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Highlights

What is a Canadian Exploration Expense?

Brian R. Carr, *Thorsteinssons LLP*

Following recent amendments to the definition of "Canadian exploration expense" ("CEE") in subsection 66.1(6) of the Act, the CRA has issued updated guidelines for determining whether certain expenses qualify as CEE. Brian Carr evaluates the CRA's current position regarding which types of costs constitute CEE and concludes that the CRA's guidelines fail to consider the practical realities of the mining industry and take too much of a bright-line approach to the determination of whether an activity constitutes "exploration" as opposed to "development."

Enactment of the Multilateral Instrument in Canada

Julie D'Avignon and Kevin Guenther, *Stikeman Elliott LLP*

Bill C-82, An Act to implement a multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting, received Royal Assent in Canada on June 21, 2019, and was deposited with the Organisation for Economic Co-operation and Development (the "OECD") on August 29, 2019. With the deposit of the notice of ratification, 84 of Canada's bilateral treaties are now eligible to be covered by the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "MLI"). Developed by the OECD to assist contracting jurisdictions to implement base erosion and profit shifting measures in a coordinated manner, with a focus on addressing perceived treaty abuse. Julie D'Avignon and Kevin Guenther discuss the implementation of the MLI in Canada, the mandatory and optional provisions of the MLI and the principal purpose test.

BC Mineral Tax Update

Randy Morphy and Rob Biggar, *Borden Ladner Gervais LLP*

Two decisions concerning the Mineral Tax Act (British Columbia) ("MTA") were released in 2018. Although neither outcome was surprising, the decisions are noteworthy because MTA cases are relatively uncommon. Randy Morphy and Rob Biggar summarize these cases and conclude that mine operators can take comfort that the Courts will interpret the MTA with common sense and with regard to the plain wording of the relevant provisions.

What is a Canadian Exploration Expense? *

Brian R. Carr, ***Thorsteinssons LLP***

Introduction

The Canada Revenue Agency ("**CRA**") recently issued updated guidelines (the "**2019 Guidelines**")[1] for determining whether an expense qualifies as a Canadian exploration expense ("**CEE**") pursuant to paragraph (f) of the definition of "Canadian exploration expense" in subsection 66.1(6) of the *Income Tax Act* (Canada).[2] The 2019 Guidelines update the guidelines issued in 2007[3] and 2017.[4]

The 2019 Guidelines reflect the amendment to paragraph (f) of the definition of CEE[5] to provide that the costs of environmental studies and community consultation are CEE provided that such costs are for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada. Such costs include costs undertaken to obtain a right, license or privilege for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada. This amendment removed the prior exclusion of these expenses on the basis that each such expense was a Canadian development expense ("CDE").[6]

Many of the positions taken by the CRA in the 2019 Guidelines are obvious and by no means controversial. However, there are several positions that are not supported by the current language of paragraph (f) or rely on an interpretation of the paragraph that is problematic and that is not consistent with a unified, textual, contextual and purposive interpretation of the Act. Moreover, in many instances, the CRA in the 2019 Guidelines treats the relevant expenses as if they were incurred in a vacuum and not as part of a broader commercial endeavour.

Before proceeding to an analysis of the CRA's position in the 2019 Guidelines, it is necessary to address briefly the question of *why* the categorization of the expenses matters. This is not always obvious.

In some instances, the CRA takes the position that an expense may be a (CDE), (ii) the cost of a capital asset, or (iii) as eligible capital property ("**ECE**")[7] and not CEE. The consequence of categorizing an expense as one of these types of expenses, and not as CEE, is that a taxpayer may deduct expenses belonging to each of those categories of expenses at a slower rate than the rate at which a taxpayer may be able to deduct CEE.[8]

In some cases, the CRA takes the position that an expense is deductible in accordance with section 9 and not a CEE. At first blush, this difference is not important since a taxpayer can deduct such expense in the year incurred. If the taxpayer claims a deduction in respect of an expense pursuant to section 9, the taxpayer will be in a similar position as if the taxpayer had deducted the expense as CEE.[9] However, a corporation is entitled to renounce CEE pursuant to the flow-through share rules[10] whereas the taxpayer cannot renounce a current expense. The ability to renounce may be very significant to a corporate taxpayer, particularly corporate taxpayers in the junior mining sector that rely on issuing flow-through shares as a means of financing exploration activities. In addition, the entitlement to provincial mineral exploration tax credits can depend on statutory language that is virtually identical to that found in paragraph (f) of the definition of CEE.[11]

Basis of CRA's Position

To understand the CRA's position in the 2019 Guidelines, it is essential to understand the CRA's approach to what constitutes CEE.

Paragraph (f) provides that a CEE includes any expense incurred for the purpose of determining the existence, location, extent or quality of a mineral resource. A mineral resource is defined in subsection 248(1) as follows:

> "mineral resource" means:
> a) a base or precious metal deposit,
> b) a coal deposit,
> c) a bituminous sands deposit or an oil shale deposit, or
> d) a mineral deposit in respect of which
> (i) the Minister of Natural Resources has certified that the principal mineral extracted is an industrial mineral contained in a non-bedded deposit,
> (ii) the principal mineral extracted is ammonite gemstone, calcium chloride, diamond, gypsum, halite, kaolin or sylvite, or
> (iii) the principal mineral extracted is silica that is extracted from sandstone or quartzite;

Those in the mining industry are very much guided by the concept that it is necessary to bring mineralization into commercial production; the discovery of mineralization is of no value unless the mineralization so discovered can be extracted and sold at a profit. Moreover, a person exploring for and developing mineralization will not incur an expense unless that expense is ultimately directly or indirectly[12] for the purpose of extracting minerals at a profit. This economic reality has been recognized in the jurisprudence for many years. In *Johnson's Asbestos Corp. v. Minister of National Revenue*,[13] the Court described mineral exploration as: "testing for the existence and the extent of an ore body and […] 'ore body' means an area of rock containing [minerals] in such quantity and of such quality as to make the removal of the rock containing the asbestos a commercially feasible proposition." In *Oro Del Norte S.A. v. R.*,[14] the Court said that the predecessor provision to paragraph (f) of the definition of CEE captured "activities undertaken in assessing whether there exists [a]…deposit which will warrant in economic terms the development of a mine to recover marketable minerals."

Recognizing this commercial reality makes perfect sense because the "resource scheme is written with an eye to commercial realities."[15]

The CRA takes what I would call a physical approach to the interpretation of paragraph (f). The position of the CRA is that paragraph (f) refers to a "mineral resource" but does not refer to the terms, "mineral reserve" or "ore." According to the CRA, the definition of mineral resource does not include the concept of economic viability. In contrast, the terms "ore" and "mineral reserves" are clearly terms that have not only a physical connotation but also an economic one as well.[16] There can be neither ore nor reserves unless the mineralization can be extracted profitably.

But the CRA is ignoring the words of paragraph (f), which includes an expense incurred to determine the "quality" of a mineral deposit. The ordinary meaning of the word "quality" is of the widest possible scope, encompassing any characteristic, feature, attribute, or trait associated with a thing. Surely the quality of a mineral deposit includes whether there exist reasonable prospects for economic extraction from it. Indeed, the very concept of a reserve refers to the economically mineable *part of* a mineral deposit: see *Canadian Institute of Mining, Metallurgy and Petroleum ("CIM") Definition Standards.*

Expenses that those in the mining industry must incur — to determine whether mineralization has economic value — do not necessarily coincide with the views of the CRA as to whether something is incurred with the purpose of determining the existence, location, extent or quality of a mineral resource. Several examples of this dichotomy exist in the 2019 Guidelines and are discussed below. Moreover, as discussed below, the CRA in the 2019 Guidelines is at times inconsistent as to whether economic criteria are relevant to the determination of CEE.

A taxpayer may incur expenses to determine either the technical or economic viability of a project that may not help determine the physical limits of the mineral resource or the physical or chemical composition of the mineral resource. One example from recent litigation of which I was a part, was a study to forecast the price of molybdenum for the next 20 years. The taxpayer conducted a study which indicated that based on realistic assumptions, the mineral resource could not be mined at a profit, and consequently the exploration work was halted and the mineral resource was not brought into production. The study determined the poor commercial quality of a deposit because it demonstrated the lack of mineral reserves in the deposit. By all accounts, such an expenditure therefore satisfied the wording of paragraph (f) of the definition of CEE, but the CRA did not agree.

Furthermore, the CRA takes an idealized view of how a mine may be developed. The CRA assumes that:

(i) a taxpayer carries out exploration work on a property;
(ii) the taxpayer completes the exploration activities and decides whether to bring a mine into production; and
(iii) on the assumption that the taxpayer decides to proceed, the taxpayer incurs the expenses to bring a mine into production.

In practice, the development of a mine is not so neat and tidy. Again, to borrow from recent experience, Western Troy was doing a significant amount of engineering work at the exploration stage to determine the extent of the reserves. For example, such engineering work determined how the mine could be developed to enable the mining of the greatest amount of mineralization. Again, while these expenses on a narrow reading of the words of paragraph (f) may not be determining the existence, location, or extent of the deposit, they are most certainly being incurred to determine the commercial quality of that deposit by ascertaining if the deposit contains reserves. Moreover, these studies (from scoping studies, to preliminary economic assessments, to pre-feasibility studies, to a final feasibility study) are iterative in nature: they must be done over and over to determine — with increasing confidence in accordance with *National Instrument 43-101 (Standards of Disclosure for Mineral Projects)* — the true commercial quality of a deposit.

I do not intend to review those expenditures described in the 2019 Guidelines where the CRA's position is obvious and not controversial.

With that background in mind, I will now address those items in the 2019 Guidelines that are more controversial. One of the problems in reviewing the positions of the CRA in the 2019 Guidelines is that the CRA gives no factual examples to illustrate its positions. Therefore, in some instances, it is difficult to understand why the CRA has drawn the distinctions that it has.

Specific Items

1. Preliminary Planning

The very first expenditure considered on the review table illustrates the difficulty of understanding the position of the CRA in the absence of a factual situation. This item provides that preliminary planning for a potential exploration activity to be undertaken is a section 9 current expense and not a CEE.

The CRA might be correct in factual circumstances similar to those described in *Wacky Wheatley's TV & Stereo Ltd. v. Minister of National Revenue*[17] in which expenses incurred to establish a business were considered not to be capital expenses. The most recent example of that line of reasoning is that of *Canada v. Rio Tinto Alcan Inc.*[18] in which the Federal Court of Appeal held that expenses incurred in advising the board of directors as to whether to proceed with an acquisition of a capital asset were on income account.

Consider the situation in which the geologists of a corporation incur expenses to determine whether to allocate funds to exploring in Ontario, British Columbia or abroad in Argentina. Any expenses so incurred would not be for the purposes outlined in paragraph (f) but would be for the more remote purpose of whether to engage in exploration activity on any particular property. In any particular real-life factual situation, whether an expense is a section 9 current expense or a paragraph (f) expense should be clearer.

One would presume that the minute that a taxpayer focuses on any specific property, the purpose of any activity of the taxpayer with respect to that property is to determine at least the existence of a mineral resource on that property and that the expenses incurred are CEE.

2. Environmental Studies and Community Consultations

The description of qualifying environmental studies and community consultations in the 2019 Guidelines is narrower than that provided by the Act. The 2019 Guidelines refer to environmental studies and community consultations required to obtain exploration permits or conducted in relation to an exploration activity. However, the Act refers to expenses of a taxpayer for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada including environmental studies or community consultations (including studies or consultations to obtain a right, licence or privilege).

3. Preliminary Sampling

The comments in the 2019 Guidelines on preliminary sampling illustrate the distinction that the CRA draws between an expense incurred to determine the existence, location, extent and quality of a mineral resource and an expense incurred to evaluate the economic viability of the mineral resource. The CRA comments in footnote 4 of the 2019 Guidelines that if preliminary sampling is done to help evaluate the economic viability or technical feasibility of a project, it is not eligible. As stated above, a taxpayer engaged in mining activities will incur an expense only if it is directly or indirectly for the purpose of extracting minerals at a profit. In most circumstances, an expense that a taxpayer incurs to determine the physical limits, or physical or chemical composition of the mineral resource will also help the taxpayer determine the economic viability or technical feasibility of the project. However, as outlined above, although a taxpayer may incur costs for determining whether there are mineral reserves, according to the CRA, such costs will not satisfy the provisions of paragraph (f).

4. Bulk Sampling

The CRA accepts that expenditures incurred in bulk sampling in reasonable sizes qualify under paragraph (f) as CEE if the purpose of the bulk sampling is to test the physical and chemical characteristics of the mineral deposit. However, the CRA takes the position that expenses of bulk sampling will not constitute paragraph (f) expenses if the purpose is to evaluate the optimal processing method.

This is a very difficult distinction to justify due to the inherent overlap in determining the physical and chemical characteristics of a mineral deposit and the optimal processing method. A processing method may only be viable if the ore has certain properties. Therefore, determining the properties of the ore informs the determination as to whether a specific method may be used. The evaluation of the optimal processing method is a conclusion that can only be made after all of the physical and chemical characteristics of a mineral deposit have been determined. Therefore, the determination of the optimal processing method will necessitate the determination of the physical and chemical characteristics of the ore. It is difficult to see what test could be carried out that would determine the optimal processing method that would not at the same time determine some physical or chemical property of the ore.

5. Resource Determination

The CRA takes the position that tests and analysis associated with the definition of the deposit in the ground qualify as CEE pursuant to paragraph (f). The CRA refers in particular to expenses incurred to determine the location, extent and quality of the mineral resource.

The CRA goes on to state that activities for reserve estimation are not eligible. According to the CRA, reserve estimation involves factors, such as processing, and economic or social, factors, to convert mineral resources into mineral reserves.

The CRA's position on resource estimation is consistent with its view that only expenses that determine the physical nature of a deposit qualify as CEE pursuant to paragraph (f).

Perhaps the CRA's position would be more easily understood with an example. It is certainly easy to accept that expenses relating to determining how to process the ore would not qualify as a CEE since any such expenses would relate to activities that do not relate to exploration. It is more difficult to accept that engineering expenses incurred during the exploration phase that go to determine how to mine the reserves do not qualify as CEE. After all, such expenses ultimately determine the commercial quality of a deposit including whether that deposit contains reserves.

6. Deposit Modelling

One of the expenses referred to in the 2019 Guidelines is "Deposit modelling and estimates of cut-off grade and estimation of geological continuity at the selected cut-off." The CRA comments that 3-D computer modelling uses data obtained from sampling activities to determine orientation, configuration and spatial distribution of a mineral deposit and serves to calculate the quantity of resources for evaluation purposes. The CRA goes on to state that identification of location and configuration of parts of the deposit that meet minimum cut-off grade criterion helps determine the extent and quality of the resource.

What is significant about the CRA's position is that it recognizes that expenses incurred to determine the cut-off grade qualify as CEE pursuant to paragraph (f). As I have discussed above, the CRA's general position is that tests undertaken for economic purposes do not qualify for treatment as CEE pursuant to paragraph (f). Cut-off grade is purely an economic concept that will depend on a number of factors, including the anticipated long-term price of a metal. The cut-off grade for gold at $1,000USD is far higher than the cut-off grade of gold at $2,000USD. This demonstrates the inconsistency of the CRA's position and supports my view that an expense incurred to determine the commercial quality of a deposit is a CEE.

7. Metallurgical Testing

The CRA describes this expenditure as one in which samples are tested to determine the physical and chemical properties of the resource. According to the CRA, metallurgical testing by separation processes is required to determine the actual percentage of mineral contained in the ore that can be recovered.

The CRA comments that metallurgical testing will be allowed under paragraph (f) if it is undertaken for determining whether any processing method is feasible for separating the pay minerals/metals from the waste or contaminants. If the testing is performed for determining an optimal method of separation (i.e., how to maximize value from processing), it will not be allowed. The CRA also comments that pilot plant testing will not qualify under paragraph (f).

My comments about metallurgical testing are similar to those for Bulk Sampling. Each method is going to depend on the physical or chemical characteristics of the ore. One method is going to be preferable because of the physical or chemical characteristics of the ore. Any test designed to determine the optimal method is going to determine some physical or chemical characteristic of the ore. Therefore, it is difficult to see how one can determine which method is optimal without at the same time testing for either the physical or chemical properties of the ore.

It is not clear why the CRA is of the view that expenses of pilot plant testing do not qualify as paragraph (f) expenses. Usually such testing is designed to confirm the properties (and therefore the qualities) of the ore in an operational setting.

8. Pre-feasibility Studies and Feasibility Studies

These studies are defined by the Canadian Institute of Mining, Metallurgy and Petroleum. The CRA's position is that such expenses are generally operating expenses under section 9 unless the expenses satisfy the purpose test in paragraph (f). I think that the CRA has stated its position rather inelegantly. Undoubtedly, if an expense satisfies the purpose test in paragraph (f), it is a CEE. What the CRA is saying is that it anticipates that in most circumstances, such expenses are operating expenses that do not satisfy the purpose test in paragraph (f).

As observed above, pre-feasibility studies and feasibility studies are part of the continuum of studies that are required to determine — with increasing confidence in accordance with *National Instrument 43-101 (Standards of Disclosure for Mineral Projects)* — the true commercial quality of a mineral deposit. The first of these studies are scoping studies and preliminary economic assessments, of which there may be multiple iterations involving continued exploration and expansion of estimated reserves. With more detailed drilling and testing, the quality of the mineral reserve estimate increases allowing higher confidence categories that can support preliminary feasibility studies. There can be more than one iteration of preliminary feasibility studies, particularly with continued expansion of the commercial quality of the deposit in the form of increased mineral reserve estimates. Eventually a decision can be made to complete a full feasibility study including the final mine development plan, which will confirm — with precision and the highest level of confidence — the economically mineable part of a mineral deposit. All these studies are undertaken to determine, with increasing confidence, the quality of the mineral deposit and therefore the costs incurred on them satisfy the purpose test in paragraph (f).

Once a feasibility study is complete and a final decision is taken to build the mine, it is well-settled that the expenses incurred in bringing the mine into production fit within former paragraph (g) of CEE and current paragraph (c.2) of the definition of CDE in subsection 66.2(5): see *Teck-Bullmoose Coal Inc. v. R*.[19]

Conclusion

The 2019 Guidelines are helpful in determining whether an expense satisfies the provisions of paragraph (f) of the definition of CEE and is therefore a welcome release by the CRA. It is unfortunate that the CRA did not provide more factual examples to assist the reader in understanding the distinctions that the CRA was drawing.

Many of the positions taken by the CRA are informative and not controversial. But I disagree with some of the CRA's positions that involve vital expenditures incurred in the mining industry, as I have outlined in this article. We will see whether there are any challenges to the positions taken by the CRA and what the outcome of those challenges is.

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* I wish to thank Ian J. Gamble of our Vancouver office for his very helpful comments and assistance in the preparation of this article.

[1] Canada Revenue Agency, "Mining Expenditure Review Table", CRA Views 2019-0796791I7 (Ottawa: CRA, 21 February 2019).

[2] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp), as amended (herein referred to as the "**Ac**t".) Unless otherwise stated, all references are to the Act.

[3] Canada Revenue Agency, "Re: Canadian exploration expense", CRA Views 2007-0252761E5 (Ottawa: CRA, 19 September 2007).

[4] Canada Revenue Agency, "Re: Canadian exploration expense", CRA Views 2016-0675902I7 (Ottawa: CRA, 24 January 2017).

[5] *Budget Implementation Act*, S.C. 2016, c. 7, ss. 7(1).

[6] Subsection 66.2(5).

[7] Class 14.1.

[8] A taxpayer may claim a deduction in respect of its cumulative Canadian development expense account at 30% per annum on a declining balance basis subject to the proposed additional allowance rules and property belonging to Class 14.1 at 5% per annum subject to the proposed additional allowance rules whereas a taxpayer may be able to deduct up to 100% of its CEE incurred in a year.

[9] There are some differences. The deduction that a principal-business corporation may claim in respect of its cumulative Canadian exploration expense ("**CCEE**") account is limited to its income as defined in ss. 66(2). In contrast, a taxpayer must claim a deduction in respect of its s. 9 expenses and this may produce a non-capital loss. Non-capital losses may expire but a CCEE account does not. However, since non-capital losses may be carried forward 20 years, the expiration of non-capital losses should not be significant in most cases.

[10] See ss. 66(12.6) to (12.75).

[11] See for example the mineral exploration tax credit rules in s. 25.1 of the *Income Tax Act* (British Columbia), R.S.B.C. 1996, c. 215.

[12] I refer to indirect expenses that do not need to be incurred to bring a mineral resource into commercial production but are required under the terms of a license. An example of such an expense is an environmental study. The taxpayer could bring the mine into production without the environmental study, but the license or the legislation governing the license requires the taxpayer to conduct an environmental study.

[13] [1965] 65 D.T.C. 5089 (Can. Ex. Ct.) at para. 30.

[14] [1993] 93 D.T.C. 5217 (Fed. T.D.) at para. 30.

[15] *Canadian National Railway v. Minster of National Revenue*, [1994] F.C.J. No. 933 (Fed. C.A.) at para. 50.

[16] My comments on the position of the CRA are based in part on recent litigation in which I was involved. See *Western Troy Capital Resources Inc v. Her Majesty the Queen* 2016-3101(IT)G.

[17] [1987] 2 C.T.C. 2311 (T.C.C.).

[18] 2018 FCA 124 (F.C.A.), affirming [2017] 1 C.T.C. 2103 (T.C.C. [General Procedure]).

[19] [1998] 3 C.T.C. 195 (Fed. C.A.), affirming [1997] 1 C.T.C. 2603 (T.C.C.).

Changes to Canada's International Tax Treaty Landscape: Enactment of the Multilateral Instrument in Canada

Julie D'Avignon and Kevin Guenther, Stikeman Elliott LLP

On June 21, 2019, Bill C-82, *An Act to implement a multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting*, received Royal Assent in Canada. Bill C-82 ratifies the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "MLI"). The MLI was developed as part of an initiative of the Organisation for Economic Co-operation and Development (the "OECD") to assist contracting jurisdictions to implement base erosion and profit shifting measures in a coordinated manner, with a focus on addressing perceived treaty abuse. An Order in Council notifying the OECD of the Royal Assent of Bill C-82 was deposited with the OECD on August 29, 2019. The deposit of Canada's instrument of ratification with the Depositary of the MLI was the remaining step in order for the MLI to enter into force in Canada. Canada originally signed onto the MLI on June 7, 2017, and is one of nearly 100 signatories to date. This article examines the enactment of the MLI in Canada, the optional and mandatory provisions of the MLI, the interaction of the general anti-avoidance rule (the "GAAR") with the MLI's principal purpose test (the "PPT") and concludes by highlighting key areas of impact for the resource sector and international tax structures.

With the deposit of Canada's instrument of ratification with the OECD, the MLI will enter into force in Canada on December 1, 2019. For withholding taxes, the MLI will come into effect for applicable tax treaties on January 1, 2020. In terms of all other taxes, the MLI will come into effect for applicable tax treaties for taxable periods beginning on or after June 1, 2020, meaning it will come into effect on January 1, 2021 for taxpayers with a December 31 year-end.

The MLI does not amend Canada's bilateral tax treaties. Instead, the MLI alters the effect and interpretation of the preamble and certain provisions in those treaties which Canada designates the MLI to "cover" (i.e., subject to the MLI), on a treaty-by-treaty basis. Upon signing the MLI, Canada gave notice that 75 out of 94 bilateral tax treaties would be covered by the MLI ("Covered Tax Agreements") and therefore subject to modification by the MLI. However, Canada's notice of ratification deposited with the OECD listed 84 bilateral treaties to be covered by the MLI and has given notice that other treaties may be covered by the MLI based on bilateral negotiations at a future date. Notably, the U.S. is not a signatory to the MLI, and as such the Canada-U.S. tax treaty will not be affected by the MLI, pending future developments. The U.S. asserts that its treaty network contains strong enough provisions to prevent treaty shopping, primarily through the detailed limitation on benefits provisions contained in its treaties.

Although the large majority of Canada's treaties will be open to becoming Covered Tax Agreements, the MLI will not come into effect for a particular treaty until Canada's treaty partner has also deposited its instrument of ratification, acceptance or approval with the OECD. Additionally, the specific impact that the MLI may have on a particular Covered Tax Agreement will depend on which articles of the MLI are unilaterally reserved from taking effect by either Canada or its treaty partner. Only those articles that both treaty partners do not reserve against will apply to the Covered Tax Agreement. Where either Canada or its treaty partner reserves against a particular optional provision, that article will not alter the effect of the underlying tax treaty.

Mandatory and Optional Provisions

While some articles of the MLI are optional and may be reserved, three key articles are mandatory and will apply in respect of a particular tax treaty if both Canada and its treaty partner list that bilateral treaty as a Covered Tax Agreement. The mandatory provisions include the addition of preamble language focused on preventing treaty shopping, as well as provisions dealing with the prevention of treaty abuse and the formation of a mutual agreement procedure ("MAP").

Addressing perceived treaty abuse was one of the focuses of the OECD initiative that gave rise to the MLI and forms the core of the mandatory provisions. The preamble consists of a declaration against the creation of opportunities for non-taxation and reduced taxation through both tax evasion and tax avoidance, including treaty-shopping arrangements, and will apply to all Covered Tax Agreements where substantially similar language is not already present.

In addition to the introduction of this extended preamble, all signatories to the MLI will be required to adopt a principal purpose test ("PPT") intended to curb perceived treaty abuse, with the possible addition of a simplified Limitation on Benefits ("LOB") provision. Alternatively, such jurisdictions will be required to indicate an affirmative or negative intent to bilaterally negotiate a detailed LOB provision or retain the PPT and implement the simplified LOB established under Article 7 of the MLI.

Canada will include the PPT in its bilateral agreements. Canada has also retained a statement in its notice of ratification that it intends, where possible, through bilateral treaty negotiation, to adopt an LOB either in addition to or in replacement of the PPT. However, some of Canada's treaty partners have indicated a preference for the PPT.[1] Canada has also chosen to allow a saving provision whereby the Minister of National Revenue may determine whether a benefit should be granted despite its denial under the PPT, in consultation with the competent authority of Canada's treaty partner.

The PPT applies if one of the principal purposes of an arrangement or transaction is to obtain one or more treaty benefits in a way that is not in accordance with the object and purpose of the treaty. The PPT reflects a contextual approach influenced by the mandatory preamble language. Specifically, the PPT (Article 7) states:

> Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.[2]

The MAP requires contracting jurisdictions to ensure that persons may present their case to the appropriate tax authority where they believe they have been taxed in a manner not reflected by the Covered Tax Agreement. There is also an optional provision for mandatory binding arbitration which will be applied to approximately 20 of Canada's treaties.

The remaining provisions of the MLI are optional. Canada has broadly reserved against all but four of the optional articles. In particular, Canada has reserved against all but the following optional provisions in the MLI:

- a tie-breaker rule for dual-resident entities (Article 4);
- a minimum one-year holding period test to access the enhanced treaty-based withholding tax rate on dividends received by corporations in which a significant interest is held (Article 8); and
- a one-year lookback test to determine whether capital gains on a sale of equity interests derive their value principally from immovable property for purposes of a Covered Tax Agreement (Article 9).

Canada is not able to add further reservations to provisions of the MLI. However, Canada can withdraw reservations to certain provisions as further analysis is undertaken.

The Interaction of the GAAR and the PPT

The PPT represents a noteworthy change to the Canadian tax treaty landscape. While substantial uncertainty remains regarding the interaction and application of the PPT and Canada's domestic general anti-avoidance rule (the "GAAR"),[3] the Canada Revenue Agency has recently indicated that it will apply the PPT first, followed by the GAAR. Concerns remain regarding whether the PPT and the GAAR will lead to differing conclusions. While similar in some respects, there are key differences in the language of both tests. These differences should to be taken into account when evaluating potential tax structures.

Impact of the MLI on International Tax Structures

There have been ongoing concerns that the MLI may deter investment into Canada due to resulting uncertainty and risks of additional tax. Private equity firms and global organizations investing in Canada's natural resource industry will need to assess the PPT, particularly where they seek to employ international structures which utilize the exemptions and benefits contained in Canada's bilateral tax treaties. While these structures have been found to be non-abusive by Canadian courts under the GAAR, the language of the preamble together with the PPT creates uncertainty with such structures and may constrain future planning. Additionally, there are no grandfathering provisions to relieve structures created before the MLI comes into effect. It is important for foreign investors to review their strategies in preparation for the coming into effect of the MLI in Canada.

Conclusion

In summary, the MLI will come into force on December 1, 2019, and begin to alter Canada's bilateral tax treaties beginning January 1, 2020, and June 1, 2020, for withholding taxes and other taxes, respectively where such a tax treaty is also covered by Canada's treaty partner. To allow for tracking the impact of the MLI to various Covered Tax Agreements, a list of signatories and parties along with coming into force dates and lists of which optional provisions have been reserved and will not apply is available online through the OECD.[4]

Although the MLI is just now coming into force, its effect will continue to expand and reverberate throughout the international tax community for many years to come. The PPT should be considered in respect of existing structures, as well as future planning.

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[1] S. Smith, 2019 International Fiscal Association, "2019 IFA Conference – Stephanie Smith on MLI", online: <https://taxinterpretations.com/content/528872>.

[2] "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (2016) at 8, Organisation for Economic Co-operation and Development, online (PDF): <www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf>.

[3] A discussion of the GAAR is beyond the scope of this article.

[4] "Signatories and Parties to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting" (28 June 2019), Organisation for Economic Co-operation and Development, online (PDF): http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.

BC Mineral Tax Update

Randy Morphy and Rob Biggar, ***Borden Ladner Gervais LLP***

The British Columbia Supreme Court (the "**BCSC**") and the British Columbia Court of Appeal (the "**BCCA**") were called upon to interpret the *Mineral Tax Act* (British Columbia) (the "**MTA**")[1] in two cases in 2018. In *Huckleberry Mines Ltd. v. Her Majesty the Queen in Right of the Province of British Columbia*[2] the BCSC considered the effect of hedging transactions entered into by a shareholder of a mine operator when determining the gross revenue of the operator under the MTA. In *Thompson Creek Metals Company Inc. v. British Columbia (Minister of Finance)*,[3] the BCCA considered the timing of the cumulative expenditure account ("**CEA**") addition for expansion costs under the prescribed allowance for new mines in the *Mineral Tax Costs and Expenditures Regulation* (the "**Regulation**").[4] Both decisions confirm that mine operators can expect the courts to apply the MTA in a straight-forward manner that is consistent with the plain language of its provisions.

Huckleberry Mines Ltd. v. The Queen

Huckleberry Mines Ltd. ("**Huckleberry**") operates a copper and molybdenum mine in British Columbia. Huckleberry's shareholders include three Japanese companies which operate smelting businesses (the "**Smelter Companies**") and Marubeni Corporation ("**Marubeni**"), which carries on a commodities trading business.

Prior to the transactions at issue, Huckleberry sold copper concentrate directly to the Smelter Companies. When concentrate was shipped, the Smelter Companies made a provisional payment to Huckleberry based on the prevailing price for copper on the London Metal Exchange around the time of shipment (the "**Shipping Time LME Price**"). The sale price was determined several months later based on the prevailing price for copper around the time the concentrate was processed (the "**Smelting Time LME Price**"). Huckleberry would then make (or receive) a settlement payment to the extent the provisional payment was more (or less) than the sale price. This arrangement exposed Huckleberry to copper price fluctuations which made it difficult to manage cash flow.

In 2005, Huckleberry, Marubeni, and the Smelter Companies agreed that Marubeni could, at its sole discretion, purchase certain quantities of copper from Huckleberry at a fixed price if Marubeni entered a "hedging operation" under which it (i) agreed to sell the concentrate to the Smelter Companies at the Smelting Time LME Price, and (ii) entered into a hedging transaction that would produce a gain (or loss) if the Shipping Time LME Price was greater than (or less than) the Smelting Time LME Price. The fixed price paid by Marubeni to Huckleberry for this concentrate was equivalent to the Smelting Time LME Price plus (or minus) Marubeni's hedging gain (or loss).

Commercially, this all worked. The Smelter Companies paid a price based on the Smelting Time LME Price, Huckleberry received a price based on the Shipping Time LME Price and Marubeni received a small commission for its services and otherwise broke even (i.e., any profit realized by Marubeni on the sale of concentrate was offset by a loss on the hedging transaction, and vice versa).

The price of copper increased in 2006. As a result, Marubeni realized hedging losses of around $60 million which were deducted in determining the fixed price paid to Huckleberry for the concentrate. Huckleberry in turn used this fixed price as the "price paid or payable"[5] for the concentrate in computing its gross revenue under the MTA. The Court made two important findings of fact in relation to these transactions. First, it held that Marubeni entered the hedging transactions in its own capacity and not as agent for Huckleberry. Second, it held that as a contractual matter, Huckleberry was entitled to receive the fixed price and no more for the copper sold to Marubeni.

Paragraph 2(1)(t) of the Regulation provides that "costs or losses in respect of hedging transactions" cannot be deducted from gross revenue. Therefore, if Huckleberry had instead directly sold the concentrate to the Smelter Companies for the same price as Marubeni and directly incurred the same hedging loss as Marubeni, its gross revenue under the MTA would have been $60 million higher. This was perhaps why the Minister of Finance (the "**Minister**") took issue with the lower gross revenue amount, as a matter of policy (although one wonders whether the Minister would have objected to a higher gross revenue amount if copper prices had decreased in 2006).

Huckleberry was assessed on the basis that the price paid or payable for the concentrate should be the price received by Marubeni from the Smelter Companies because Marubeni's hedging loss should not reduce Huckleberry's gross revenue under the MTA. The Minister relied upon a broad reading of paragraph 2(1)(t) of the Regulation to support this conclusion. However, the Court stated that subsection 2(1) of the Regulation is concerned with costs incurred by the *operator* of a mine. In this context, the Court found that paragraph 2(1)(t) refers only to hedging transactions conducted by the operator of a mine or an agent acting on behalf of the operator.[6] Therefore, the hedging losses incurred by Marubeni fell outside the scope of paragraph 2(1)(t) of the Regulation, even though they had the effect of reducing Huckleberry's gross revenue.

The Minister further argued that the MTA should be read purposively to exclude all hedging transactions because they did not affect the value of resources taken, and the purpose of the MTA is to obtain payment for the value of such finite resources taken by operators.[7] The Court rejected this argument, stating that the purpose of the MTA is achieved where the amount included in an operator's gross revenue is the price the operator actually received for the mineral product and noting that the Legislature could not have intended for the Province to collect tax on amounts that the operator did not receive and was not entitled to receive.[8]

The application seeking leave to appeal this decision was dismissed by the BCCA.[9] In its reasons for dismissing the application, the BCCA stated that the amount "paid or payable" by Marubeni to Huckleberry for the concentrate was a question of contractual interpretation, which is a question of mixed fact and law.[10] The BCCA noted that decisions of a trial court regarding questions of mixed fact and law are entitled to deference and concluded that the proposed appeal lacked sufficient merit when evaluated against this standard.[11] The BCCA viewed the finding of fact that Huckleberry was contractually entitled to receive the fixed price and no more as dispositive of the issues on appeal. It did not seriously entertain arguments that hedging transactions undertaken by third parties should affect tax payable under the MTA, stating that the MTA is abundantly clear in this regard.

This decision clarifies that paragraph 2(1)(t) of the Regulation operates only to exclude costs of hedging transactions conducted by an operator or its agent from the calculation of an operator's gross revenue.

Thompson Creek Metals Company Inc. v. British Columbia (Minister of Finance)

Thompson Creek Metals Company Inc. ("**Thompson**") operated a molybdenum mine in British Columbia. Beginning in 2008, Thompson undertook an expansion project to increase the mine's capacity by approximately 78%. The mine achieved this increased capacity in March 2012.

Under the MTA, an operator must pay a tax equal to the amount by which 13% of its net revenue from a mine exceeds the balance of its cumulative tax credit account.[12] In computing net revenue, an operator may deduct the balance of its cumulative expenditure account ("**CEA**").[13] The prescribed allowance for new mines allows an operator to add to its CEA one third of certain capital expenditures incurred in the expansion of a mine that meets one of the criteria set out in paragraph 5(1)(a) of the Regulation.

Given the BCCA's reliance on the precise language of paragraph 5(1)(a) in its analysis, the relevant portions of the Regulation are worth setting out in detail:

> *… the allowance for new mines … shall be 1/3 of the costs and expenses … that*
>
> > *(a) were incurred by the operator for the purpose of earning gross revenue from the operation of a mine that meets one of the following criteria:*
> >
> > > *…*
> > >
> > > *(iv) the mine was expanded … to the extent that the greatest designed capacity, measured in tonnes of input of ore, of the mill that processed the ore from the mine was not less than 25% greater in the fiscal year of the mine immediately following the expansion than it was in the fiscal year of the mine immediately preceding the expansion*

Thompson spent approximately $64 million and $36 million in connection with the expansion project in 2008 and 2009, respectively, and added one third of these amounts to its CEA in those years under the prescribed allowance for new mines. The Minister disallowed the addition of these amounts on the basis that the mine had not yet achieved the required increase in capacity. The issue to be determined by the Court was whether CEA additions under the prescribed allowance were properly added to Thompson's CEA in 2008 and 2009.

The Court found that the present tense of the phrase "*meets one of the following criteria*" indicates that the criterion in 5(1)(a)(iv) of the Regulation must be satisfied at the time the operator seeks to add an amount to its CEA.[14] Similarly, the reference to capacity in the fiscal year of the mine immediately following the expansion was viewed as an indication that the test should be applied and the CEA addition should occur following the expansion of the required extent.[15] The Court also found that the purpose of the prescribed allowance for new mines was to encourage new mine development, and concluded that requiring a mine expansion to be completed prior to allowing an operator to claim the allowance was consistent with that purpose.[16]

Thompson argued that the Regulation should permit it to add the amounts to its CEA in the year the expenses were incurred based on the context of the MTA, which recognizes capital costs when they are incurred. However, the Court distinguished capital costs from incentive credits such as the prescribed allowance for new mines and concluded that there was no inconsistency in recognizing capital costs when they are incurred while requiring an expansion to be complete before recognizing costs associated with the prescribed allowance.[17]

Finally, the Court noted that its interpretation of the Regulation was based on circumstances in which amounts were added to an operator's CEA in years prior to an expansion being completed. The Court explicitly stated that its comments should not be taken to address circumstances where an expansion is phased over several years and the required capacity increase is achieved in a fiscal year prior to the completion of the entire expansion.[18]

This decision has clarified that operators may not add amounts in respect of expansion costs to their CEA under the prescribed allowance for new mines before the expansion has been completed to the required extent.

Conclusion

Mine operators should take comfort in the Courts' straight-forward application of the MTA in the *Huckleberry* and *Thompson Creek* decisions. In both decisions, the Court interpreted the disputed provision in a manner that was consistent with the plain meaning of its language. The results in these decisions may be unsurprising, but certainty and predictability are always welcome in the application of taxation statutes.

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[1] *Mineral Tax Act*, R.S.B.C. 1996, c. 291 [MTA].
[2] 2018 BCSC 1481, 2018 CarswellBC 2336 (B.C. S.C.) [*Huckleberry Mines*].
[3] 2018 BCCA 370, 2018 CarswellBC 2593 (B.C. C.A.) [*Thompson Creek*].
[4] *Mineral Tax Costs and Expenditures Regulation*, B.C. Reg. 405/89 [MTCER].
[5] See MTA, *supra* note 1, ss. 8(4).
[6] *Huckleberry* Mines, *supra* note 2 at para. 94.
[7] *Ibid.* at paras. 99-100.
[8] *Ibid.* at para. 103.
[9] See *Huckleberry Mines Ltd. v. British Columbia (Finance)*, 2019 BCCA 124, 2019 CarswellBC 818 (B.C. C.A.).
[10] *Ibid.* at para. 45.
[11] *Ibid.* at para. 38.
[12] See MTA, *supra* note 1, s. 2.
[13] *Ibid.*, s. 6.
[14] *Thompson Creek*, *supra* note 3 at para. 10, 2018 CarswellBC 2593.
[15] *Ibid.* at para. 17.
[16] *Ibid.* at para. 18.
[17] *Ibid.* at para. 20.
[18] *Ibid.* at para. 22.

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