Rethinking Provincial Resource Taxes

By Steve Suarez, Borden Ladner Gervais, LLP

Canada's provinces derive quite a bit of revenue from taxes on non-renewable resources ($79 billion from 2009 to 2013)1. A new thought-provoking study from the C.D. Howe Institute raises some important questions on how best to design these taxes.

With Alberta's new government poised to overhaul its resource tax regime, the C.D. Howe Study[1] is timely. Well-advised governments understand that a properly designed tax system is not about simply raising as much revenue as possible, but also about encouraging (or not discouraging) the type of activity that generates the revenue from which tax is taken. As the C. D. Howe Study puts it, "[R]esource taxation systems should concern themselves only with getting the maximum value out of the physical energy and resource assets buried under ground without discouraging the investment and effort required to find and extract assets."

This is a particularly challenging exercise in resource taxation, where the type of investment required to actually generate revenue is quite risky and expensive, and occurs over a very long timeframe. Exploration to simply find a potential resource is a low-percentage exercise, and even when a viable resource is found it take many years of development and pre-production work before the first dollar of revenue is created. Mining companies aren't happy to find that they have a quasi-partner ready to share in the benefits of successful projects but not the losses.

> Well-advised governments understand that a properly designed tax system is not about simply raising as much revenue as possible, but also about encouraging (or not discouraging) the type of activity that generates the revenue from which tax is taken.

The C.D. Howe Study reviews different resource tax regimes around the world, and concludes that existing gross royalty levies do not create the right incentives or accurately reflect the profitability of a project. The ideal resource tax incorporates all of the costs involved in the relevant economic activity so as to tax only the profits, not merely the revenue—there are few things more discouraging to mining companies than to be paying tax on unprofitable projects, which is often what occurs under economically-distorting gross royalty regimes.

Taxes based on cash flow from a project are a demonstrably fairer way for governments to extract their fair share from a resource development while maintaining enough incentive for the mining company to continue making the expenditures involved in exploring and developing. Truly profitable projects bear high taxes under such a regime, while marginal ones incur little or no tax. Norway is described as "the poster child for non-renewable resources policy", with a 51 per cent resource tax that is acknowledged as successful in terms of both encouraging development and raising revenue. The Australian resource-rent tax proposed in 2010 is also cited as a useful precedent, although sub-optimal in that losses are not refunded to the taxpayer (as they are under the Norwegian cash-flow petroleum tax) but rather carried forward at a risk-free interest rate.

Within Canada, the B.C. net-revenue mining tax is identified in the C.D. Howe Study as being "of particular interest because it resembles an efficient resource-rent tax." While losses are not refundable as in a true cash-flow tax, they are carried forward with an assumed financing cost.

Provincial governments seeking to attract resource-sector investment (and the many benefits they bring) would be well-advised to consider whether their taxation policy fairly prices risks and costs into the resource tax base. The C.D. Howe Study usefully sets out how to achieve a fairer resource tax regime that creates the appropriate incentives. M

Steve Suarez is a partner in the Toronto office of Borden Ladner Gervais LLP. He can be reached at 416-367-6702, ssuarez@blg.com or through the website, www.miningtaxcanada.com.

Did You Know?

Revenues from oil and gas resources fund a significant share of provincial budgets in Western Canada—currently 10 percent in British Columbia and 20 percent in both Alberta and Saskatchewan. A number of factors, such as resource prices, royalty rates, and resource abundance, drive changes in these revenues. These three provinces also raise a substantial share of their general corporate and personal income taxes from non-renewable resource companies and their employees.

Source: C.D. Howe Institute

Reference

1. "Drilling Down on Royalties: How Canadian Provinces Can Improve Non-Renewable Resource Taxes", by Robin Boadway and Benjamin Dachis, available at www.cdhowe.org.