The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants

The Canadian Bar Association 500-865 Carling Avenue Ottawa, Ontario K1S 5S8	The Canadian Institute of Chartered Accountants 277 Wellington Street West Toronto, Ontario M5V 3H2

July 27, 2004

Mr. Len Farber
General Director
Tax Policy Branch
Department of Finance
17th Floor, East Tower
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Dear Mr. Farber:

Re: Deductibility of Mining Taxes

We are writing to you with respect to the phase-out of the resource allowance and its replacement by a deduction for royalties and mining taxes. The government has clearly indicated that taxpayers are to be permitted to deduct the full amount of royalties and mining taxes paid. However, the way in which it is proposed to implement the change with respect to mining taxes will not produce this result.

This submission describes why the intended result will not be achieved, and proposes an approach for consideration by you and your colleagues. The issue discussed in this submission is not new. It was identified when mining taxes were deductible in the era before the resource allowance was introduced. However, as a result of the introduction of the resource allowance in 1974, the issue has remained dormant since then.

Full Deductibility

The February 18, 2003 Budget announced that the resource allowance would be eliminated and that there would be "a deduction for *actual* provincial and other Crown royalties and mining taxes paid" (emphasis added). The replacement is to be phased in over 5 years. It is clear that the Budget contemplated the full deductibility of mining taxes paid.

The government's intention to allow the full deduction of the actual amount of taxes paid was repeated in the Technical Paper[1] released by the Department of Finance in March 2003:

> The new structure for federal income taxation of resource income consists of the following elements … a deduction for income tax purposes of actual provincial and other Crown royalties and mining taxes paid …

This intention was stated again during the debate on Second Reading of Bill C-48 in the Senate (Bill C-48 contained the provisions to enact the new resource regime). The Honourable Wilfred P. Moore said in part:

> The new regime introduced in Bill C-48, to be phased in over five years, will ensure that resource sector firms are subject to the same statutory rate of corporate income tax as firms in other sectors *and that they will be able to deduct actual costs of production*, including provincial and other Crown royalties and mining taxes, rather than an arbitrary allowance. [emphasis added]

Proposed Implementation

The Department of Finance is proposing that the deductibility of provincial mining taxes be implemented by an amendment to section 3900 of the *Income Tax Regulations* (the "Regulations"). Section 3900, in conjunction with paragraph 20(1)(v) of the *Income Tax Act* (the "Act"), permits a taxpayer to deduct provincial mining taxes on income from certain mining operations. The deduction is currently limited to the mining of industrial minerals such as gravel, sand, sulphur, graphite, clay and asbestos. The amendment would repeal the definition of "minerals" in section 3900, with the result that the broader meaning of this term in the Act would apply and so the deduction would be available for taxes on income from mining operations generally.

Concerns with Regulation 3900

The proposal to implement the deductibility of provincial mining taxes by expanding the scope of section 3900 will, in many cases, result in those taxes not being fully deductible by taxpayers. Hence, this approach to implementation is inconsistent with the above-noted statements that *actual* provincial mining taxes paid will be deductible.

Section 3900 permits a taxpayer to deduct a *proportion* of the mining taxes paid by the taxpayer to a province for a year. The proportion is computed by multiplying the actual amount of taxes paid by a fraction, the numerator of which is the taxpayer's income derived from mining operations in the province for the year and the denominator of which is the taxpayer's income in respect of which the taxes were paid. This fraction has been interpreted such that income in the numerator means income as determined under the Act (with the modifications specified in section 3900), whereas in the denominator it means income as computed under the relevant provincial mining tax act. Because there are generally differences between the computation of income under the Act and under provincial mining tax acts, the fraction is often less than one, with the result that only a portion of actual provincial mining taxes paid is deductible.

[1] "Improving the Income Taxation of the Resource Sector in Canada", Department of Finance Technical Paper, March 2003.

In our view, the limitation in section 3900 is inappropriate. There is no apparent policy reason why a taxpayer should be prevented from deducting the full amount of taxes paid under a provincial mining tax act simply because the province has used a different base for the tax than is used for income tax purposes. Furthermore, taxes on mining income serve a similar purpose to provincial resource royalties. For constitutional and other reasons, the provinces have generally not imposed royalties in respect of mining activities, but rather have employed taxes on mining income. The fact that provinces obtain their share of resource-related revenue in the form of special mining taxes rather than royalties should not make any difference to the deductibility of the amounts paid. From the producer's point of view, both forms of levy are simply a cost of production.

The issue of the limited deductibility of provincial mining taxes has been around for many years. The Royal Commission on Taxation, in its 1966 Report, recommended that such taxes be fully deductible. A different approach was adopted in the tax reform that followed that Report, involving an abatement of federal tax. This approach was to take effect after 1976. However, as a result of subsequent developments, including the dramatic increase in oil prices, the federal government first introduced a resource abatement in 1974, and later the resource allowance regime that has been in place since 1976. Consequently, the limitation on the deduction of mining taxes under section 3900 ceased to be an issue in 1974.

For a detailed discussion of the history of mining taxes and their deductibility, see the Appendix to this submission. A recurring theme in the history of section 3900 (and its predecessor) is the lack of any policy rationale for the formula contained therein. Certainly no policy rationale for such a formula is evident in the February 18, 2003 Budget.

A further concern with section 3900 is that it provides a deduction in respect of a mining tax only if the tax is imposed under a statute that is restricted to the taxation of persons engaged in mining operations. In the case of Newfoundland, mining tax is imposed by the *Mining and Mineral Rights Tax Act, 2002*, which includes a mineral rights tax. The mineral rights tax is not a tax on persons engaged in mining operations. It applies, *inter alia*, to a person who receives royalty income or other consideration that is contingent upon the production of a mine or computed by reference to the amount or value of production from a mining operation, where the consideration is for the grant or assignment of any right issued under the *Mineral Act*. Thus, tax under this Act will not qualify for deduction under section 3900. We have not reviewed the mining tax legislation of other provinces to determine whether a similar problem exists with any other province's legislation.

Equity

Limiting the amount of provincial mining taxes that may be deducted, while imposing no similar limitation on deductions for royalties (including profit-based royalties in the case of oil sands) that can be claimed by the petroleum industry, would not be equitable treatment of different taxpayers in the resource sector. Moreover, it would result in unfairness within the mining industry as well, since some jurisdictions now impose a royalty on mining profits instead of a tax. One example is the royalty payable on diamond production in the Northwest Territories.[2] Such levies on diamond production will be fully deductible in computing income (after the phase-in).

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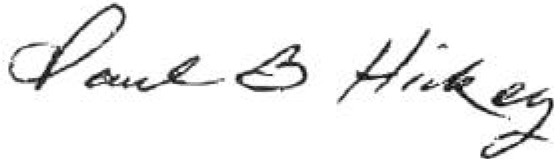
[2] Section 65 of the *Canada Mining Regulations*, C.R.C., c. 1516.

Suggested Approach

To address the concerns identified above, the Joint Committee suggests that the change with respect to mining taxes be implemented in a different manner. A new provision would be introduced to provide for the full deductibility of provincial mining taxes. The provision could describe the types of taxes that are to qualify for the deduction. For example, it could allow a deduction for any taxes paid under a statute that imposes a tax on persons engaged in mining operations. "Mining operations" would be given a meaning similar to that in the definition in subsection 3900(2) of the Regulations. Alternatively, the provision could permit the deduction of taxes paid under prescribed provincial statutes. A regulation would be enacted listing the mining tax statutes of the provinces.

We trust that you will find our comments helpful. As always, we would be pleased to meet with you and your colleagues to elaborate on any of the points in this submission.

Yours truly,



Paul B. Hickey, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Brian R. Carr
Chair, Taxation Section
Canadian Bar Association

Cc: Daryl Boychuk, Senior Tax Policy Officer, Finance Canada

APPENDIX

HISTORY OF MINING TAXES AND THEIR DEDUCTIBILITY

The deductibility of provincial mining taxes[3] has an extensive history in Canada – in law and policy. This Appendix describes the history of those taxes and the issues relating to their deductibility. A full appreciation of this history is essential to an understanding of the approach we have suggested in our submission.

An Old Tax

Provincial mining taxes have been around a long time. Mining taxes pre-date the general income tax in Canada. For example, the combined province of Upper and Lower Canada imposed a mining royalty tax before confederation and the antecedent of the current mining tax in Ontario dates back to 1891.[4]

Provincial Revenue from Resource Production

A province can levy a charge on resource production within its boundaries in one of two ways. First, where the province has a proprietary interest in the resource it may levy (or reserve to itself) a royalty on production - as compensation for granting or relinquishing certain proprietary rights in the resource to operators. In this context the province is being compensated in its capacity as a landowner.[5]

Second, a province has the right under the constitution to levy "direct" taxes on persons within the province.[6] A direct tax is one which by its nature tends to be borne by the person on whom it is imposed, and is not passed on to another. A direct tax can be levied in addition to (where available) a royalty because the province's constitutional powers in respect of its property and direct taxation are not mutually exclusive.

In the case of conventional oil and gas in Canada, most provinces have opted to impose levies on production by way of royalties created at the time the oil and gas leases are granted. The provinces have employed this method likely because of the homogeneous nature of conventional petroleum and the fact that the market value of the petroleum "at the well-head" is relatively easy to establish.[7]

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3 In this submission the phrase "provincial mining taxes" includes comparable mining taxes in the three Territories of Canada.

4 See R.D. Brown, "The Fight Over Resource Profits", Volume XXII, No. 4, 1974 CTJ 315, at footnote 8.

5 D.Y. Timbrell, "Taxation of the Mining Industry in Canada", Studies of the Royal Commission on Taxation, Number 9, May 1964, page 67, paragraph 163. This report is referred to in this Appendix as the "1964 Royal Commission Study". See also the decision in *C.I.G.O.L. v. Gov't of Sask*., 80 D.L.R. (3d) 449 (SCC). The federal government also levies royalties, for example, on diamond production in the Northwest Territories.

6 Ibid. The power to levy direct taxes was first contained in the *British North America Act*, subsection 92(2), and later became subsection 92(2) of the *Constitution Act, 1867*.

7 Report of the Royal Commission on Taxation, Volume 4, Taxation of Income, page 349, fourth full paragraph. This report is referred to in this Appendix as the "1966 Royal Commission Report".

Originally, the provinces derived revenue from mining by levying a flat charge per ton of ore removed. This was within their constitutional power only if structured as a royalty. Some provinces did not own the resources - such as Ontario in the case of gold - or alternatively granted interests in the resources royalty-free. If a province did not have a proprietary interest in a resource, it sometimes sought to impose a tax on gross production. However, the Courts held such a tax to be unconstitutional - being in the nature an "indirect tax" and therefore *ultra vires*.[8]

As time went on, most provinces granted interests in their mineral resources outright (i.e., royalty-free), and as a result framed their levies on mineral production in the form of a tax on "mining profit". Such a tax was a "direct tax", as being a tax on income, and was thus within the constitutional power of the province to impose.[9]

The Problem With Mining Taxes

Had the provinces, where possible, pursued a policy of imposing levies on mineral production in the form of royalties and not mining taxes, the federal tax position would be simple and clear. Such was the case, as noted above, in the petroleum context. From the very start of income taxation in Canada, royalties were excluded from income altogether as a matter of property law, or alternatively, were an ordinary deductible business expense.[10]

By as early as 1930 the federal income tax position was not the same for provincial mining taxes on mining profits. At that time, it became an issue as to whether any tax based on "mining profits" was a deductible expense because it was uncertain as to whether such tax was laid out "for the purpose of earning income" or whether it was imposed on that income "once earned". In order to resolve this issue, a specific statutory deduction for mining taxes was inserted into the federal income tax legislation.[11]

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8 *The King v. Caledonian Collieries Limited*, (1928) A.C. 358. See the 1964 Royal Commission Study, page 67, paragraph 163, and the 1966 Royal Commission Report, page 349, last paragraph. To a similar effect see the decision in *C.I.G.O.L. v. Gov't of Sask.*, 80 D.L.R. (3d) 449 (SCC).

9 In *Nickel Rim Mines Ltd. v. A.-G. for Ontario*, [1966] 1 O.R. 345, the Ontario Court of Appeal considered whether the tax imposed by Section 4 of the *Mining Tax Act*, R.S.O. 1950, chapter 237 was *ultra vires* of the province as not being "direct". On appeal Porter, C.J.O., who delivered the judgment of the Court of Appeal, agreed with the trial judge Wells, J. that the tax, in so far as it applied to realized profits, was a direct tax. Porter C.J.O further held that the profits tax on ore not yet sold was also a direct tax.

10 1966 Royal Commission Report, page 349, third full paragraph. 1964 Royal Commission Study. See also Edward Rowe, "Deductibility of Crown Charges under Bill C-48", Federated Press, Resource Sector Taxation, Volume II, No. 1 2003 for a discussion of the deductibility of royalties, including profit-based royalties.

11 1964 Royal Commission Study, page 67-8, last paragraph. The specific statutory prohibition was contained in a predecessor provision to the current paragraph 18(1)(a). See *Roenisch v. M.N.R.*, 1 DTC 199 (Ex. Ct.). See also Brian Carr, "Mining Taxes: An Old Problem Revisited", Federated Press, Resource Sector Taxation, Volume II, No. 1 2003. As pointed out therein, the non-deductibility of these taxes is not entirely free of doubt. Non-deductibility of profit-based mining taxes is taken as a working assumption in this Appendix.

1944 to 1948 – Original Tax Policy

One of the specific recommendations in the Report of the Royal Ontario Mining Commission in 1944 was that the amounts payable by mining companies under the *Mining Tax Act* of Ontario should be allowed as a deduction under the federal *Income War Tax Act* and *Excess Profits Tax Act*. The Commission regarded the tax as an absolutely necessary expense in determining the proper cost of the ore.[12]

The Dominion-Provincial Conference on Reconstruction was held in 1945. One of the federal government's proposals at the time was to reserve to itself, temporarily, exclusive jurisdiction over taxes on income, with the exception of taxes on mining and logging profits. These were seen to be within the clear purview of the provinces. The proposal also recognized that such mining taxes "are recognized costs of operation and as such can be deducted from taxable income for Dominion tax purposes".[13]

Following upon this statement, the first specific federal tax provision recognizing a deduction for mining taxes on profits was paragraph 5(1)(w) of the *Income War Tax Act*, applicable to 1947 and later years. In describing this provision, the Acting Minister of Finance at the time said:

> Provincial income tax on that particular kind of income in the Province [i.e., mining profits], which today ordinarily is not allowed, will in future be allowed … In the past Provincial income tax [on mining profits] was not allowed as a deduction … In the future it will be … .[14]

In 1947, paragraph 5(1)(w) read:

> …such amount as the Governor in Council may, by regulation, allow for amounts paid in respect of taxes imposed on the income … by … a Province … by way of a tax on income derived from mining operations …

In 1948 a change was made to this provision to allow for mining taxes levied by municipalities as well as provincial governments, and to allow for a deduction on the accrual basis rather than on a paid basis.[15] Thus, for years 1947 and 1948 the provision read:

> …such amount as the Governor in Council may, by regulation, allow in respect of taxes on income for the year from mining … operations …[16]

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12 1964 Royal Commission Study, page 140, paragraph 311.
13 Ibid, page 140, paragraph 312.
14 Ibid, page 141, paragraph 313.
15 Ibid, page 141, paragraph 316.
16 This same wording is found in current paragraph 20(1)(v).

With the introduction of the 1948 *Income Tax Act*, regulations were promulgated pursuant to this provision, determining the amount of the deduction for mining taxes.[17] As will be explained below, these regulations proved to have the effect of not allowing a full deduction for mining taxes. In fact, some taxpayers found that only a small portion of provincial mining taxes were deductible in computing federal income.[18] Importantly, and rather astonishingly, this effect was not the result of any published tax policy decision by the Department of Finance.[19] A recurring theme has been the distinct lack of any policy rationale underlying the structure of the applicable regulations.

1949 to 1967 – The Problems with Regulation 701

As just observed, although the clear tax policy had been to allow a deduction for mining taxes as a recognized cost of production, the regulations promulgated pursuant to the statutory provision did not implement that tax policy.

The reasons for the lack of a full deduction were many, but the essential problem was that the formula in Regulation 701 provided for a deduction of a proportion of mining taxes based on:

$$\frac{\text{“income derived from mining operation in the province”}}{\text{“income in respect of which the provincial mining taxes were paid”}}$$

and the federal government interpreted the ratio to the effect that "income" in the numerator of the fraction meant federal income, and in the denominator it meant income determined under the provincial mining tax statute. This interpretation was ultimately sustained in a split decision of the Supreme Court of Canada.[20]

The problem arising from this interpretation was simply that the base for taxation under the provincial mining tax acts differed, substantially, from income as determined for purposes of the federal act. Moreover, provincial mining tax acts differed as between themselves. As a result, the formula in Regulation 701 operated quite arbitrarily and taxpayers in some provinces suffered more from the random working of the formula than taxpayers in other provinces.[21]

A mismatch could arise for a number of reasons, including the following:[22]

a. interest was not deductible in computing mining profits in most provinces;[23]

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[17] Section 701 of the Regulations in force at the time. Section 701 is the predecessor to the current section 3900 of the Regulations.
[18] 1964 Royal Commission Study, page 68, paragraph 164.
[19] Ibid, page 142, paragraph 317.
[20] *Quemont Mining Corp.* v. *Minister of National Revenue,* 70 D.T.C. 6046 (S.C.C.), affirming 66 D.T.C. 5376 (Ex. Ct.).
[21] 1964 Royal Commission Study, page 68, paragraph 165.
[22] Most, if not all, of these would persist to this day.
[23] R.D. Brown, "The Fight Over Resource Profits", supra footnote 3.

b. royalties paid to private resource owners were not deductible in computing mining profits in most provinces;[24]

c. certain administrative and overhead costs were not recognized in computing mining profits in most provinces;[25]

d. gains and losses on the hedging of production might not be treated consistently for federal tax purposes and provincial mining tax purposes;[26]

e. the "processing allowance" computation in mining tax regimes was not always consistent with the assumed processing allowance computation in Regulation 701;[27]

f. Regulation 701 did not prescribe any specific method for allocating federal income between the provinces;[28] and

g. in a mining partnership with an off-calendar year-end, the federal income could fall into a different taxation year than substantially the same income computed for mining tax purposes.[29]

Regulation 701 had therefore become well known as arbitrary and entirely unsatisfactory.

1964-66 Royal Commission – Revisiting 1944 Tax Policy

The 1964 Royal Commission Study noted the foregoing history and problems with Regulation 701, and concluded as follows:

> The formula in Regulation 701, as it is interpreted by the Department, states, in effect, that unless the computation of income under the provincial mining tax acts is brought into line with the federal act, the deduction for provincial mining taxes is going to work in an arbitrary way. … It seems neither necessary nor desirable to present this sort of ultimatum to the provinces. Each has its own complex tax structure which has been built up over many years. Ontario's mining tax, for example, antedates the federal income tax … . This is a matter of tax sharing where the federal and provincial governments should co-operate to arrive at a joint solution.[30]

The 1964 Royal Commission Study went on to recommend the following alternate solutions to the problem:

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24 Ibid.
25 Ibid.
26 Edward Rowe, "Deductibility of Crown Charges under Bill C-48", Federated Press, Resource Sector Taxation, Volume II, No. 1 2003.
27 R.D. Brown, supra footnote 3, and Edward Rowe, ibid.
28 Edward Rowe, supra footnote 26.
29 This is simply a result of the formula where, for example, mining tax is levied on the partners on a calendar year basis and the partnership has a January year-end for federal purposes.
30 1964 Royal Commission Study, page 68-9.

> The type of solution which seems possible is for the federal government to allow a credit against federal tax for a stipulated percentage of federal income derived from mining in each province and to allow no deduction against income for provincial mining taxes. … This is essentially the system used for provincial income taxes and it has worked well. … Another solution would be to allow all provincial mining taxes as deductions from federal income, producing a result similar to that for the oil companies which can deduct all of their [royalties].

In the 1966 Royal Commission Report the alternate solution is recommended as the appropriate tax policy. The Report concludes:

> Whether the provincial governments derive revenues from natural resources through lease payments, royalties, or a tax on income, the charges are nevertheless a cost of acquiring a supply of the mineral or petroleum concerned. Therefore, such charges, regardless of their form, should be deductible ***in full*** in the computation of income in the same way as any other cost of doing business. However, as they are a cost of doing business, they should not be eligible for any form of tax credit. [emphasis added]

It will be observed that the alternate tax policy solution proposed in 1964, and put forward in 1966, is the same proposal that appears in the Department of Finance March 2003 Technical Paper. The tax policy proposed in 1964, and put forward in 1966, was one of full deductibility – i.e., doing away with the arbitrary and unsatisfactory formula in Regulation 701.

<u>1971 Tax Reform</u>

Tax reform enacted at the end of 1971[31] introduced a scheme, to commence after 1976, that would deny any deduction for provincial mining taxes in computing federal income and, at the same time, allow an increased federal abatement of 15% of mining profits. This recognized the fact that provinces levied the significant additional burden of a tax on mining profits, and also recognized the well-known problems with Regulation 701. These amendments, commencing after 1976, were introduced to create "tax elbow room" for the provinces to allow them to preserve, or develop, tax policies for mining companies operating within their borders.[32]

<u>1974 to 2003</u>

As a result of world events in 1973, the Canadian tax system applicable to the resource industry was significantly altered.[33] War in the middle-east had caused the price of oil to increase dramatically. The price of minerals was also on the rise.

At that time, the provinces increased their royalties and taxes substantially. The federal government reacted in 1974 to deny any deduction in computing federal income for provincial

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[31] Bill C-259.

[32] R.D. Brown, "The Fight Over Resource Profits", supra footnote 3, at page 317. See also Summary of 1971 Tax Reform Legislation, Honourable E.J. Benson, Minister of Finance, page 48.

[33] See Brian R. Carr, "Recent Amendments to the Resource Tax Regime", paper delivered at the 2003 Annual Conference of the Canadian Tax Foundation.

royalties and taxes on resource production. With respect to the oil and gas industry, it did so through the enactment of paragraph 12(1)(o), paragraph 18(1)(m), and subsections 69(6) to (10). Paragraph 12(1)(o) added to the operator's income the province's share of production that would not otherwise be included in its income as a matter of property law.[34] Paragraph 18(1)(m) denied any deduction for all other forms of provincial royalties and taxes on gross production. Subsections 69(6) to (10) ensured that these restrictions could not be avoided by having sales of petroleum or minerals take place between operators and provinces at less than fair market value.

In the mining industry, these provisions were equally applicable to some royalties on mining production - such as a recently introduced mining royalty in British Columbia.[35]

However, with respect to mining taxes on profits, these were (as explained earlier) already not deductible otherwise than to the extent specifically allowed by the formula in Regulation 701. The vast majority of these taxes became completely non-deductible by an amendment to the definition of "mineral" in Regulation 701 so as to exclude minerals from a "mineral resource". This had the effect of not allowing any deduction under that regulation in respect of provincial mining taxes on profits from the production of a mineral resource.

In the place of non-deductibility of all such provincial levies on resource production, the federal government introduced an additional abatement. The June 23, 1975 budget eliminated the abatement and introduced the "resource allowance", being a deduction in computing federal income equal to 25% of resource production profits calculated after operating expenses and capital cost allowance but before interest expense and exploration and development expenses.

There were no further developments prior to the announcement in the 2003 Budget that the resource allowance would be phased out and replaced by full deductibility of actual mining taxes.

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[34] Edward Rowe, supra footnote 26.

[35] R.D. Brown, "The Fight Over Resource Profits", supra footnote 3, at page 320.