Tax and transfer pricing considerations for Canadian-headquartered mining companies

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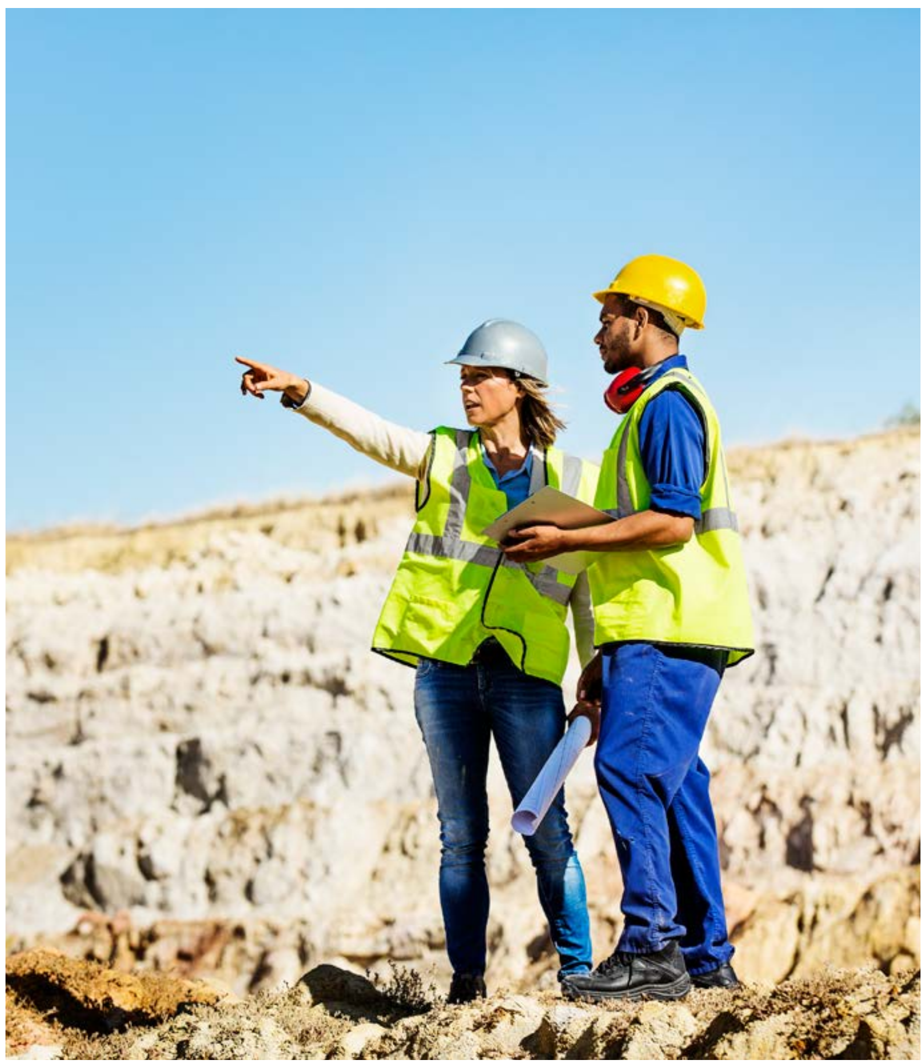
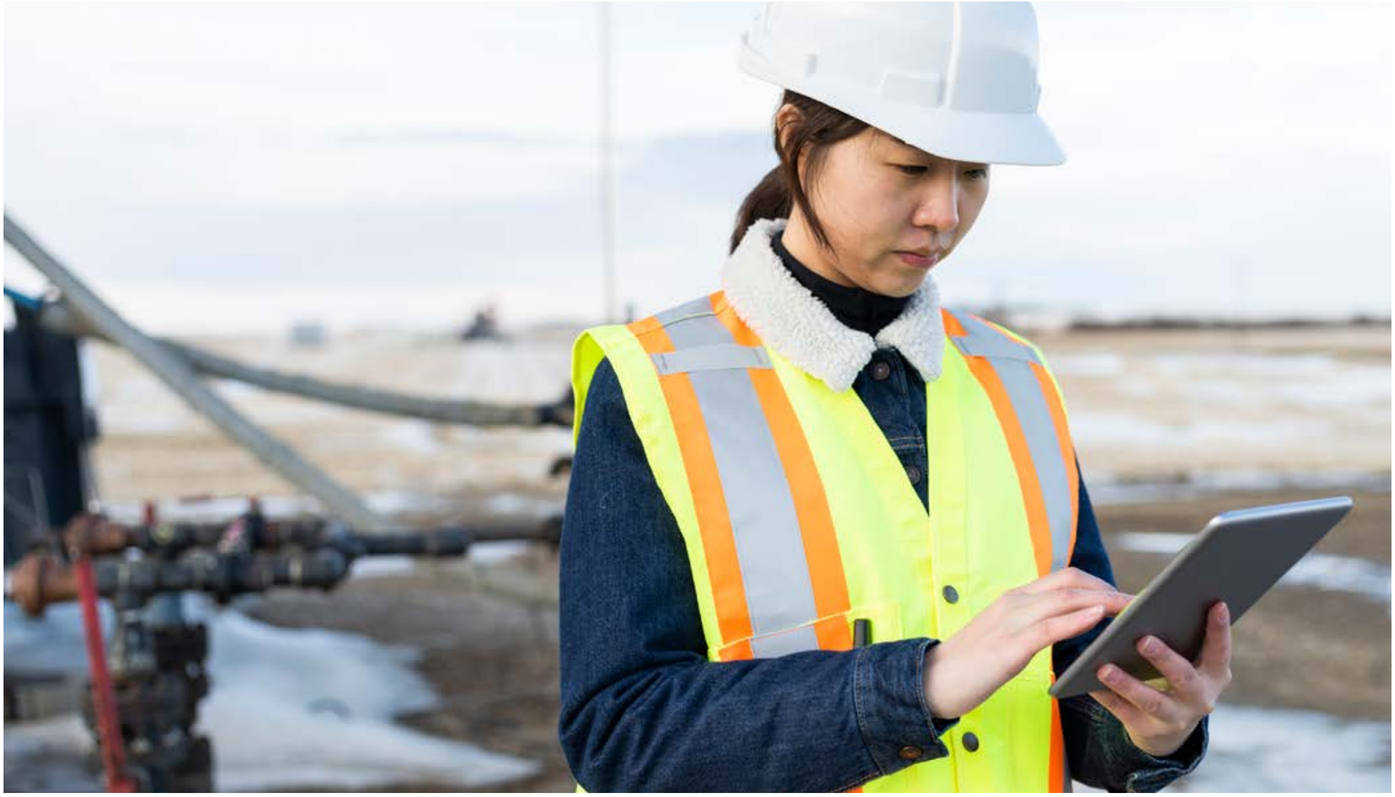
Canada's competitive position in the mining industry is driven by numerous factors, including access to natural resources, access to capital, supply chain capabilities and favourable tax incentives. This unique position has allowed Canada to become a global hub for exploration stage and producing mining companies. Not only are nearly 50 percent of publicly-traded mining companies listed on a Canadian stock exchange[1], but many of them are Canadian-headquartered mining companies that operate on a global scale—with executive management based in Canada, and mining operations (namely exploration, development and production) based in other jurisdictions.



1 Canadian federal budget 2021-2022: Proposed transfer pricing measures and the impact on taxpayers



From a tax perspective, this latter arrangement can pose serious challenges if mining companies don't have a robust transfer pricing framework in place. Such a framework offers a host of benefits by allowing the Canadian parent company to reduce tax risks, particularly those that arise when a parent company does not earn significant revenues and starts to accumulate losses, while its foreign subsidiary is in the commercial production stage and generating taxable income in its jurisdiction.

In this article, we highlight key transfer pricing opportunities for Canadian-headquartered mining companies. The considerations outlined in this article are relevant to both exploration stage and producing companies.[1]

Financing

The mining industry is capital intensive, specifically in the exploration and development stages. During these stages, a mine may be financed through internal and/or external financing (such as debt or streaming transactions).

Debt financing

A Canadian parent company may use equity capital to finance the mining operations of its foreign subsidiary through intercompany loans. The terms of these loans generally need to be consistent with those between independent parties dealing at arm's length. In establishing these terms, the tax and transfer pricing legislation in Canada and the foreign jurisdiction need to be considered, including thin capitalization rules, withholding tax and tax deductibility of interest paid by the foreign subsidiary. An interest-bearing loan could provide an opportunity for a multinational enterprise (MNE) to repatriate profits back to the Canadian parent company in a tax efficient manner relative to equity, depending on the circumstances. At the same time, Canada's transfer pricing rules also permit non or low-interest-bearing loans to be made to operating subsidiaries, which gives Canadian-headquartered mining companies considerable flexibility in intercompany financing.

Alternatively, a Canadian parent company may assist its foreign subsidiary in raising and securing external debt. Depending on the assets and standalone creditworthiness of its foreign subsidiary, a Canadian parent company may raise and secure third-party debt on behalf of its foreign subsidiary. The credit rating and assets pledged by the Canadian parent may allow the foreign subsidiary to obtain more favourable financing terms than it would have on a standalone basis. In this case, the Canadian parent company would need to be compensated at an arm's length amount (e.g., a service fee for its capital-raising efforts). In this example, the intercompany service fee would provide an opportunity for the Canadian parent company to use its accumulated losses, thereby not paying any additional income tax in Canada on the intercompany service revenue. Furthermore, the foreign subsidiary would recognize an intercompany service fee expense, thereby reducing its taxable income.

Streaming transaction

Under a streaming transaction, a financing party (internal or external) will agree to purchase minerals at a future date for a fixed price over a period of time in exchange for an upfront payment. The upfront payment is then used by the mine to finance development of a project and production of minerals. The transaction is generally secured by the assets of the mine.

In the context of an external streaming transaction, a Canadian parent company may guarantee the delivery of minerals and may incur costs (related to securing the agreement) on behalf of its foreign subsidiary. The foreign subsidiary may not be able to secure financing without the efforts and guarantee provided by the Canadian parent company. In this case, the Canadian parent company would need to be compensated at an arm's length amount, which may include an intercompany performance guarantee fee and a service fee (for efforts related to securing the agreement). Similar to debt financing, these intercompany fees would achieve tax efficiencies across multiple jurisdictions (through Canadian loss utilization and reduction of foreign taxable income), while mitigating transfer pricing risks.[3]

Centralized services

To achieve supply chain efficiencies and minimize costs, a mining company may centralize the provision of various services, including marketing, procurement, research and development (R&D) and other support services.

Marketing

Mining MNEs compete globally for customers, investors and government partnerships. To compete efficiently in the global market, marketing functions of an MNE may be centralized and performed by the Canadian parent company on behalf of all entities within the MNE.

Marketing functions performed centrally may add varying degrees of value to the mining operations depending on the nature of the function (marketing support versus a marketing agent). Marketing support services may include:

- assisting with advertising;
- assisting with investor and public relations;
- conducting market research; and
- developing marketing strategies.

By comparison, a marketing agent may:

- negotiate contracts,
- take title to the minerals,
- assume (or control) the associated risks, and
- assume responsibility for delivery to the buyer.

The marketing hub would need to be compensated a cost-based or value-based amount that reflects the functions performed, assets used and risks assumed by the entity. An entity acting as a marketing agent would generally be compensated differently than an entity providing marketing support services.

It is important to note that the nature of the marketing activities performed by a Canadian parent company on behalf of its foreign subsidiary may give rise to a permanent establishment (PE) in Canada for the foreign subsidiary in instances where the Canadian parent company is acting on behalf of the foreign subsidiary and exercising, in Canada, an authority to conclude contracts that are binding to the foreign subsidiary. The existence of a PE in Canada for a foreign subsidiary could result in Canadian income tax obligations.

Procurement

The procurement process is crucial for a mining company to ensure it has secured sufficient machinery, raw materials and other inputs at favourable prices over the life of the mine. The procurement functions of an MNE may be centralized and performed by the Canadian parent company on behalf of all entities within the MNE.

These procurement functions may include:

- selecting and vetting suppliers;
- maintaining supplier relationships;
- identifying scope of supply;
- negotiating contract terms;
- maintaining quality control; and
- monitoring the procurement process.

The procurement hub would also generally own the supplier lists and relationships and assume the risks associated with the procurement function.

3 Canadian federal budget 2021-2022: Proposed transfer pricing measures and the impact on taxpayers

A foreign subsidiary may realize significant cost savings and supply chain efficiencies resulting from the negotiation efforts and supplier relationships of the Canadian parent company, as well as the scale of the global operations. A foreign subsidiary may not be able to obtain these cost savings and efficiencies on a standalone basis. As such, the procurement hub would need to be compensated a cost-based or value-based amount that reflects the functions performed, assets used and risks assumed by the entity. The compensation paid to a procurement hub is often based on more than a simple cost or cost-based mechanism due to the significant value contributed.

Research and development

R&D in the mining industry can lead to the development of valuable intangibles, including engineering designs, process improvements and know-how, and innovative mining methods/techniques.[4] Through the development and enhancement of intangibles, mining companies may realize significant supply chain efficiencies and other economic benefits. In an instance where the R&D functions of the MNE are centralized and performed by the Canadian parent company on behalf of all entities within the MNE, the Canadian company would need to be compensated on a value-based amount that reflects the functions performed, assets used and risks assumed in the context of the development, enhancement, maintenance, protection and exploitation (DEMPE) of the MNE's intangibles.

Moving forward

In the absence of a transfer pricing framework and contemporaneous documentation, a Canadian company is exposed to potential transfer pricing penalties when there is an income adjustment by the Canada Revenue Agency (CRA) that exceeds the penalty threshold (equal to the lesser of 10 percent of gross revenue for the year and $5 million). As previously mentioned, it is often the case that the Canadian parent company of a mining MNE has minimal or no revenue and is accruing losses. The fact that the Canadian company is accruing losses does not prevent it from being exposed to potential transfer pricing penalties. Rather, the lack of revenue will be a significant risk factor for the imposition of transfer pricing penalties, to the extent that the CRA proposes an income adjustment. The transfer pricing penalty will be equal to 10 percent of the income adjustment.

There are unique opportunities for Canadian-headquartered mining companies to establish a transfer pricing framework that minimizes transfer pricing risks and achieves efficiencies across multiple jurisdictions. To maximize the benefits, the framework should be implemented at the onset of the mining operations (ideally during acquisition of mining assets or commencement of exploration activities), monitored on an ongoing basis and updated (as needed) based on changes to the business and the transfer pricing environment.

1 https://www.nrcan.gc.ca/science-data/science-research/earth-sciences/earth-sciences-resources/earth-sciences-federal-programs/minerals-and-economy/20529

2 This article is based on a scenario where the Canadian parent company has accumulated losses, as this is often found to be the case.

3 In a recent court settlement between Wheaton Precious Metals Corp. ("Wheaton"), a Vancouver-based precious metals streaming company, and the Canada Revenue Agency ("CRA"), Wheaton was required to charge a services fee to its non-resident related party for capital raising costs incurred by Wheaton for the purpose of funding streaming transactions entered to by its non-resident related party.

4 The definition of an intangible provided by the Organization for Economic Cooperation and Development in the 2017 edition of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations is based on the creation of significant economic value and broadly provides that an intangible is "something that is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances".