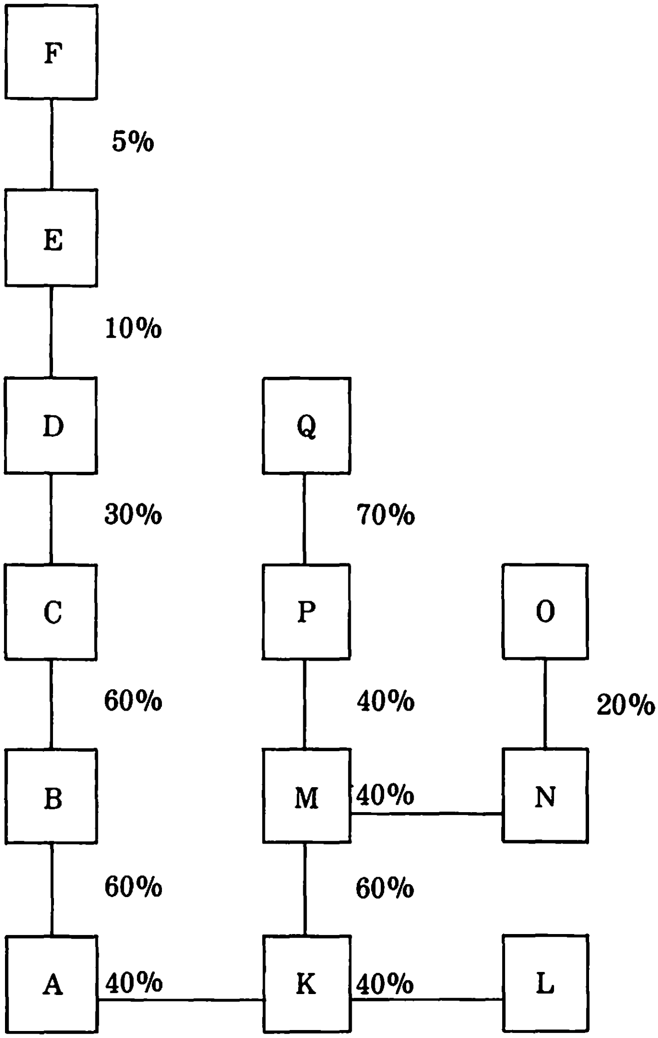
(b) *Non-arm's length chain measurement*

In a non-arm's length chain, the COR of the non-arm's length investor is simply multiplied by the number of units of the class that the non-arm's length party holds in the person with whom it is not dealing at arm's length. This applies regardless of the number of links in the non-arm's length chain. For example, if Corporation B owns 70 shares out of 100 of a class of Corporation A, then in calculating A's COR, 70 multiplied by the COR of Corporation B is added to the beneficial Canadian ownership of the remaining shares of the class of Corporation A calculated in the usual manner.

Whenever the end of a non-arm's length chain is reached, the last member of the non-arm's length chain has its COR measured on the basis of the basic formula referred to above as if it were a qualified applicant (i.e. list all large holdings being holdings representing at least 0.5% of the class and list sufficient intermediate holdings to bring the listed holdings to 50% of all Canadian addressed holdings other than small holdings. This is the basic ½ of 1%/50% formula.)

There may be situations where there are a number of non-arm's length and arm's length chains in one large corporate chain. In such a case, whenever the end of a particular non-arm's length chain is reached, the last corporation in the non-arm's length chain is treated as if it was an applicant and it must calculate its COR using the ½ of 1%/50% formula. If there is a corporation behind this last corporation, and it is at arm's length, then an arm's length chain has been formed. The second corporation is treated as a primary investor in the first corporation. If the arm's length chain continues to one more entity, that entity uses the FIRA control test or treats itself as if it was a primary investor, as the case may be.

An example of the integration of arm's length with non-arm's length chains is shown below.



A's COR is:
- (i) 60% of B's COR, plus
- (ii) the beneficial ownership of the 40% interest measured using the ½ of 1%/50% basic system applicable to qualified applicants.

B's COR is:
- (i) 60% of C's COR, plus
- (ii) the beneficial ownership of the 40% interest measured using the ½ of 1%/50% basic system.

C is the last corporation in a non-arm's length chain consisting of A, B and C and therefore C's COR is measured as if it were a qualified applicant using the ½ of 1%/50% basic system which would include measuring the COR of D's 30% interest on the same basis.

D's COR is measured using the 5%/25% basic system which would include measuring the COR of E's 10% interest. The 5%/25% basic system is used because D is a primary investor in C.

E's COR is measured by applying the FIRA control test as it is a secondary investor (unless it fails the FIRA test in which case E must use the 5%/25% basic system as if it were a primary investor).

F's COR need not be measured for the purpose of determining the COR of A, the applicant, as E is beyond two arm's length levels from A (unless E must use the 5%/25% basic system as if it were a primary investor).

K's COR is:

(i) 60% of M's COR, plus

(ii) the beneficial ownership of the 40% interest measured using the 5%/25% basic system since K is a primary investor in A.

L's COR is measured by application of the FIRA control test as it is a secondary investor unless it is required to use the 5%/25% basic system because it fails the FIRA test or its indirect interest in applicant A of 16% is too great. (This would be the case if application were being made in 1983 or subsequent years.)

M's COR is measured as if it were a qualified applicant using the ½ of 1%/50% basic system because M is the last corporation in a non-arm's length chain consisting of M and K.

N's COR is measured using the 5%/25% basic system because it is a primary investor in M.

O's COR is measured as a secondary investor (i.e. the FIRA test or calculate as if O was a primary investor).

P's COR is:

(i) 70% of Q's COR, plus

(ii) the beneficial ownership of the 30% interest measured using the 5%/25% basic system as P is a primary investor in M.

Q's COR is measured using the ½ of 1%/50% basic system because Q is the last corporation in a non-arm's length chain consisting of P and Q.

(c) *Nominee holdings*

Often ownership interests will be held through a nominee such as an investment dealer, a trustee, or an agent. In such a case, a qualified applicant or an investor, as the case may be, may elect one of the following methods of identifying and measuring the beneficial ownership of the nominee holding.

(i) With respect to each nominee holding, if the nominee holding meets the test of a small holding and has a Canadian address, it will have a COR of 100%. If the nominee holding meets the test of a large or intermediate holding, then the nominee must provide the applicant or the investor with the mix of specific holdings making up the nominee holding comprised of any holdings having foreign addresses, any large holdings, any small holdings, any intermediate holdings, and any "street holdings". The nominee must then provide the applicant or investor with the COR of any particular holding needed so that the applicant or investor can apply the relevant formula.

(ii) Alternatively, the total holdings of a nominee may be treated as a single holding in which case the COR of that single holding must be determined by the nominee as if the nominee was a qualified applicant.

These rules will be very important to corporations such as junior oil corporations, many holdings of which are held through broker margin accounts.

(d) *Unidentified street shares*

Where a qualified applicant is dealing with a nominee that is an investment dealer and uses the method described above relating to large or intermediate holdings, rules are provided to deal with the situation where such large or intermediate holdings are not identified. If the aggregate of unidentified shares in street form held in the name of all investment dealers does not exceed 5% of that class of shares outstanding, the unidentified shares may be excluded entirely from the total holdings of the class of shares to be measured. Otherwise, subject to the exception noted in the next sentence, unidentified street shares in excess of the 5% of the outstanding shares of a class receive a COR of 0%. During the period ending December 31, 1985, transitional rules will be provided to allow a qualified applicant to include unidentified street shares in excess of the 5% of the class of shares outstanding in the COR formula.[25]

(e) *Investment dealers*

Special rules have been formulated for dealing with investment dealers with respect to their role in the course of a distribution of securities and in their role as market makers.

Where an investment dealer is acting as a principal in the course of a primary or secondary distribution of common shares, convertible preferred shares or convertible debentures, the dealer may hold the particular securities of a corporation for up to a maximum of sixty days without affecting the COR of that corporation. Where a prospectus has been filed with a recognized Canadian securities commission, this sixty day period runs from the date of the final prospectus. In the case where a prospectus has been issued in the course of a distribution outside the jurisdiction of a recognized securities commission, the sixty day period will run from the date of the formal signing between the issuing COR applicant and its underwriters.

Where an investment dealer is acting as a principal in the course of a secondary distribution of common shares where a prospectus is not required, the investment dealer may hold these shares for a maximum of sixty days without affecting the COR of the issuing applicant. This sixty day period will run from the date that the securities were purchased by the investment dealer. Where an investment dealer acts as an agent in the course of a private placement his participation will not affect the COR of the issuing applicant. In either of these situations, the qualified applicant must notify the PMA where the distribution exceeds 10% of the outstanding shares of the applicant.

Where common shares or convertible preferred shares or convertible debentures of an applicant are beneficially owned by an investment dealer for its own account, this holding will be measured for COR determination purposes in the same way as any other holding of the same size.

If certain conditions are met, common shares held by an investment dealer in its capacity as a registered trader or market maker will be

25. *See* n. 15 at 35-37.

deemed to be Canadian owned for COR measurement purposes. These conditions are that the dealer must provide a certificate from the relevant stock exchange certifying that he is a recognized registered trader or market maker in the applicant's common shares, and in no event may the aggregate of the applicant's common shares that are deemed to be Canadian owned in this manner exceed 0.5% of the common shares then outstanding. Any amount held in excess of 0.5% will be measured by applying the COR of the investment dealer to the holding.

4. *Determination of Canadian Control*

For the purposes of the COR rules, Canadian control will be determined using the rules under the Foreign Investment Review Act[26] and the regulations thereto. Under that Act, a corporation is Canadian controlled unless it is controlled in any manner that results in *de facto* control being held by a non-eligible person or a group of persons any member of which is a non-eligible person. For purposes of the COR rules, a partnership will be deemed to be a corporation of which the beneficial holders of ownership interests in the partnership are shareholders. A limited partnership will be considered as controlled in Canada if its general partner is controlled in Canada. A trust will also be deemed to be a corporation and the persons having a beneficial interest in the trust will be deemed to be the shareholders of the corporation with the trustees being the members of the board of directors.

A corporation that holds a current and valid opinion of the Minister under subsection 4(1) of the Foreign Investment Review Act that it is not a non-eligible person will be deemed to be Canadian controlled for COR purposes. Conversely, should the Minister responsible for the administration of the Foreign Investment Review Act conclude that a person is non-eligible at a time after a determination to the contrary by the PMA, the PMA's decision will be reversed effective from the date the Minister responsible for FIRA so advises.

5. *Administration*

The rules governing the application for a COR certificate are set out in the April 22nd Paper beginning at page 44.

Generally, a COR certificate will be effective as of the date of receipt of the application for the certificate and shall be valid, subject to material variations, for a period of twelve months from the date of receipt of the application. Where the control status of a holder of a COR certificate has changed or where, as a result of a transaction or a series of transactions in which the holder of a certificate has participated either directly or indirectly, its COR decreased by more than one percentage point, it shall forthwith give notice in writing to the PMA which shall issue a revised certificate. The effective date of the revised certificate shall be the date of the material change.

A holder of a certificate may apply for a revised certificate at any time where its COR has increased or it has become Canadian controlled. This revised certificate shall be effective until the expiry date of the certificate previously in effect.

Advance rulings similar to those issued by the Department of National Revenue with respect to income tax matters may be provided by the

26. *Supra* n. 24.

PMA on any matter relating to the interpretation and application of the COR measurement rules.

Normally an application for a COR certificate should include the following information:

(a) Financial statements as of the qualified applicant's latest fiscal year end. These financial statements should be audited where the statements are ordinarily audited. Otherwise the financial statements to be submitted should comply with the presentation standards as set out by the Canadian Institute of Chartered Accountants Handbook.

(b) A confirmation of the details of the share structure of an applicant corporation together with full details of any convertible instruments.

(c) Details with respect to the informal equity of the qualified applicant.

(d) A detailed COR calculation and supporting documentation.

(e) Particulars supporting the determination of control status.

(f) Where the applicant is an individual, the application must include a statement of the citizenship and residence of the individual or his status under the Immigration Act.[27]

A short form application is available for a "small business".

One of the consequences of the issuance of a COR certificate is that the PMA may conduct any audits which it deems necessary to ensure that the information included in an application along with the supporting documentation was accurate, prepared with reasonable diligence and attention and that the best efforts were used to obtain all relevant information.

The Minister of Energy, Mines and Resources is given a great degree of latitude in exercising his discretion with respect to the determination of an applicant's COR. Where the Minister has reasonable grounds to believe that a qualified applicant has entered into an arrangement with any person, or has participated, directly or indirectly, in any transaction in order to circumvent the purpose and intent of the rules respecting the measurement of COR or the determination of control, he may attribute to a qualified applicant the COR or control status that, in his opinion, would have otherwise prevailed in the absence of such arrangements or transactions. Furthermore, where it can be clearly established that the application of the rules respecting the COR measurement or the determination of control produce a result which is manifestly unjust and inequitable, and what would otherwise be an unintended effect, the Minister, in his sole discretion, can either reject the application with or without reason or modify the result as he sees fit.

27. *Supra* n. 16.