

# The 13th Annual Americas School of Mines Basics of Mining Taxation - Canada

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## Life Cycle of a Mine

- Exploration /Evaluation
  - acquisition, permitting, exploration, feasibility, financing
- Development
  - capital development of the mine
- Operation/Production
  - production, refinement, waste treatment, marketing, transport
- Reclamation
  - returning the site to better than original condition

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## Exploration and Development Expenses

Initial exploration & development expenses generally qualify as one of these for tax:

- Canadian Exploration Expense (“CEE”)
- Canadian Development Expense (“CDE”)
- Foreign Resource Expense (“FRE”)
- Canadian Exploration and Development Overhead Expense (“CEDOE”)
- Foreign Exploration and Development Expenses (“FEDE”)

## Canadian Exploration Expense (“CEE”)

- CEE is defined in subsection 66.1(6)
- In general terms, CEE consists of virtually all Canadian exploration and pre-production development expenses including those incurred (from 66.1(6)(f))
  - to determine the **existence, location, extent or quality** of a mineral resource in Canada, including **prospecting, rotary, diamond, percussion or other drilling, geological, geophysical or geochemical surveys, and trenching, test pits, and preliminary sampling;**

## Exploration and Development Expenses

### CEE Cont'd (paragraph (g))

- Incurred before the start of production, to bring a new mine in Canada into commercial production, including the expense of clearing, removing overburden and stripping, sinking a mine shaft, and constructing an adit or other underground entry
- But not including
  - (v) CDE, or
  - (vi) expenses related to an existing mine (that has already reached production in reasonable commercial quantities)

## CEE Considerations

To determine qualification for CEE treatment need to consider

1. When has “production in reasonable commercial quantities” been reached?
  - CRA administrative practice: the first day of the three month period during which the mill operates at 60% capacity
2. Is it a “new mine” or an existing mine?
  - Some guidance based on case law

## New Mine Case Law

In instances where a “new mine” has been opened at or near site of a former or abandoned mine, courts have indicated:

- The word “*mine*” means not “a portion of the earth containing mineral deposits” but rather “*a mining concern taken as a whole, comprising mineral deposits, workings, equipment and machinery capable of producing ore.*”
- “*The interval between cessation of operations by Purdy Mica Mines Limited (the previous operator) and the commencement of those of the appellant the property had lost the character of a mine. What the appellant acquired was not a mine but a derelict and abandoned property which it hoped to develop into a mine.*”

*(North Bay Mica Co. v. Minister of National Revenue (58 DTC 1151))*

- “*Mining itself is completed by the production and hoisting of the ore and one can well conceive of a single mill serving several mines.*”

*(The Minister of National Revenue v. MacLean Mining Co. (70 DTC 6199))*

## Canadian Development Expense (“CDE”)

- CDE is defined in subsection 66.2(5)
- In general terms, CDE includes:
  - The **acquisition costs** of Canadian resource properties; and
  - The **cost of mine shafts and main haulage ways** or similar underground work incurred after coming into commercial production.

## Canadian Exploration and Development Overhead Expense (“CEDOE”)

- CEDOE is a subset of both CEE and CDE
- CEDOE is defined in Regulation 1206
- In general terms CEDOE includes any CEE or CDE in respect of:
  - Administration or management;
  - Maintenance, taxes, insurance or rent for property that is not used “substantially all” for the purpose of exploration or development; or
  - The profit component of certain payments made to a person who is “connected” with the taxpayer (generally a person holding 10% interest or more in the taxpayer).
- These costs can be deducted as operating expenses or added to the CEE/CDE pools

## Foreign Resource Expense (“FRE”)

- FRE is defined in subsection 66.21(1)
- FRE is in effect for taxation years beginning after 2000. Prior to this time the expenses were referred to as “foreign resource and development expense” (“FEDE”).
- In general terms, FRE consists of expenses incurred in acquiring, exploring and developing a foreign resource property owned by a Canadian resident.
- FRE has a separate pool for each country. FEDE expenses were all pooled together (no country segregation).

## Deduction of Resource Pools

- CEE, CDE and FRE are accumulated in pools which are recorded on Schedule 12
- These pools have an indefinite carryforward period
- A taxpayer may deduct the full amount of the cumulative CEE pool in the year to the extent of the company's income from any source (the deduction is optional)
- A taxpayer may deduct up to 30% of the cumulative CDE pool in the year - this is restricted if it's a short taxation year (the deduction is optional)
- CDE can be claimed to create losses; CEE can be claimed to create losses only if the taxpayer is not a principal business corporation
- Proceeds from the sale of Canadian resource property reduce the cumulative CDE balance

## Deduction of Resource Pools

- A taxpayer may deduct the lesser of its foreign resource income from a specific country in a year and 30% of the cumulative FRE pool in respect of that country.
- The taxpayer is also allowed to claim, in aggregate, the lesser of 30% of the cumulative FRE pool for all countries and its foreign resource income from all countries.
- In any event, the taxpayer can claim up to 10% of its total cumulative FRE regardless of the amount of foreign resource income (i.e.: against any source of income). These deductions are optional.
- FEDE can offset foreign income from any country. Allowed to claim 10% against any source of income.
- If any pool balance becomes negative the credit is taken into income

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## Successor Corporation Rules

- Purpose of Successor Rules: (Section 66.7)
- To prevent “loss trading”
- Special rules allowing the transfer of properties along with related resource expenditures
- Result is that you can only use successored pools against properties against which the pools are “streamed”

## Successor Corporation Rules

- What causes resource pools to become successored?
- An acquisition of control (ss. 111(5))
  - The original owner is deemed to be successor owner of property related to the pools
- Transfer of pools (ss. 66.7(7) or (8))
  - The purchaser of a Canadian resource property makes joint successor election with the prior owner of the property

## Successoring on Acquisition of Control

### Example – Part A

- Target Co has two resource properties (Prop A & B) & a CEE pool of \$10 million
- Acquisition Co has one resource property (Prop C) which is operating & profitable; Acquisition Co has no tax pools
- Acquisition Co purchases Target Co for \$10 million & winds-up Target Co
- Result:
- On wind-up Acquisition Co inherits \$10 million CEE pool which is restricted by AOC of Target Co & can only be claimed against income from Prop A & B (i.e., Target Co's former properties)

## Successoring on Acquisition of Control

### Example – Part B

- Same example, except prior to wind-up Target Co transfers Prop A & B to Acquisition Co for \$10 million

### Result:

- Acquisition Co has an unrestricted CDE pool of \$10 million that can be used against income from Prop A, B or C
- You can “unsuccessor” pools if you have a property with value

## Transfer of Pools

Example – Transfer of “all or substantially all” of Canadian resource property (“CRP”)

- Vendor Co has four resource properties (Prop A, B, C & D)
- Vendor Co has Canadian resource pools of \$20 million
- Acquisition Co has one resource property (Prop E) which is operating & profitable; Acquisition Co has no tax pools
- Acquisition Co purchases Prop A, B & C for \$10 million
- Vendor Co & Acquisition Co. make joint successor election pursuant to 66.7(7) or (8)

Result:

- Acquisition Co. gets unrestricted CDE pool of \$10 million for purchase of Prop A, B, & C; joint successor election provides it with undeducted resource pools of Vendor Co. of \$10 million

## Transfer of Pools

### Issues – Transfer of “all or substantially all” of CRP

- Example assumes that Prop A, B & C comprised “all or substantially all” of Vendor Co’s Canadian resource properties
  - Property D retained by Vendor Co
- How do you measure “all or substantially all”?
  - Value? Dollars spent? Quantity?

Successor Rules

## Successor Corporation Rules

### Concluding Thoughts

- Successored pools can be transferred – can have an unlimited number of “predecessor” owners
- Tracking of properties on hand is key
- Very complicated section of the Act – language is hard to follow
- Form T2010 for transfers of property / resource pools
- AOC means automatic successoring of pools
- Successor pools can be unrestricted to the extent that properties have value

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## Flow-Through Shares

- A tax-advantaged investment that helps resource companies access capital markets.
- **Qualifying corporations** issue shares to investors and use proceeds to incur **qualifying expenditures**.
- Flow-through **agreement** determines timing and terms.
- Qualifying expenditures are “**renounced**” to investors who are entitled to deductions (rather than the corporation).

## Qualifying Corporations

Flow-through issuing corporation must be a “**principal business corporation**” (“**PBC**”).

As it relates to mining companies, a PBC is generally one whose principal business is any of, or a combination of, the following:

- Mining or exploring for minerals.
- Processing or marketing of metals or minerals that were recovered from mineral ores.
- A corporation all substantially all of the assets of which are shares of the capital stock or indebtedness of one or more PBCs and that are related to the corporation.

## Qualifying Expenditures

- Qualifying mining exploration generally includes:
  - Grass-roots exploration expenses; and
  - Pre-production expenses to bring a new mine into production.
- Equipment, costs mineral property, and corporate overhead costs are ineligible expenditures.

## Agreement & Timing

- Must have a flow-through agreement between investor and the PBC.
- Generally, unless modified by agreement, the PBC has two years to incur and renounce qualifying expenditures.
- Qualifying expenditures must be incurred on or after date of the flow-through agreement – no warehousing.

## “Renounced” Expenditures: Tax Result

- Corporation forgoes deduction for renounced expenditures.
- Investor entitled to deduction.
- Investor’s flow-through share has no tax cost so deduction is recaptured on sale of share (normally at 50% capital gain rate).
- Investment economics even further enhanced by potential benefit of investment tax credits.

## Some Other Important Points

- Flow-through shares must be economically equivalent to an ordinary common share, with no special conditions attached to it.
- No guarantees against loss from investment permitted.
- Penalty clauses for failure of corporation to properly renounce.
- Compliance aspects must be adhered to.

## The “Look-Back” Rule

- Special rule available for grass-roots exploration expenses.
- Allows corporations to renounce expenses incurred in the following year effective December 31 of a particular year.
- Note – penalty and interest charges payable by corporations to compensate for “early” deduction by investor.

## “Super” Flow-Through Shares

- In 2000, the federal government introduced a temporary 15% investment tax credit to help encourage mining exploration investment and spending.
- Some provinces followed federal lead: BC (20%), Ontario (5%), Saskatchewan (10%), & Manitoba (10%)
- Quebec – 150% super deduction program instead.
- Only individuals (not trusts or corporations).
- Program extended several times. It was reintroduced in 2006 for FTS issued between May 2, 2006 and March 31, 2008. The 2009 Federal budget extended the eligibility for the mineral exploration tax credit to FTS entered into on or before March 31, 2010. The look-back rule can be used to make 2010 expenditures renounced effective December 31, 2009.

## Flow-Through Shares

### “Super” Flow-Through Shares (cont’d)

- Only subset of grass-roots exploration for new mines qualifies as super-flow through (exploration from surface and above + limited bulk sampling).
- Generally, the investors will at least break-even if they sell the shares for  $\frac{1}{2}$  issue price.

## Flow-Through Shares

### Super Flow – Through – BC Example

	<b>BC</b>	
Combined federal/provincial tax rate – 2008	43.70%	
Federal / Provincial tax credit	15%/20%	
Amount of investment	\$1,000	
Less: Tax benefit of deduction of flow-through investment – federal	(290)	
Less: Tax benefit of deduction of flow-through investment – provincial	(147)	
Subtotal	(437)	
Less: 15% non-refundable federal investment tax credit	(120)	
Less: Provincial tax credit	(200)	
Add: Income tax on federal tax credit (taxed in 2009)	52	
Add: Income tax on provincial tax credit (taxed in 2008)	87	
	(618)	
Net cost of \$1,000 investment in flow-through shares	\$382	
Break Even Proceeds	\$488	

## Two Tier Flow-Through Arrangements

- The entity issuing the flow-through share is often not the entity that owns title to the exploration property.
- A parent cannot incur CEE on a subsidiary's property for no consideration (CRA document #9601605).
- Solution 1: Parent company (a PBC) issues flow-through shares intended to finance exploration on property owned by a wholly-owned subsidiary through a “double-tier” renunciation
- Solution 2: Parent “farm-in” on subsidiary's property

## Two Tier Flow-Through Arrangements

- Subsidiary renounces expenditures to Parent; Parent renounces expenditures to investors
- Double-tier renunciations can be done in a look-back scenario. The character of CEE is not retained to the parent for purposes of meeting look-back rules.
- Renunciation from subsidiary to parent cannot be done on a look-back basis (non-arm's length); therefore, subsidiary should renounce monthly to parent in following year when parent is relying on look-back rules in order to minimize the look-back finance charge (i.e., Part XII.6 tax).

## Farm-In by Parent

- See IT-125R for the Canada Revenue Agency administrative positions on farm-ins on unproven properties.
- Farm-in interest can be “unwound” with tax-deferred transfer of interest to subsidiary.

## Importance of New Mine Status

- Qualifying expenditures for the flow-through program are exploration costs related to a **new mine**.
- Can still have a new mine where a mine exists or previously operated on site; for example:
  - Separate underground mines;
  - Open pit mines as separate mines; or
  - Abandoned mines.

## Non-Flow Through Warrants

Warrants are often included as sweeteners to subscribers in flow-through offerings.

- The warrants can be either issued as flow-through or non-flow-through.
- If non-flow-through warrants, the subscription price allocated to the warrants cannot be renounced to flow-through shareholders.

## Non-Flow Through Warrants

### **Example:**

- PBC issues \$100 unit comprising of a flow-through share and a non-flow-through warrant.
- No explicit allocation of the subscription proceeds is made between flow-through share and non-flow-through warrant.
- PBC often assumes that you can renounce \$100 to the flow-through share and that a nil value is implied for the non-flow-through warrant.

## Non-Flow Through Warrants

### Issue:

- CRA could, with 20/20 hindsight, attribute some value to the warrants and reduce the flow-through renunciations accordingly.
- How do you value? Black-Sholes, other?
- Solution is to allocate a negligible amount (\$0.001) to flow-through warrant
- Is a nominal allocation to warrants reasonable?

## Share Issue Costs – Possible Pitfall

- Junior company intends to use flow-through shares to finance exploration, but has limited cash available to cover issuance costs.
- Flow-through share definition requires that PBC covenant to incur CEE and renounce the full amount of flow-through issuance proceeds.
- Solution: Do a separate non-flow-through offering to finance issue costs in order to stay onside of requirements.
- Package of flow-through and non-flow-through shares gives ACB to investor for non-flow-through shares (identical properties – averaging required).
- Premium on flow-through shares.

## Flow-Through Shares

### Issues to look out for:

- New mine status
- Parent renouncing flow through shares on property owned by its subsidiary (must have farm in or back to back agreements)
- “Super” flow through shares are a separate subset of expenditures
- Qualifying expenditures (no overhead allocations, financing costs, careful of environmental or community consultation costs)

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## Tax Credits

- Pre-Production Mining Expenditure Tax Credit
- BC Mining Exploration Tax Credit (BC METC)
- Quebec tax credits

## Pre-Production Mining Tax Credit

- Federal tax credit
- To provide a tax incentive to Canadian corporations incurring pre-production mining expenditure not funded by flow-through shares
- Only available to “taxable Canadian corporations”
- Renewed on an annual basis
- Must be claimed within one year after the filing due date for the particular year

## Tax Credits

### Eligible Expenditures

- Pre-production mining expenditures, which includes grassroots CEE and preproduction development costs (pp. 66.1(6)(f) and (g))
- Minerals eligible for this ITC are included in the definition of “pre-production mining expenditures” in subsection 127(9)

## Tax Credits

### Pre-Production Mining Tax Credit

- Non-refundable tax credit
- Expenditures incurred in:
  - 2003 – 5%
  - 2004 – 7%
  - After 2004 – 10%
- T2 schedule 31 (Part 16)
- 3 year carry back, or 20 year carry forward
- Tax credits received must be deducted from the CEE pool

## Tax Credits

### BC Mining Exploration Tax Credit

- 20% refundable tax credit on “qualified mining exploration expenses”
- Scheduled to expire on December 31, 2016
- Eligible taxpayers may receive a refund for any credit claimed in excess of tax payable
- Additional 10% credit for expenditures within prescribed Mountain Pine Beetle affected areas

## Tax Credits

# BC Mining Exploration Tax Credit

## Who can claim it?

- eligible individuals (e.g.. prospectors),
- corporations, and
- as of April 1, 2003, active members of a partnership conducting grassroots mineral exploration in British Columbia

## Eligibility Requirements for BC METC

- An **individual** must have resided in BC on the last day of the taxation year
- A **corporation** must have maintained a permanent establishment in BC at any time in the taxation year
- Eligible individuals or corporations that are **active members of a partnership** may claim their proportionate share of the partnership's tax credit

## Tax Credits

### Qualified Mining Exploration Expense

- Incurred by a taxpayer after July 31, 1998 and before January 1, 2017
- For the purpose of determining the existence, location, extent or quality of a mineral resource in British Columbia,
- Including any expense incurred in the course of:

#### Prospecting

- Carrying out geological, geophysical or geochemical surveys
- Drilling by rotary, diamond, percussion or other methods, or
- Trenching, digging test pits and preliminary sampling

## Tax Credits

# Qualified Mining Exploration Expense

The expenditure must be

- In respect of goods and services that are all, or substantially all, provided in British Columbia
- Reasonable in the circumstances
- Reduced by the amount of assistance that the taxpayer has received
- Examples in Bulletin CIT 005

## Tax Credits

# Qualified Mining Exploration Expense

The expenditure must **not** be:

- CEDOE
- Related to the cost of purchasing or leasing certain seismic data
- An expense that has been claimed by another person in relation to the BC METC
- Other examples in Bulletin CIT 005

## Applying for the BC METC

- Corporation must complete schedule 421 of T2
- The form must be submitted when filing the federal income tax return
- Application must be filed within 36 months after the end of the taxation year for which the credit is claimed
- Tax credit must be deducted from CEE pool when received

## Tax Credits

### Quebec Tax Credits

- Refundable tax credit between 15% and 38.75% of eligible exploration expenses
- Non-refundable credit in the range of 15% to 30% of eligible expenses may be claimed only up to the amount of income and capital taxes payable for a taxation year
- Maximum total credits of 45% against income tax for eligible expenditures

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## Capital Cost Allowance

- Specific deduction to allow write-off of the cost of capital assets
- Costs are accumulated in “undepreciated capital cost” (“UCC”) pools
- Different rates of deduction for different pools
- Mutually exclusive to exploration and development

## Class 41 Assets

- Only UCC class specific to the mining industry
- Tangible assets used in a mining operation - buildings, equipment, machinery for processing ore
- Different Class 41 subclasses
- Subject to general ½ year-rule and “available for use” rules
- Separate class needed for each individual mine

## Class 41(a)

- Available to allow mining companies to recover large start-up costs
- Buildings and equipment acquired before the commencement of commercial production of a mine or “major expansion” of a mine (defined as where there is a 25% increase in mine capacity)
- Accelerated depreciation available of up to 100%
- Accelerated claim cannot exceed the UCC balance and taxable income from the new mine before the deduction of:
  - Resource allowance (phased out by December 31, 2007)
  - Exploration and development expenses (CEE, CDE, FEDE)
  - Interest expense
- The income from each mine must be calculated on an individual basis

## Capital Cost Allowance

### Class 41 (a.1)

- Expenditures incurred after March 6, 1996 that are in excess of 5% of the gross income from a mine
- Accelerated depreciation available of up to 100%
- Class 41(a.1) accelerated claims must be claimed before Class 41(a) accelerated claims can be used
- Accelerated claims are limited to the income from the mine

## Capital Cost Allowance

### Class 41(b)

- Generally relates to mining buildings and equipment acquired after the commencement of commercial production, although a detailed review of what is included should be reviewed when unsure
- Expenditures do not qualify for accelerated depreciation and therefore are depreciated at 25%

## Roads, Townsite Costs and Related Intangibles

- For costs incurred for public roads, townsites, or related intangibles such as access rights, the taxpayer does not end up with ownership of the assets and so has no property to depreciate
- For property acquired after March 6, 1996, these expenditures are classified as depreciable property unless expensable as temporary access roads to oil and gas wells
- Costs may end up in various classes including Class 10(n) or (p), 15, 17 or 41, depending on the use to which they are related.

## Capital Cost Allowance

### Class 41(a) - Example

UCC = \$100,000

New mine income = \$45,000

- Step 1: Calculate the regular CCA:  $25\% \times \$100,000$ .
- Step 2: Calculate the new mine income after the CCA claim in Step 1:
  - $\$45,000 - \$25,000 = \$20,000$ .
- Step 3: Determine the lesser of the new mine income and UCC:
  - New mine income = \$20,000
  - $UCC = \$100,000 - \$25,000 = \$75,000$
- Step 4: Calculate final CCA claim:  $\$25,000 + \$20,000 = \$45,000$ .

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## Structuring Domestic Resource Ventures

Various structures are used to acquire/hold/operate properties including:

- Partnership
- Joint venture
- Trust
- Royalty interest
- Farm-in

## Partnership

- Generally a partnership is not a taxable entity
- A partnership is a “flow-through” entity – it calculates income for tax purposes as if separate person and then allocates net income out to partners (income retains its character)
- CCA calculated at partnership level as part of partnership income calculation
- Resource expenditures and proceeds from disposition of resource properties (CEE/CDE/FRE) allocated directly to partners and claimed at partner level (excluded from calculation of partnership income)

## Partnership

- Alternative to corporation
- Separate entity for legal purposes
- One less layer of tax – income taxed in partners hands
- No liability protection unless use LLP or LP
- Can provide more flexibility as able to allocate resource expenses and income per partnership agreement as long as the allocation basis is reasonable and not for the purpose of reducing or postponing tax
- Income deferral advantages

## Joint Venture

- Similar to partnership but not recognized as separate entity for legal or tax purposes
- JV is co-ownership of property
- In a partnership, a partner owns an interest in the partnership and partnership holds title to assets. The partner is allocated a share of the partnership's net income.
- In a joint venture, a venturer retains direct ownership of a specific share of assets and liabilities and earns a direct share of revenues and expenses

## Trust

- Separate legal entity
- Considered an individual for income tax purposes
- Income can be taxed in the trust or allocated out to beneficiaries
- Losses can't be allocated out to beneficiaries
- Income does not retain its character on allocation, including resource income
- Unlike partnerships, resource expenditures cannot be allocated to beneficiaries – must be claimed at trust level in calculating trust's income – therefore not generally used for tax shelter

## Royalty Interest

- Royalty interests usually created by
  - Purchase of royalty from property owner; or
  - Retention of royalty on a sale of property.
- Royalty interests are “Canadian resource property” – CDE treatment
- Included in resource profits for income tax

## Farm-In

- Farm-ins are a common method of creating an unincorporated joint venture with respect to a Canadian resource property
- Transfers of assets to unincorporated joint venture is normally done at fair value for tax purposes

## Farm-In

- Based on administrative concession from CRA, qualifying farm-in results are:
- The transferor receives no proceeds of disposition;
- Transferee incurs a cost that is not characterized as property acquisition cost;
- Transferee deemed to incur exploration expenditures
- Must be unproven property
- Not for capital assets

## Farm-In

### Example

- Taxpayer A is the owner of unproven CRP.
- A agrees to let Taxpayer B receive 50% interest in the CRP in exchange for B incurring \$10 million of exploration.
- Result, no credit to A's CCDE pool and B's expenses are CEE not CDE.
- A and B each own 50% of CRP after completion of farm-in.

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Federal Tax

## Canadian Federal Tax

- Federal income tax
- Capital tax phased out
- No mining tax at federal level

## Old Rules – Resource Allowance

- Resource allowance
  - Allowed to compensate when provincial mining taxes were not deductible
  - 25% of resource profits
  - Federal tax rate reductions were not given to the resource industry since they had the resource allowance
  - Deduction often exceeded actual levies although some industries suffered levies in excess of resource allowance
  - No longer applicable – 2003 Budget phased it out over 5 years ending in 2007

## New Rules – Deduction of Mining Taxes

- Deduction for provincial mining taxes
  - Now that resource allowance is phased out, provincial mining taxes are deductible
  - This benefits companies whose provincial levies were historically greater than their resource allowance
  - The federal tax rate reductions now apply to resource income

## Federal Tax Rates

Year	Rate
2007	22.12%
2008	19.5
2009	19.0
2010	18.0
2011	16.5
2012 and beyond	15.0

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## Canadian Provincial Taxes

- Taxes include:
  - Income tax
  - Capital tax
  - Mining tax

## Provincial Taxes

### Provincial Income Tax

- Based on taxable income
- Taxable income not significantly different from federal
- Some differences include:
  - In Ontario, the resource allowance has not been phased out, and is equal to 25% of the Ontario resource profit
  - Ontario allows a 100% deduction of Ontario based CDE

## Provincial Taxes

### Provincial Income Tax Rates

	<b>2009</b>	<b>2010</b>
Alberta	10%	10%
British Columbia	11%	10.5%
Manitoba	12.5%	12%
New Brunswick	12.5%	11.5%
Newfoundland and Labrador	14%	14%
Northwest Territories	11.5%	11.5%
Nova Scotia	16%	16%
Nunavut	12%	12%
Ontario <sup>1</sup>	12%	10.99%
Prince Edward Island	16%	16%
Quebec	11.9%	11.9%
Saskatchewan	12%	12%
Yukon	15%	15%

<sup>1</sup>A 2% reduction in the Ontario rate (applicable to profits from certain activities including mining) is incorporated in the provincial rate shown.

## Ontario Harmonization

- Effective: taxation years ending after December 31, 2008
- Ontario corporate income tax payable is based on federal taxable income.
- Transitional rules introduced to address situations where a corporation suffers a benefit/loss on transition.
- New system of tax credits for mining corporations.

## Ontario Harmonization

- Prior to harmonization, tax attribute balances for ON and federal may differ
- For years ending after 2008: federal tax attributes will be used for Ontario and federal tax calculations
- Where federal tax attributes exceed Ontario - liability payable over a five year period
- Where Ontario attributes exceed federal, create transitional credit (non-refundable tax credit)
- Unused credits expire

## Provincial Capital Tax

- Levied in Manitoba, Nova Scotia, Ontario, and Quebec
- Often is the only tax paid until in production
- Calculated as a percentage of equity and most debts on the year-end balance sheet
- Can deduct eligible investments, which include:
  - Investment in shares
  - Most debts owing from other corporations
  - Undeducted CDE / CEE (in some of the provinces)

## Provincial Mining Tax

- Basic rules
- Two examples:
  - British Columbia
  - Ontario
- Other provincial developments

## Provincial Mining Taxes: The Basic Rules

- Tax on “mine mouth profit”
  - Provincial/territorial calculations vary
  - Levied in all provinces and territories
  - Rates range from 10% to 18%.
- Basic features:
  - Allowance for processing (most provinces/territories).
  - Deduction for E&D and capital costs but not property acquisition costs.
  - Limited carry-overs

## Provincial Mining Tax - BC

- Two part tax
- 2% tax on “net current proceeds”
- 13% tax on “net revenue”
- Net current proceeds tax is a minimum tax – deductible against the net revenue tax
- Pre-production E&D and PP&E deductible:
  - 0% against “net current proceeds”
  - 100% against “net revenue”

## Provincial Mining Tax - BC

- Cumulative expenditure account / New mine allowance
  - The cumulative expenditure account (“CEA”) includes capital outlays and pre-production E&D
  - 13% tax is not payable until the CEA account is nil
  - A new mine allowance provides 133% of qualifying pre-production capital and development expenditures to be added to CEA account
- Investment allowance
  - Calculated using notional interest factor (125% of federal bank rate) that is applied to the unclaimed CEA balance

## Provincial Taxes

# Provincial Mining Tax - BC

- Reclamation costs
  - Non-capital costs are deductible as operating costs
  - Capital costs are added to CEA
  - Contribution to trust fund deductible

## Net Current Proceeds Tax Calculation

### **Gross revenue**

- Value of mineral product sold (including forward sale, but excluding hedging gain or losses); and cost recoveries, government grants and subsidies for current operating costs

### **Less:**

### **Current operating costs**

- Mining, processing, transportation, selling, general and administrative expenses, but not royalties. Includes post-production development costs, but excludes pre-production development and capital costs

### **Less:**

### **Contribution to reclamation funds**

## Net Revenue Tax Calculation

### **Gross operating revenue**

- From Net Current Proceeds calculation

### **Plus:**

### **Gross revenue on account of capital**

- Proceeds on fixed asset sales and recoveries/grants/subsidies on capital assets

### **Less:**

- **CEA account deduction required to bring net revenue to nil (if possible)**

## Provincial Taxes

# Provincial Mining Tax - BC

- Example

### Stage I Tax (net current proceeds)

Revenue	\$3,000	
Less: Operating costs	(1,450)	
Net current proceeds	<u>\$1,550</u>	
Stage 1 tax at 2%	<u>\$31</u>	A

## Provincial Taxes

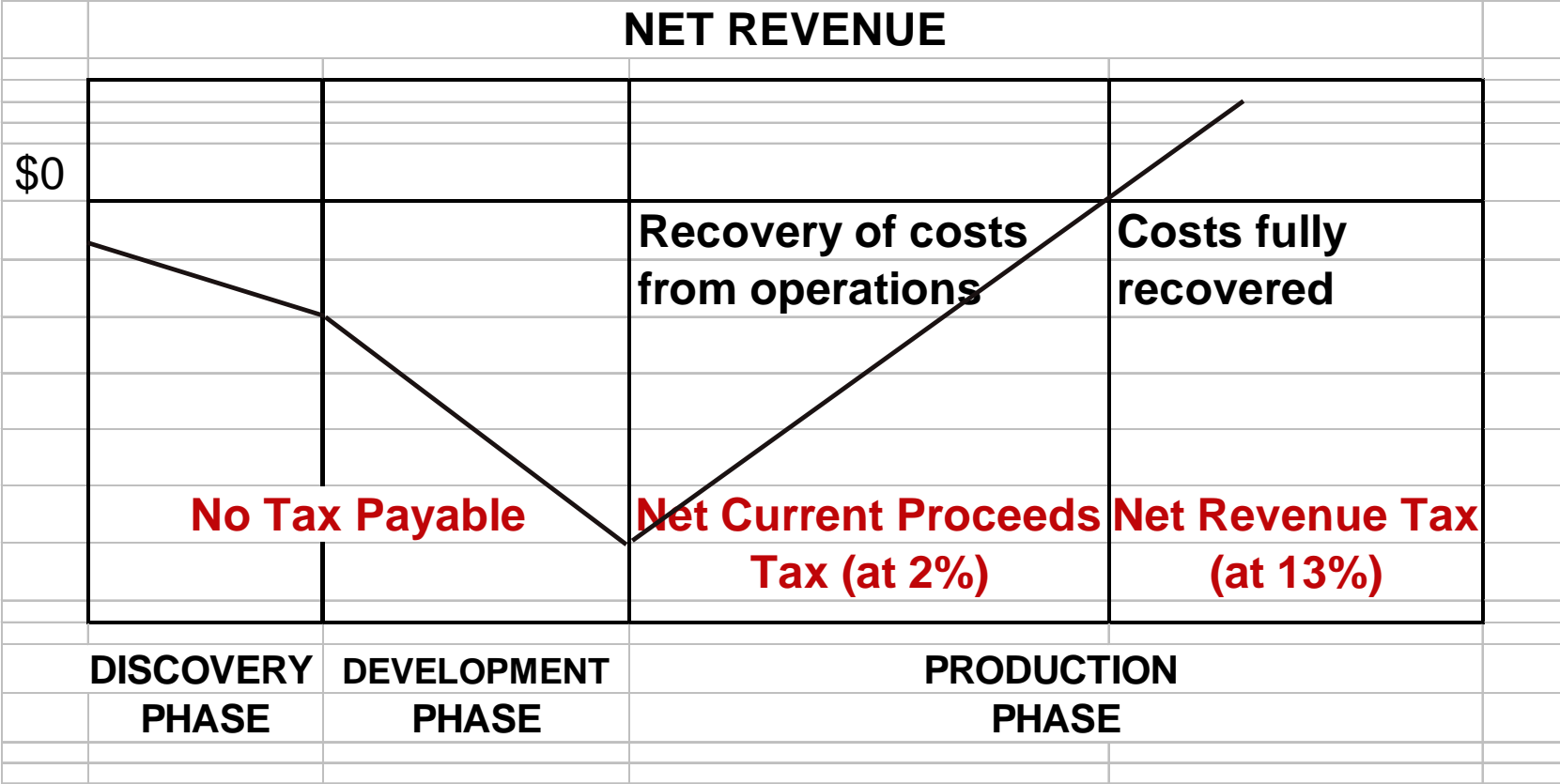
# Provincial Mining Tax - BC

- Example

### Stage II Tax (net revenue)

Revenue	\$3,000		
Less: CEA opening balance (assumed nil)	(-)		
Operating costs	(1,450)		
New equipment and exploration	(150)		
Net revenue	<u>\$1,400</u>		
Stage II tax at 13%	<u>182</u>		
Less: Credit for stage 1 tax	(31)		
Net stage II tax	<u>\$151</u>	B	
Total mineral taxes	<u>\$182</u>	A+B	(13%)

# Provincial Mining Tax - BC



## Provincial Mining Tax - Ontario

- 10% tax on taxable profit in excess of \$500,000.
- Depreciation:
  - 30% on mining assets.
  - 100% up to income from mine if acquired before completion of new mine or major expansion.
  - 15% on processing and transportation assets.
  - 0% on “social” assets.
  - Straight-line calculation.
- Exploration and development deductible in full in year incurred or carried forward indefinitely

## Provincial Taxes

### Ontario

- Processing allowance:
  - 15% of profits minimum.
  - 65% of profits maximum.
  - Rate depends on state to which ore is processed and location of processing:

Extent	Rate
Concentrator	8%
Smelter	12%
Refining	16%
Refining in Northern Ontario	20%

## Provincial Taxes

### Example: Ontario Mining Tax

Revenue	3,000
Operating costs	(1,450)
Exploration	<u>(150)</u>
	1,400
Processing allowance	(210)
Basic exemption	<u>(500)</u>
	<u>690</u>
Tax @ 10%	<u><u>69 (4.9%)</u></u>

## Recent Provincial Developments

- **British Columbia**
  - “Revenue neutral” carbon tax effective July 1, 2008 - \$10/tonne of CO<sub>2</sub> (reaching \$30/tonne July 1, 2012)
  - Harmonized sales tax (HST) effective July 1, 2010 – 12%

## Recent Provincial Developments

- Ontario
  - 2008 Budget - Elimination of Ontario capital taxes for Ontario companies engaged primarily in manufacturing and resource activities retroactive to January 1, 2007 (rather than 2008)
    - Primary test is based on salaries and wages related to manufacturing or resource activities
  - Complete phase out by 2010
  - New 13% royalty on diamonds chargeable on “value of mine’s output”. Commencing March 23, 2007.

## Recent Provincial Developments

- Yukon
  - Old provincial royalty regime was uncompetitive for mid to large size mine operations
  - November 2008: significant changes to Quartz Mining Act
    - Graduated rates, capped at 12%
    - Carryover of capital costs (depreciation and pre-production), ring-fencing, and removal of deduction for income taxes; and
    - Deductions for community economic development expense

## Recent Provincial Developments

- Quebec
  - 150% super-deduction for flow-through investors
  - Capital tax phased out by January 2011; for manufacturing companies – eliminated or reduced for taxation years ending after March 13, 2008
  - Quebec Sales Tax (QST) rate to increase from 7.5% to 8.5% on January 1, 2011

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## Reclamation and Closing Costs

- Costs are deductible only when incurred
  - Losses can be carried back for 3 years
  - Companies with a single mine may not be able to claim expenses in years where they have income if the reclamation takes longer than 3 years

## Reclamation and Closing Costs

- Qualifying Environmental Trusts
  - Must be set up under provincial guidelines
  - Cash funding is required
  - Cash funding can be deducted
  - Resolves deductibility problem but may create cash flow problems
  - Cost to post a letter of credit is significantly less than the cost of capital to fund
  - Rarely used

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Inbound Investment

## Inbound Investment

- Intercompany interest
- Repatriation strategies
- Structuring acquisitions
- Exit strategies

## Thin Capitalization

Interest deduction denied if 2:1 debt/equity ratio is exceeded.

### Debts:

- Owing to certain non-resident shareholders and non-arm's length non-residents.
- Average monthly balances based on the highest amount of debt in every month.

### Equity:

- Retained earnings – beginning of year.
- Average monthly contributed surplus and PUC contributed by a specified non-resident shareholder based on the balances at the beginning of every month.

## Withholding Tax on Interest

- 25% non-treaty rate
- Applies to non-arm's length debt and participating debt (effective January 1, 2008)
- Treaties reduce to 10%-15%

## Inbound Investment

### Withholding Tax: Canada – U.S. Treaty Protocol

Protocol entered into force on December 15, 2008

Withholding tax on interest on non-arm's length debt:

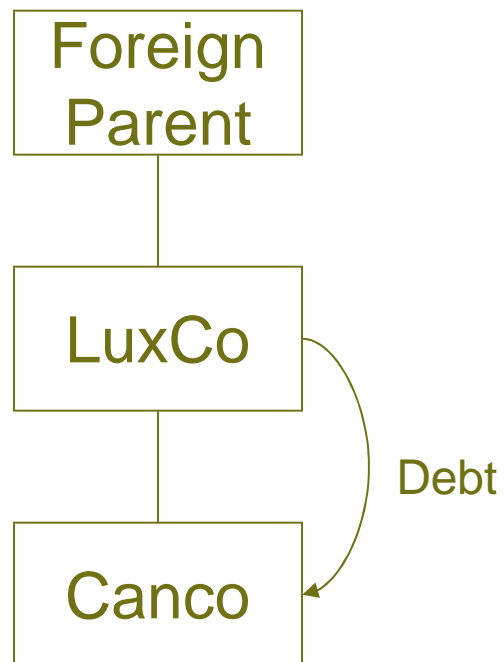
- 2008            7%
- 2009            4%
- Thereafter    0%

Inbound Investment

## Finance Company Structures

- Reduce withholding tax cost
- Reduce home country tax

## Finance Company Example



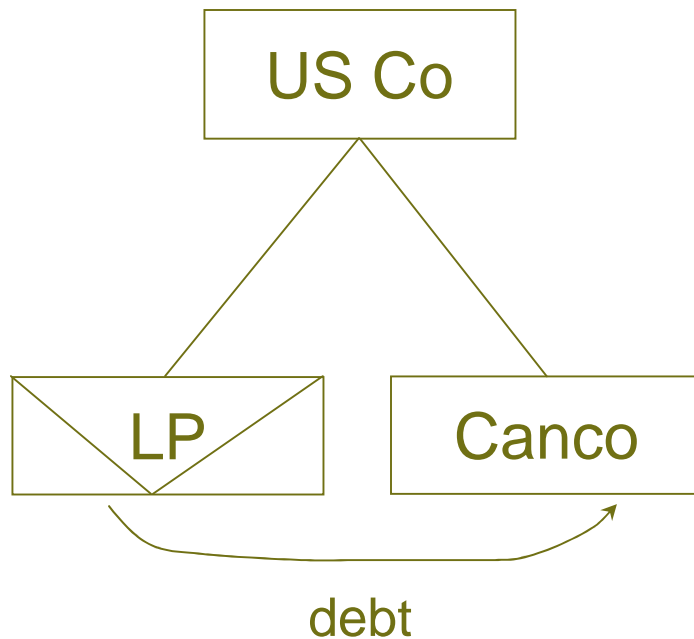
- Interest paid by Canco subject to 10% withholding tax under the Canada-Luxembourg tax treaty.
- Interest taxed in Luxembourg at a low effective tax rate.
- Dividends paid by LuxCo would attract a low, if any, rate of withholding tax.

## Hybrid Entities Under New Canada – U.S. Protocol

- Certain entities deemed to be non-resident under the treaty
- Targets: Structures used for double-dipping
- Applicable in 2010 at the earliest

## Inbound Investment

# Hybrid Entities



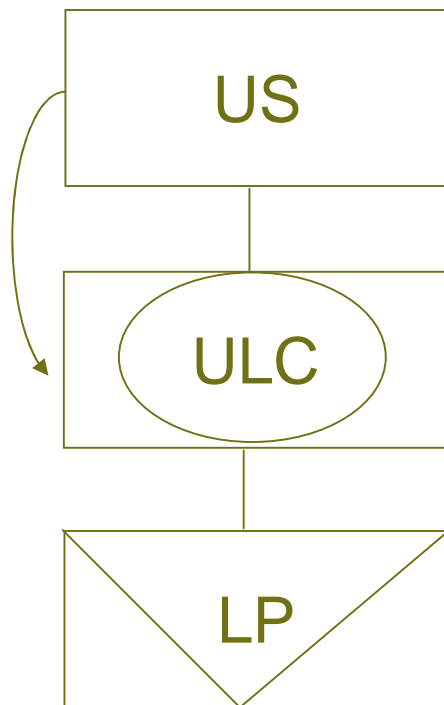
### Current:

- 10% withholding on interest paid to LP (look through to US Co)

### Proposed:

- 25% withholding on interest paid to LP (Article IV(7)(a))

## Hybrid Entities: ULCs under Canada U.S. Protocol



### Currently:

- Payments made by ULC eligible for treaty benefits (interest, royalties, dividends)

### Proposed:

- Not eligible (Article IV(7)(b) deems US parent not to be resident)

Inbound Investment

## Dividend Withholding

- 25% non-treaty rate
- 15% general treaty rate
- 5%-10% treaty rate for corporate shareholders with substantial interest

## Treaty Shopping

- Reduced withholding tax on dividends from Canco under Canada's tax treaties
- 5% withholding tax on dividends under the Canada-Luxembourg and Canada-Netherlands tax treaties
- CRA has stated that it will apply the GAAR where a non-resident company has entered into transactions to obtain a tax exemption or reduction under Canada's tax treaties.
- Tax cases

## Canada – U.S. Treaty Protocol - Article XXIX-A

- The purpose of a Limitation of Benefit (“LOB”) provision is to prevent “treaty shopping”
- The new LOB article is very similar to that in the current treaty
- The most significant change is that the new LOB article is bilateral

Inbound Investment

## Return of Capital

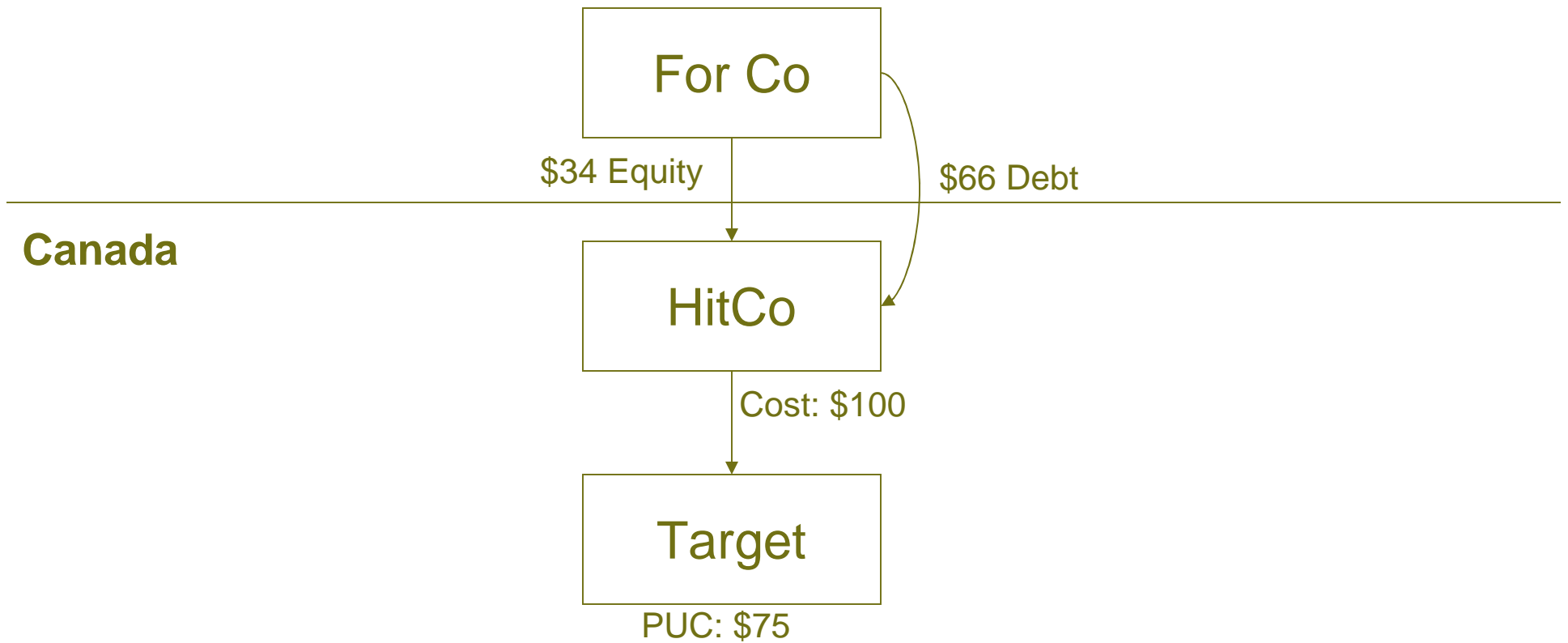
- No withholding
- Share redemption
- Impact on thin capitalization

## Structuring Canadian Acquisitions

- Maximizing PUC is good for both thin cap and repatriation
- Target has \$100 value and \$75 PUC
- Direct acquisition does not step-up PUC
- Use Canadian acquisition company
- 212.1 applies if set up later

Inbound Investment

# Canadian Acquisition Company



## Canadian Acquisition Company

- Thin capitalization
- Repatriation
- Interest expense in wrong company
- Amalgamate HitCo and Target so interest is in Target (operating company).

## Exit Strategy

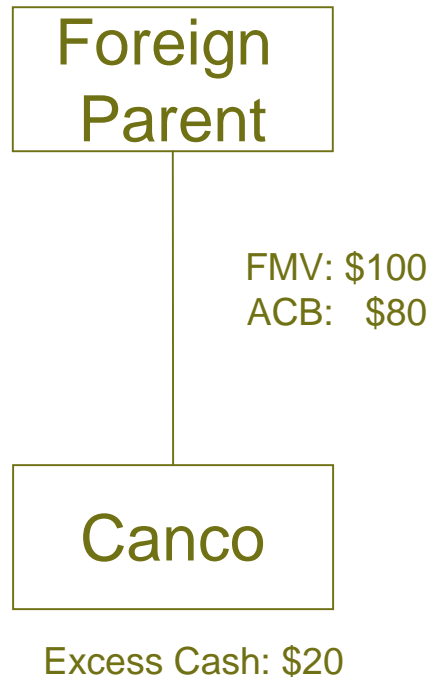
- Sale of Canco
- Canada taxes a non-resident's gain on Taxable Canadian Property.
  - Includes:
    - Shares of private company
    - Shares of public company if own at least 25%
    - Shares of foreign companies if more than 50% of value derived from Canadian real property

Inbound Investment

## Treaty Protection

- Capital gains taxed in country of residence unless derived from Canadian real property.

## Reduction of Capital Gain



Foreign Parent realizes capital gain of \$20 on sale, 50% of which is taxable in Canada at about 34% (shares of Canco are TCP).

If a tax treaty does not apply to eliminate the Canadian tax on the sale, an intermediary step may be considered:

- Canco pays a dividend of \$20 to Foreign Parent prior to the sale.
- The FMV of the shares of Canco decreases from \$100 to \$80.
- Foreign Parent sells Canco without realizing a capital gain (FMV of \$80 less ACB of \$80).
- Tax savings of \$2.4 [ $\$20 \times (17\% - 5\%)$  assuming 5% withholding].

GAAR should not, in the right circumstances, be successfully applied by the CRA.

## Converting TCP

- Stock exchange listing
- 5 year look back for 25% rule
- Share for share exchange
- Deemed TCP
- Treaty protection based on assets of acquirer

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## Foreign Affiliate Issues – An Overview

- Definition of “foreign affiliate” and “controlled foreign affiliate”
- Section 17
- Foreign accrual property income (FAPI)
- Repatriations – surplus accounts
- Capital dispositions by foreign affiliates
- Corporate residency

## Definition of “Foreign Affiliate”

- Subsection 95(1)
- Corporation not resident in Canada
- Equity percentage ownership not less than 1%
- Total equity percentage with related parties of not less than 10%

## Definitions of “Controlled Foreign Affiliate”

- Subsection 95(1)
- A foreign affiliate controlled by the taxpayer, or would be controlled by the taxpayer if the taxpayer owned all the shares owned by:
  - The taxpayer
  - Persons NAL to the taxpayer
  - Four or less Canadian resident shareholders other than the taxpayer or those NAL to the taxpayer
  - Persons who are NAL to the group of four or less Canadian resident shareholders

## Section 17 – Overview

- Provision designed at to prevent Canadian corporations from employing capital outside of Canada by way of non- or low interest bearing loans, thereby avoiding Canadian tax on the income derived from that capital
- Deemed interest income
- Exception for loans to controlled foreign affiliates used in active business
- Other exceptions

## Outbound Investment

### Subsection 17(1)

- Deemed interest benefit if:
  - Amount owing by a non-resident person to a Canadian corporation
  - Remains outstanding for more than one year
  - No reasonable rate of interest
- Interest is computed at the prescribed rate of interest
- Deductions may be granted in respect of interest actually received

## Exceptions to subsection 17(1)

- Subsection 17(8)
  - Loan to a controlled foreign affiliate
  - Used by the CFA to gain or produce income from an active business
  - Or to make a loan to another CFAS and the interest income on the loan is not FAPI
- Subsection 17(7)
  - Where Part XIII tax is paid (non-resident withholding tax)
- Subsection 17(9)
  - Transactions between unrelated parties on sales of goods and services (trade receivables)

## Subsection 17(2) pitfall

- Subsection 17(2) is an anti-avoidance provision
- Applies where it is reasonable to conclude that the non-resident debtor owes an amount to the creditor because the corporation in Canada lent to the creditor either directly or indirectly
- Subsection 17(3) - exception to 17(2)
  - If both non-resident entities are CFAs
  - The debtor and the creditor meet certain arm's length conditions

## FAPI – An Overview

- The foreign accrual property income (“FAPI”) rules are anti-deferral provisions that subject Canadian taxpayers to current tax on FAPI earned indirectly through a controlled foreign affiliate, regardless of whether the income is repatriated to Canada (FAPI taxed on an accrual basis vs. exempt/taxable surplus taxed on received basis)
- An offsetting deduction is granted that is an effective tax credit for any foreign taxes paid on the FAPI

## Definition of FAPI

- Subsection 95(1)
- An aggregate of:
  - Income from property
  - Income from business other than an active business
  - Taxable capital gains (other than on dispositions of excluded property)
  - Active business income from a non-qualifying country (non-treaty/no TIEA) will be FAPI (effective 2009).

## FAPI – Foreign accrual tax deduction

- Subsection 91(1)
- Include FAPI in income
- Subsection 91(4)
- Deduction available equal to the foreign accrual tax multiplied by the relevant tax factor

## FAPI – Definition of active business income

- Subsection 95(1)
- Income from any business other than:
  - an investment business
  - a business deemed to be a business other than an active business
- Income that pertains to or is incident to active business
- Income deemed to be active business income by virtue of paragraph 95(2)(a)

## FAPI – Subsection 95(2)(a) Exception

- Deems income from property to be active business income
- If the income is reasonably considered directly related to the active business of a related non-resident and would be included in active business income of the other corporation if earned by it
- Only applies if the Canadian corporation has a qualifying interest in the CFA
  - 10% or more of votes and value throughout the year

## Repatriations – An Overview

- Rules regarding repatriations are designed to provide relief from double taxation
- Relevant to corporate shareholders receiving dividends from foreign affiliates
- Two basic surplus accounts
  - Exempt surplus
  - Taxable surplus
- Tax treatment differs between the two

## Repatriations – Exempt Surplus

- Paragraph 113(1)(a)
- Dividends from exempt surplus dividends are entirely exempt from Canadian tax
- Regulation 5907

## Repatriations – Exempt Surplus (cont'd)

- Exempt surplus consists of:
  - Active business income that is earned by a foreign affiliate that is resident in, and carrying on business in, a designated treaty country
  - Dividends from taxable Canadian corporations
  - Non-taxable portion of capital gains
  - Some taxable capital gains (see slide #24)
  - Exempt surplus dividends received from another foreign affiliate

## Repatriations – Taxable surplus

- Paragraphs 113(1)(b) and (c)
- Dividends from taxable surplus are taxable and are subject to an effective tax credit for any foreign tax paid on the income generating the dividends
- Regulation 5907

## Repatriations – Taxable surplus (cont'd)

- Taxable surplus consists of:
  - Active business income earned by a foreign affiliate that is resident in, and carrying on business in, a country other than a designated treaty country
  - Some taxable capital gains (see slide #24)
  - Taxable surplus dividends received from another foreign affiliate
  - Income that has been taxed as FAPI
  - If country with TIEA will be treated as exempt surplus

## Repatriations – Pre-Acquisition Surplus

- Dividends from pre-acquisition surplus are deductible
- Canco's ACB of the FA reduced by the amount of the pre-acquisition surplus dividend net of any withholding taxes paid
- If the ACB becomes negative, Canco realizes a capital gain

## Recharacterization of Income

- If FA carries on an investment business, the income is deemed to be property income
- Some types of property income deemed active
- E.g. If Finance Co lends to Opco, the interest income can be deemed active

## Business Other Than Active Business

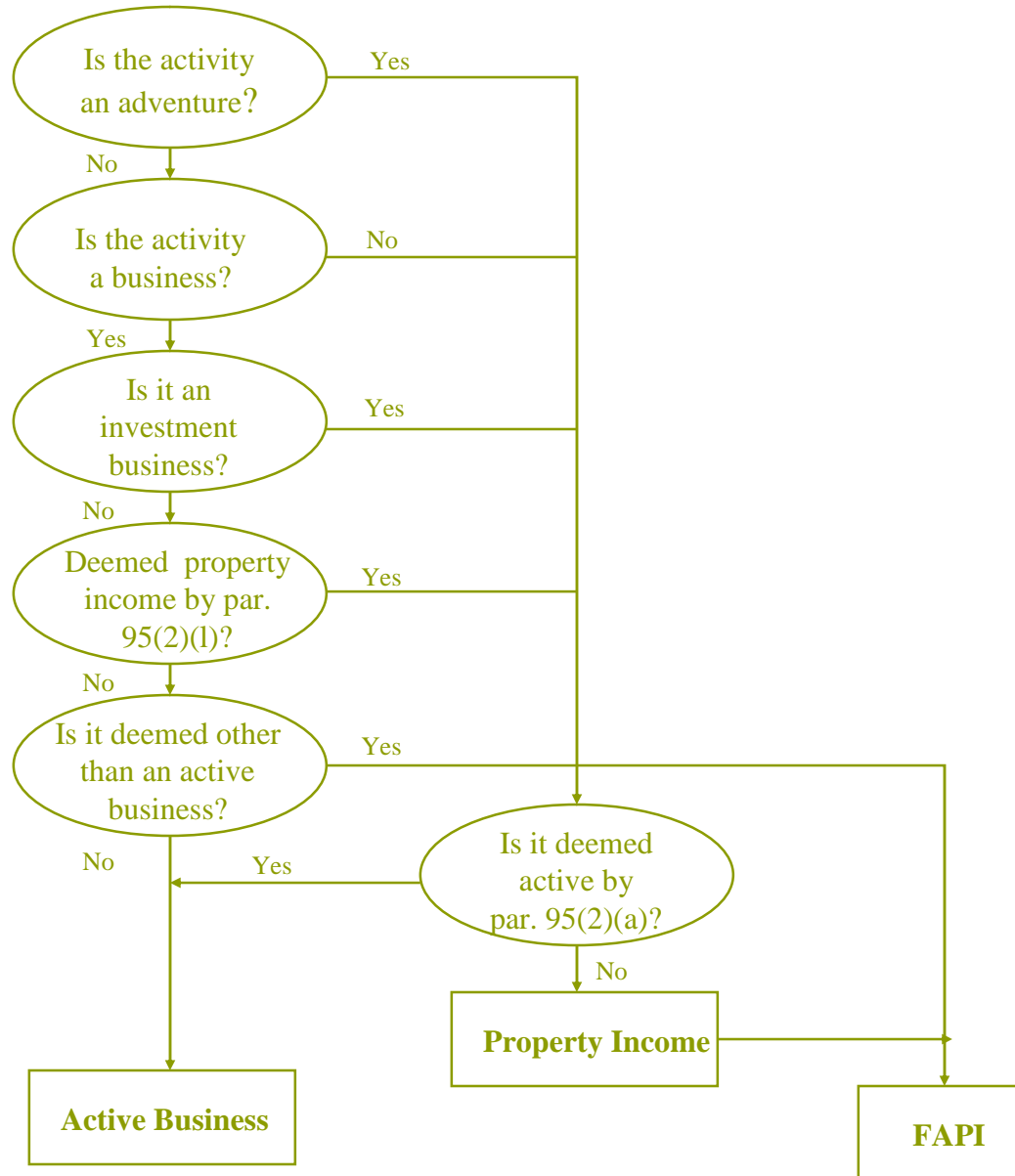
The income of a FA from an active business may be recharacterized as income from a business other than an active business, in which case it will always be included in FAPI.

E.g.

- sale of property
- insurance of Canadian risks
- income from Canadian debt and lease obligations
- provision of certain services

## Outbound Investment

# Income Characterization



## Hedging Income

- The income of a FA from commodities hedging should not be included in FAPI:
- Futures/options re commodities that are manufactured, produced, extracted or processed by the FA or a related person are not investment properties;
- The FA should not be viewed as earning income from a business the principal purpose of which is to earn profits from the disposition of investment property.

## Hedging Income (cont'd)

The income of a FA from a currency hedging business could be FAPI:

- Currencies are investment properties;
- The FA could be viewed as earning income from a business the principal purpose of which is to earn profits from the disposition of investment property; unless
- The income is incidental to the active business operations of the FA;  
or
- The income is directly related to the active business operations of a related company and can be recharacterized as income from an active business under 95(2)(a)(i).

## Order of Distributions

- A dividend is first deemed paid by FA from exempt surplus to the extent of its exempt surplus at that time;
- The remaining portion of the dividend up to the taxable surplus of the FA at that time is deemed to have been paid from taxable surplus;
- Any remaining portion of the dividend is deemed to have been paid from “pre-acquisition surplus”; and
- Inclusion of current year earnings in surplus – 90 day rule.

## Capital dispositions by FAs – An Overview

- Capital gains and losses incurred by foreign affiliates
- Whether or not the asset that is disposed of is “excluded property” determines whether the gain is
  - FAPI
  - Exempt surplus
  - Taxable surplus

## Definition of “excluded property”

- Subsection 95(1)
- Property held by the foreign affiliate for the purpose of earning income from active business carried on by the foreign affiliate
- Shares of another foreign affiliate where all or substantially all of the fair market value of the other foreign affiliate’s property is attributable to excluded property
- Debt receivable from another foreign affiliate if actual or deemed interest on the debt is active business by virtue of paragraph 95(2)(a)

## Capital dispositions – surplus accounts

- Exempt surplus includes:
  - Non taxable portion of capital gains
  - Taxable portion of capital gains on disposition of excluded property that is an active business asset in a designated treaty country

## Capital dispositions – surplus accounts (cont'd)

- Taxable surplus includes:
  - Taxable portion of capital gains on disposition of excluded property that is an active business asset in a non-designated treaty country
  - Taxable portion of capital gains on dispositions of excluded property that are not active business assets (e.g.: shares, partnership interests)
  - Taxable portion of gains taxed as FAPI

## Disposition of Foreign Resource Properties

- Where a foreign affiliate that is an exploration company realizes a gain on the disposition of a foreign resource property (investment property), such gain will be investment business income unless:
  - i) The principal purpose of the business was not to earn profits from the disposition of investment property (e.g., where the exploration company planned on bringing the property into production); or
  - ii) The disposition occurred as part of a business which is excluded as an investment business.

## Disposition of Foreign Resource Properties (cont'd)

- Where a FA realizes a gain on the disposition of shares of an exploration company, the taxable portion of the gain will be included in FAPI if the shares of the exploration company are not excluded property. This will be the case where the exploration company was carrying on an investment business and could not satisfy requirement (i) or (ii) above.

## Corporate residency – An Overview

- Subsection 2(1)
- Canadian resident corporations pay Canadian tax on their worldwide income
- Subsection 2(3)
- Non-resident corporations are taxed only on their Canadian sourced income
- Is what seems to be a foreign affiliate actually a Canadian corporation?

## Corporate residency – statutory provisions

- Paragraph 250(4)(a)
- Any corporation incorporated in Canada after April 26, 1965 is deemed to be a Canadian resident
- Subsection 250(5)
- A corporation which is deemed not to be a Canadian resident for the purposes of an applicable tax treaty is deemed not to be resident in Canada for all purposes of the Act
- Concern especially in regard to corporations incorporated in countries where there is no treaty with Canada

## Corporate residency – location of management

- In the absence of statutory or treaty provisions, residency is determined by common law
- Residence of the board of directors
- Location of directors' meetings
- Location and manner of overall policy and decision making
- Daily decision making

## Offshore Holding Company

### Advantages

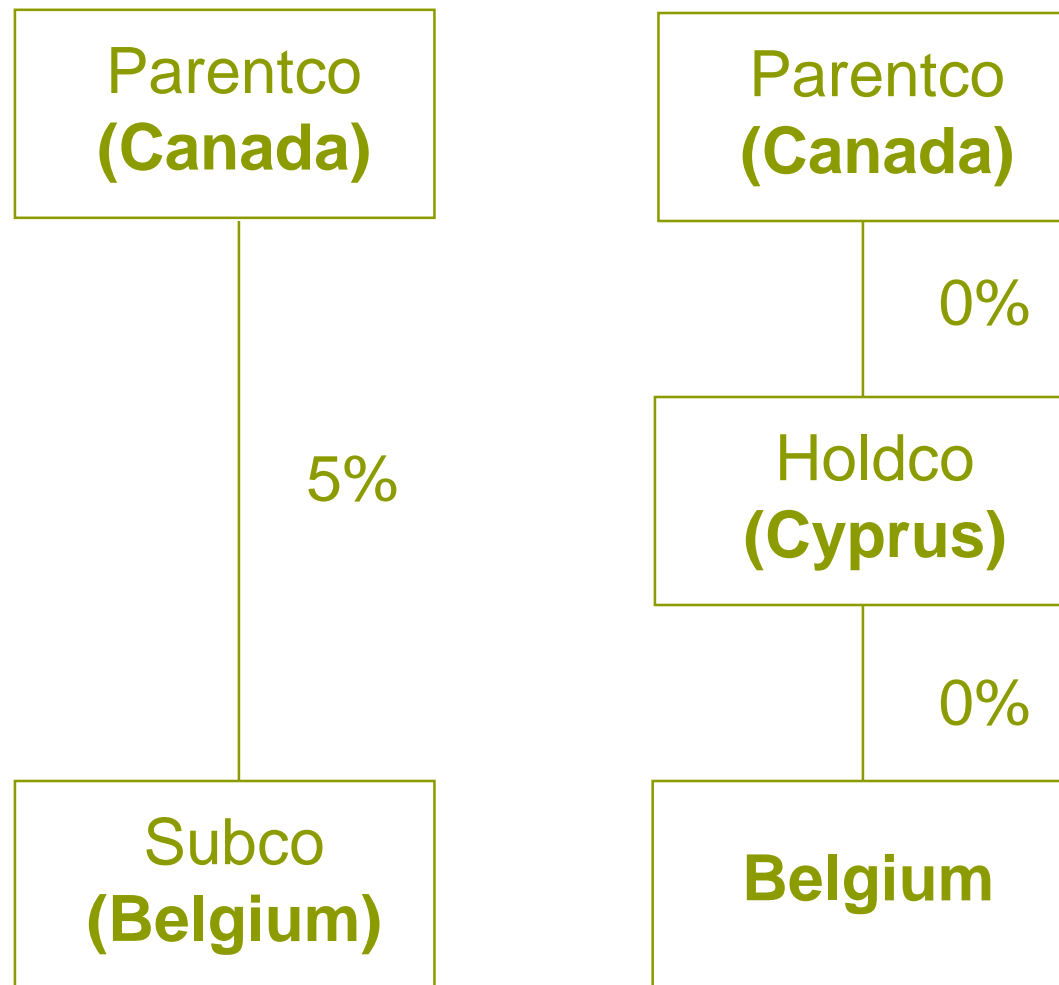
- Reduced rate of withholding
- Potential tax deferral
  - Capital gains
  - Dividends
- Mixer company

### Potential Tax Disadvantages

- Adds administrative costs
- Adds complexity
- Subsection 95(6) – anti-avoidance rule

## Outbound Investment

### Reduced Rate of Withholding



## Tax Deferral on Capital Gains



Parentco taxed in Canada on the sale of FA if held directly by Parentco.

Tax deferral possible if Holdco sells the shares of FA:

- Non-taxable portion of the capital gain added to the exempt surplus of For Holdco.
- Taxable portion of the capital gain added to the taxable surplus of For Holdco.
- Income or profits taxes paid by For Holdco in respect of the taxable portion of the capital gain would be added to the UFT account of For Holdco.
- No FAPI if the shares of FA are excluded property.
- Parentco pays tax in Canada only on the receipt of taxable dividends from For Holdco.

## Tax Deferral on Low Taxed Taxable Surplus

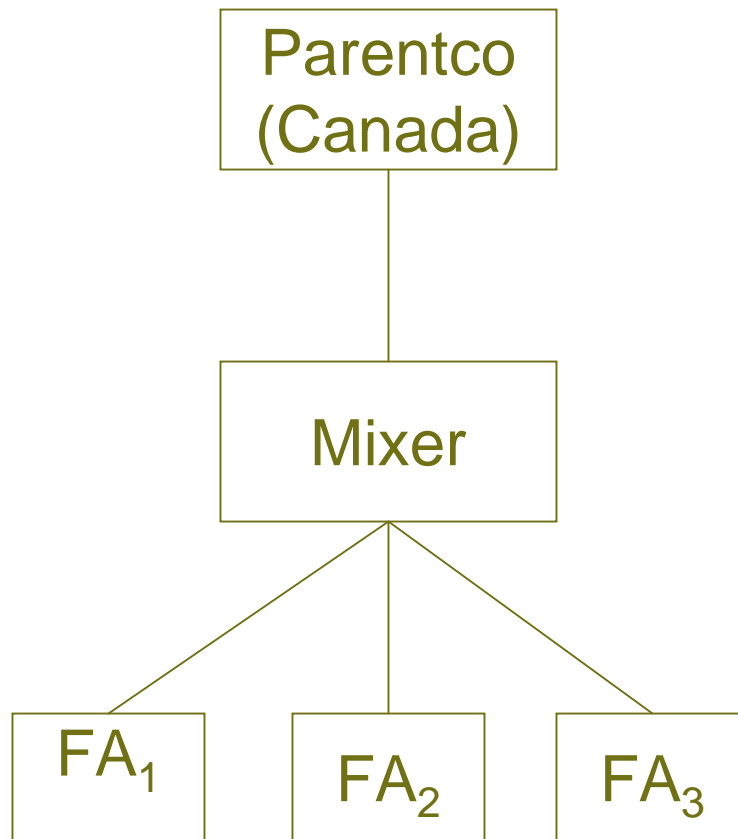


Taxable surplus dividends from FA received by Parentco (if FA held directly) could be taxable if the UFT of FA insufficient to fully reduce the income inclusion.

Taxable surplus dividends from FA received by For Holdco would not result in immediate Canadian taxation provided the funds are reinvested by For Holdco.

## Outbound Investment

### Mixer Company



If  $FA_1$  tax rate < Canadian rates,  
Parentco taxable on dividends from  
taxable surplus of  $FA_1$ .

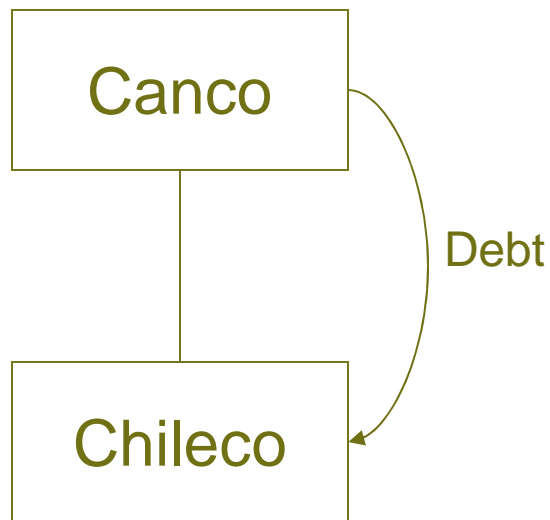
If  $FA_2$  tax rate > Canadian rates,  
Parentco not taxable but excess UFT.

Mixer receives taxable surplus  
dividends from  $FA_1$ ,  $FA_2$  and  $FA_3$ .

UFT account of the Mixer includes the  
income or profits taxes paid by  $FA_1$ ,  
 $FA_2$  and  $FA_3$ .

When Parentco receives a taxable  
surplus dividend from Mixer, it can  
claim a higher UFT deduction than it  
would if it received the taxable surplus  
dividends directly from  $FA_1$ ,  $FA_2$  and  
 $FA_3$ .

## Financing Foreign Operations



The interest paid by Chileco to Canco reduces income subject to 17% Chilean tax plus 18% distribution tax.

The interest paid by Chileco would ordinarily be subject to a domestic withholding tax rate of 35%. This rate of withholding is reduced to 15% under the Canada-Chile tax treaty.

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