Case Study

Topic 3.2

AUDIT OF THE MINING INDUSTRY

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Presentation PPT

1. INTRODUCTION

Canada is a mining country, producing some 60 minerals and metals. It is also a global mining leader and accounted for 37 percent of world exploration in mining in 2012[1].

Although the financial returns can be lucrative, mining involves high risk and large capital requirements. It can take a tremendous amount of exploration work to find a feasible mineral deposit and then many years to develop the mine and bring it into production. Adding to these risk factors is the reality that mining companies are vulnerable to price volatility and cyclicality.

The Canadian tax provisions for mining entities recognize these commercial risks. Tax incentives not only encourage exploration and the development of new mines, they allow a mining company to recover much of its capital investment before paying taxes.

1 *Source: Natural Resources Canada*

Because of the special tax regime and the uniqueness of the industry, government audits of mining companies pose special challenges. The purpose of this paper is to discuss items the staff of the Canada Revenue Agency (CRA) focus on when auditing mining companies, as well as resources available to them.

2. HIGHLIGHTS OF THE CANADIAN MINING TAX REGIME

2.1 General features of the Canadian mining tax regime

Under Canada's federalism model, the country is divided into ten provinces and three territories with each having its own provincial/territorial government. Income tax is payable at both the federal and provincial/territorial level. The provinces and territories also levy a mining tax or royalty.

Considering the distinct commercial risks faced by mining companies (as noted above in the Introduction), there are advantages in the Canadian tax system:

a) The Canadian mining tax regime acknowledges the high risk and high capital nature of the industry by allowing for the recovery of much of the capital investment in a mine before taxes are paid.
b) Price volatility and the cyclical nature of mining are mitigated by not taxing non-profitable taxation years. Federally, taxes are based on taxable income which, generally, is calculated by deducting from revenue reasonable expenses incurred to earn that revenue. Similarly, most provincial and territorial royalties and mining taxes are based on net production profits, rather than gross revenue or net smelter production. There are also generous rules to carry back and carry forward losses.
c) Another advantage is that the mining tax regime in Canada is reasonably stable so that mining companies have more tax certainty as they plan for the long life of a mine.

Some complexities of the Canadian system are:

a) Other taxes levied by the federal and provincial governments are not profit based. Examples include payroll taxes, sales taxes and property taxes.
b) Special tax rules to address the uniqueness of the resource industry results in a complicated tax regime. This is magnified by the provinces and territories having their own mining tax or royalty regimes.

c) In general, the provinces and territories have jurisdiction over mineral rights for their land and their own sets of mining regulations.

2.2 mining tax incentives

Canada's tax system has several tax incentives for the mining industry aimed at encouraging exploration, the development of new mines and capital investment in mining. The overall aims are to increase economic activity, jobs and global competitiveness. These incentives include:

a) Canadian exploration expense.

This includes the costs of:

- "grassroots" exploration (initial phase exploration) - expenses incurred for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada; and
- Pre-production development – expenses incurred to bring a new mine into development and incurred before it reaches commercial production levels[2].

These costs are accumulated in a non-expiring tax pool from which the mining company can make an optional tax deduction of up to 100% of the pool. The cost of depreciable property is excluded.

b) Canadian development expense

This includes:

- The acquisition costs of Canadian resource properties; and
- The cost of permanent underground work that is incurred after the mine comes into production.

Again these costs are accumulated into a non-expiring tax pool from which the mining company can make an optional tax deduction of up to 30% of the balance. The cost of depreciable property is excluded.

c) Accelerated capital cost allowance

Usually, the cost of depreciable mining property, (such as buildings, mills, equipment etc.) is eligible to be amortized for Canadian tax purposes at a 25% rate on a declining balance. However, if the costs

2 *To be phased out by 2017. Instead such costs will be Canadian development expense at a lower write off rate of 30 percent.*

are in respect of a new mine or a major expansion of an existing mine, they may be eligible for a 100% amortization rate[3].

d) Foreign resource expense

If a Canadian corporation has mining properties in other countries the company can accumulate the costs of these foreign mining properties, and exploration costs incurred in respect of them, in a non-expiring tax pool for each country. The company can claim a tax deduction of the lesser of its foreign resource income from that country and 30% of the pool balance.

e) Investment Tax Credit

A mining company can also earn investment tax credits on eligible exploration costs and pre-production costs of 5 % and 10 % respectively which can be used to reduce tax payable. They can be carried back for 3 years and forward for 20 years[4].

3. AUDITING CANADIAN MINING CORPORATIONS

3.1 Risk Assessment

Auditors at the Canada Revenue Agency analyze every large entity and prioritize high-risk files for audit. (See the paper by Canada on "Risk Analysis and Audit Software Tools".) Some of the risk factors we look at are:

- Whether the entity is a multinational corporation or group of corporations
- Whether tax haven countries are involved
- Whether the entity has a history of aggressive tax planning
- Whether potential audit adjustments would be material
- Industry issues, practices and trends
- Prior audit history of the entity
- Whether there has been a takeover, merger, major disposition or reorganization
- The tax situation of the entity (e.g. Does it have a series of loss years)

3.2. Areas of focus of a mining company audit

Since Canada has rich tax incentives for mining, it is important that

3 *To be phased out by 2020.*

4 *The 5 % credit for exploration expenses is being phased out by 2013. The 10% credit for development costs is being phased out by 2015.*

claims for those incentives by taxpayers are accurate. Accordingly our auditors ensure that expenses claimed as Canadian exploration expense, eligible for an up to 100% write-off, meet the tests in our legislation. For example:

- As noted above, there is a purpose test for eligibility of exploration costs; consequently, our auditors must verify that the costs are "for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada".
- Pre-production expenses must be for the purpose of bringing a new mine in Canada into production. Consequently, auditors must verify that a project is a new mine as opposed to an existing mine or an expansion of an existing mine. On this issue, we often consult the geologists and engineers at Natural Resources Canada, a separate government department.
- Since eligible pre-production costs get this favourable treatment, the cut-off date of the pre-production stage is important, that is, the date when the mine reaches production in reasonable commercial quantities. Accordingly, our auditors must verify that claimed expenses are indeed pre-commercial production.

Other key areas of focus are:

- Reserves for mine closure, land reclamation costs and site clean-up. Although these are accrued for financial statement purposes, these future costs have not been incurred and are not deductible for tax.
- Acquisitions and dispositions of mining properties have specific tax rules.
- The point at which mining ends and manufacturing commences has tax implications.
- Transfer pricing – The auditor may need to verity that a cross-border transaction with a non-arm's length party was at a comparable arm's length (uncontrolled) price. This valuation is usually not difficult for many mineral sales if the minerals are in their final state, since there are public market prices for such commodities, which are easily verifiable. (It may be an issue if the mineral still has to be refined when it leaves Canada, for example, rough-cut diamonds or gold that is not at market purity.) The determination of the appropriate transfer price is a more contentious issue in respect of management fees and payments for know-how.
- Hedging – this is an issue for both commodity price hedging and foreign exchange hedging, particularly when the Canadian company hedges for related foreign companies.
- As in any other industry, our auditors would look at:

- – Whether a transaction should be on income or capital account
- – Foreign exchange transactions
- – Whether the company is involved in aggressive tax planning schemes
- – Whether tax haven countries are used in the company group
- – Whether treaty shopping is involved.

3.3 Audit challenges

A challenge for our auditors in respect of the mining industry is that there may be a significant lag between when expenses are incurred by a mining company and when they are audited. It could take ten years for a mine to start making profits and paying tax.

The time lag challenge can be aggravated by staff turnover, which can be high at mining companies, particularly in northern Canada. This can cause difficulty in verification of the tax return.

Another challenge our auditors face is that junior (small) companies may have weak accounting and documentation systems due to their small size, few employees and lack of funds for other than exploration. For example, a lot of their work is contracted out and the invoice may not specify the nature of the work done.

Finally, it is our experience that no two mines are identical; accordingly, a site visit can be valuable to the auditor. However, the reality is that mines are located across Canada and often in remote locations and therefore site visits may not be logistically or financially feasible.

3.4 Resources for CRA auditors

Our auditors use the following resources when auditing mining companies

- Company annual reports
- Minutes of shareholder meetings
- Press releases
- The company Website
- Information filed with the applicable provincial or territorial regulatory body. This would include mining plans and reclamation plans.
- Stock analyst reports which may indicate mining history and plans
- A site visit when feasible.
- An internal CRA training course on mining taxation on our Website.
- Court case law

- The CRA Form T1134, on which the taxpayer must report on foreign affiliated companies and Form T106, on which the taxpayer must report non-arm's length transactions with non-residents.
- Internal and external databases e.g. CRA technical opinions, Statistics Canada, and external tax publishers.

The auditors can consult the Mining Specialist in CRA's Industry Specialist Services area. Our industry specialists are highly experienced in the audits of their particular industry and are an excellent source of technical assistance, industry related knowledge and commercial awareness. They give training and information sessions, and help auditors with the risk assessment and assessing positions of their files. The Mining Specialist also chairs a national Mining Steering Committee Meeting where CRA experts on mining meet to discuss and resolve current issues of national importance.

Our auditors can also consult or make referrals to other specialized areas within CRA, such as International Tax and Aggressive Tax Planning, or those responsible for technical interpretations. Outside of CRA, they may ask for the specialized knowledge of the geologists and engineers at Natural Resources Canada or the legal advice of the Department of Justice.

4. CONCLUSION

The mining industry is unusual in that it can take many years of exploration to find a mineralization that is feasible to mine, more years to develop that mine and the mine itself can stay in production for many years. (Some mines in Canada have operated for several decades.) Mining operations are also exposed to fluctuating prices of commodities and are vulnerable to profit and loss cycles. The Canadian tax regime for mining aims to mitigate these factors to some extent, while also encouraging exploration for the development of new mineral deposits.

CRA auditors of mining companies need specialized knowledge of this tax regime and the mining industry and awareness of which risk items should be focused on in their audits. Due to the global presence of Canadian mining companies, auditors also need to be alert for international audit issues such as transfer pricing. It has been our experience at the CRA that the best ways to address these needs are training, effective knowledge transfer, and the availability of dedicated experts both within CRA and in other federal government departments.