A taxing regime that's worth the effort

Canadian and Québec schemes are among the most competitive in the world

BY EMMANUEL SALA AND JEAN MARC GAGNON

THE Québec tax system is one of the most generous, offering refundable tax credits of up to 38.75% in some cases, accelerated depreciation measures for certain mining assets and a preferential treatment for some exploration and development costs. As well as a flow-through share regime that may provide Québec investors with a tax deduction of up to 150% of the share acquisition cost and a provincial regime of mining royalty determined by profit rather than tonnage or revenues.

Against the backdrop of the recent launch of Plan Nord, a large development project that seeks to take advantage of the substantial mining potential of Québec, the tax measures affecting directly or indirectly the mining industry announced in the 2012 federal and Québec budgets are noteworthy.

Most of the proposed tax measures in the federal budget, such as measures targeting the benefits granted by the use of partnerships and those relating to cross-border financing, apply to all taxpayers evolving in all economic sectors, including in the mining sector.

The current federal rules limit the deductibility of interests that a Canadian resident corporation incurs on its cross-border debt to non-residents of Canada who are significant shareholders (holding more than 10% of a class of shares) or are not dealing at arm's length with such shareholders.

The federal budget increases the severity of such rules on many counts. From now on, the interest paid or payable on the part of the debt in excess of a ratio of total borrowed capital/total shareholders equity of 1.5:1 (formerly 2:1) will not be deductible in calculating a corporation's revenue.

Thus, such rules compel non-residents, which incorporate companies pursuant to Canadian or a provincial legislation to develop mining projects in Canada, to grant such corporations 40% of the financing in the form of shareholders' equity rather than debt.

Interests deemed non-deductible will be treated as dividends so that, for example, they will not be eligible to the tax withholding exemption afforded to an arm's length lender pursuant to the federal tax law nor to the tax withholding exemption afforded to a related lender under the Canada-US Tax Treaty. Moreover, pursuant to such new measures, for purposes of the thin capitalisation rules, a corporation that is a resident of Canada and member of a partnership that incurred a debt will be allocated a pro rata share of such debt.

Certain tax benefits related to the use of partnerships to operate mining businesses are thus somewhat affected by the 2012 federal budget, particularly as it is anticipated that the historically favourable rules of grossing-up the cost of their interests upon mergers or acquisitions will be harmonized with the more restrictive gross-up rules applicable to corporations.

Given these announced changes, the existing trans-border structures and future acquisition and investment transactions in which Canadian members of a multinational mining group take part will have to be re-examined.

TAX CREDIT

As for tax incentives, the 2012 federal budget will have some consequences on the Canadian scientific research and experimental development programme (SR&ED), including a deduction and tax-credit scheme for certain current and capital expenses.

Firstly, the 20% rate of the investment tax credit applicable to companies that are not eligible 'Canadian-controlled private corporations' (CCPC), will be reduced to 15%. The 35% rate applicable to eligible CCPC will be left unchanged. Secondly, capital expenses that formerly would have been expenses eligible to the Canadian SR&ED programme will henceforth be subject to the usual treatment afforded to capital expenses.

Thirdly, when a taxpayer will pay to an arm's length party an amount that is an eligible expense, only 80% of that amount will be included in the qualified expenditure pool of the taxpayer and so be eligible for the above-mentioned investment tax credit.

The 2012 federal budget also proposes phasing out the 10% tax credit that "taxable Canadian corporations" may claim as "pre-production mining expenditures". In this regard, the tax credit for basic 'grassroots' exploration expenses will be eliminated more rapidly – by 2014 – whereas the credit for pre-production development expenses will be eliminated by 2016.

Some of the measures proposed in the 2012 federal budget limit the benefits of the use of partnerships in the mining industry, restrict the flexibility of cross-border financing and have a negative impact on certain tax incentives. However, mining companies in the Province of Québec will nonetheless continue to pay little, if any, federal and provincial taxes until all capital costs have been recovered.

In this respect, the 2012 Québec budget offers various measures that continue to support the competitiveness of the mining industry. The much appreciated refundable tax credit for resources and the investment tax credit are also addressed in the 2012-2013 budget.

From now on, an investor will have to transfer to Ressources Québec an option to acquire an interest in the operation of its development project if it wishes to maximise the amount of the refundable tax credit for resources. Ressources Québec is a new governmental entity whose main role is to create more partnerships with private corporations in the mining industry.

For example, the refundable tax credit for some eligible resource expenses may reach 38.75% for companies that do not operate any mineral resource with government equity participation – it is 28.75% without government equity participation. The tax assistance for processing mineral resources will be enhanced until December 31, 2017, as property used for smelting, refining or hydrometallurgy of minerals other than gold or silver, will be included in the property eligible for an investment tax credit

While the federal and Québec tax regimes applicable to mining companies are highly complex and one must take into account the difficulties stemming from the Canadian bijuralism, these regimes nonetheless remain very advantageous to corporations taking advantage of them.

Jean Marc Gagnon, partner, and Emmanuel Sala, associate, Blakes Tax Group, Montréal Office