Tax Structuring for Canadian Investment in Latin American Mining Projects

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Topics Covered

- Branch vs. Subsidiary
- Tax Objectives
- The Canadian Controlled Foreign Corporation Regime
  - Anti: - Deferral (FAPI) System
  - Surplus (Repatriation) System
- Holding Companies & Tax Treaties
- Foreign Affiliate Dumping Rules
- Metal Stream Financing

Canada's Tax Treaties in Latin America

Full Tax Treaties

- Argentina
- Brazil
- Chile
- Colombia
- Dominican Republic
- Ecuador
- Guyana
- Mexico
- Peru
- Venezuela

Tax Information Exchange Agreements

- Costa Rica
- Panama (signed, not yet in force)
- Uruguay (signed, not yet in force)
- Belize (under negotiation)

Branch v. Subsidiary

- Foreign branch of Canco very unusual
- Reasons for preferring Forco:
  - Legal liability
  - Repatriation (and WHT) can be controlled
  - Sometimes deferral of Canadian tax on current profits and ability to defer Canadian tax on sale
  - Potential to use group cash to debt-finance Forco in favourable manner

Tax Objectives

- Minimize:
  - Source country tax on operations
  - Source country withholding tax
  - Canadian accrual basis tax (“FAPI”) on source country income
  - or defer Canadian tax on repatriation of current cash
  - Source country and Canadian tax on sale of investment
- Maximize flexibility for re-investment
  - e.g., Chilean 20 day reinvestment rule

Canada’s CFC System: The FAPI Rules

- Rules differentiate between “active business income” (ABI) and passive and “base erosion” (FAPI)

- FAPI earned by a controlled foreign subsidiary of Canco is imputed to Canco and taxed in Canada (subject to a credit for foreign taxes)

- FAPI includes:

  – passive income from property such as interest, dividends and royalties (othe than dividends from other foreign members of the Canco group), unless earned in a business of deriving such income that employs 6+ full-time employees; and
  – 50% of capital gains from the disposition of property other than “excluded property”.
  – Excluded property is (1) property used or held principally to produce ABI, or (2) shares of foreign corporations substantially all of the property of which is property described in (1), directly or indirectly

- Recharacterization rule: interest income earned by one foreign subsidiary from another foreign subsidiary that is earning ABI is itself deemed to be ABI

Canada's CFC System: The Surplus Rules

Income, gains and losses realized by Forco are classified into one of three categories. When Canco receives a dividend from Forco, Canadian taxation depends on which category the dividend relates to:

- Exempt surplus: Canco is entitled to a complete exemption (100% dividends received deduction) on dividends from Forco's exempt surplus

- Taxable Surplus: a dividend from Forco's taxable surplus is included in Canco's income, and a grossed-up deduction is permitted in respect of foreign taxes paid on the underlying income or the dividend (e.g., dividend withholding tax)

- Hybrid Surplus: essentially a hybrid of 50% exempt surplus and 50% taxable surplus: dividend included in income but deduction permitted for foreign taxes borne and for 50% of the dividend

Canada's CFC System: The Surplus Rules

- Exempt Surplus:
  - ABI earned in a country with which Canada has a tax treaty or a tax information exchange agreement (a "treaty country")
  - Capital gains on property used or held principally to produce ABI in a <u>treaty</u> country
  - 50% of capital gains on property used or held principally to produce ABI in a <u>non-treaty</u> country, and on shares of another foreign subsidiary that are not excluded property

- Taxable Surplus:
  - ABI earned in a non-treaty country
  - Income from property (except dividends from other foreign subsidiaries and passive income from another foreign subsidiary that is deemed to be ABI by recharacterization rule)
  - 50% of capital gains on property used or held principally to produce ABI in a <u>non-treaty</u> country
  - 50% of capital gains on property that is not excluded property

- Hybrid Surplus: Capital gains on shares of another foreign subsidiary that are excluded property

Canada's CFC System: Key Principles

- Earning non-FAPI through a foreign subsidiary rather than directly by Canco defers Canadian tax until fund are repatriated

  ➔ Canadian corporations rarely invest directly in foreign projects

- Earning exempt surplus is desirable, and requires the foreign subsidiary to be both resident in and carrying on business in a treaty country

- To avoid creating FAPI on a sale of shares of a foreign subsidiary, substantially all of the foreign subsidiary's assets (directly or indirectly) must consist of property used or held primarily to produce ABI

  ➔ important to minimize tainting assets

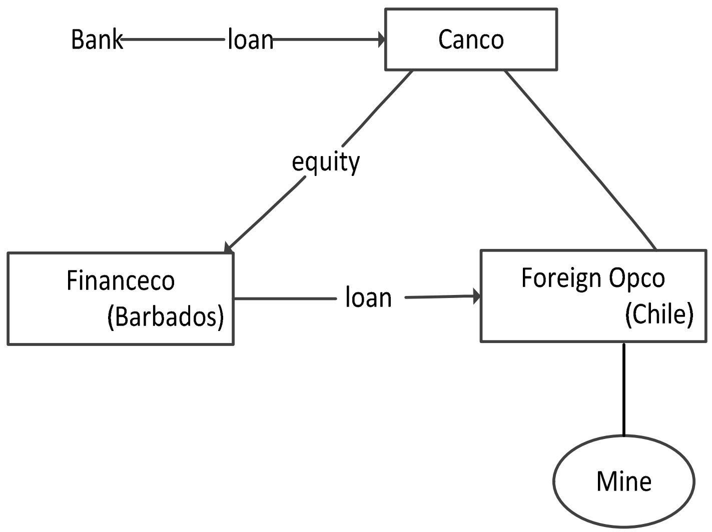
Canada's CFC System: Key Principles

- A sale of property (including shares) by a Canadian corporation will result in Canada taxing any gain, whereas a sale by a foreign subsidiary will not trigger immediate Canadian taxation (so long as the property is excluded property)

  ➔ it is often advantageous to insert foreign holding companies between Canco and foreign operating companies

Typical Foreign Affiliate Financing Structure

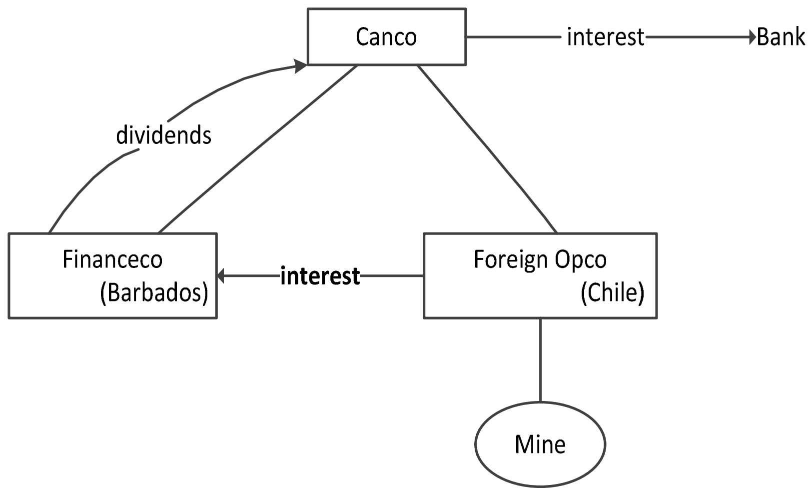
Structure



Canco borrows money from a bank, and subscribes for shares in Financeco.

Financeco loans the money to Foreign Opco, which uses the money to purchase a mine

Operation



Foreign Opco pays interest to Financeco, and deducts its interest expense for local tax purposes.

Financeco receives interest income, which for Canadian tax purposes is charaterized as ABI since it is payable from another Canco foreign affiliate out of income from its active business.

Canco receives exempt surplus dividends from Financeco, which are entitled to a 100% dividends - received deduction

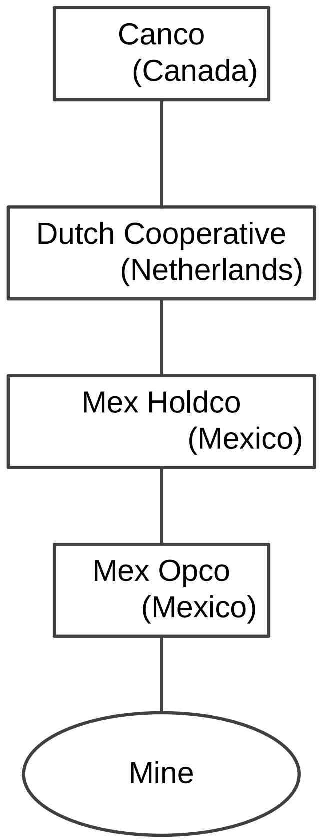
Transfer of Holding Companies

Example of using tax treaties to minimize local tax

Sale by Dutch Cooperative of Mex Holdco shares reduces Mexican capital gains rate from 30% down to 10% under Netherlands – Mexico tax treaty

No Dutch taxation of gain under Netherlands law

No FAPI in Canada if Mex Holdco shares are excluded property



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Foreign Affiliate Dumping Rules

- Rule apply, with potentially adverse consequences, to a foreign-controlled Canco that:
  - loans money to (or acquires a debt of) the FA
  - acquires shares of the FA
  - confers a benefit on or contributes to the capital of the FA;
  - acquires options or interests in respect of securities of the FA; or
  - acquires the shares of another Canadian corporation more than 75% of the value of whose property consists of shares of FAs.

Metal Streams – Species of Offtake

1. General Commercial Idea and Recent Examples

2. Basic Contractual Terms—General Discussion

3. Basic Contractual Terms—Purchase Price

4. Transaction Structuring—Domestic Transaction
   - Canadian income, mining and commodity tax considerations

5. Transaction Structuring—Offshore Transaction
   - Canadian income tax considerations
   - Foreign tax considerations

Commercial Considerations

- Vendor owns a mineral property and requires financing to complete construction of a mine or to finance other capex.

- Vendor does not want to issue debt or shares but does not mind selling non-core metal off-take.

- Reasons: non-core metal not reflected in stock price, low markets, poor credit, high debt load, shareholder dilution etc.

- Purchaser agrees to provide Vendor with upfront financing for construction and then purchase a percentage of minerals for a fixed price that is usually much lower than prevailing spot price.

Commercial Considerations (2)

- The potential loss of income from the metal subject to the transaction if the NPV of the upfront payment and all of additional fixed payments for metal sold under the contract is less than the NPV of the metal sold to the producer at the relevant spot price over the course of the contract.

- Vendor will have fewer “non-core metal credits” in determining the “total cash cost” of production.

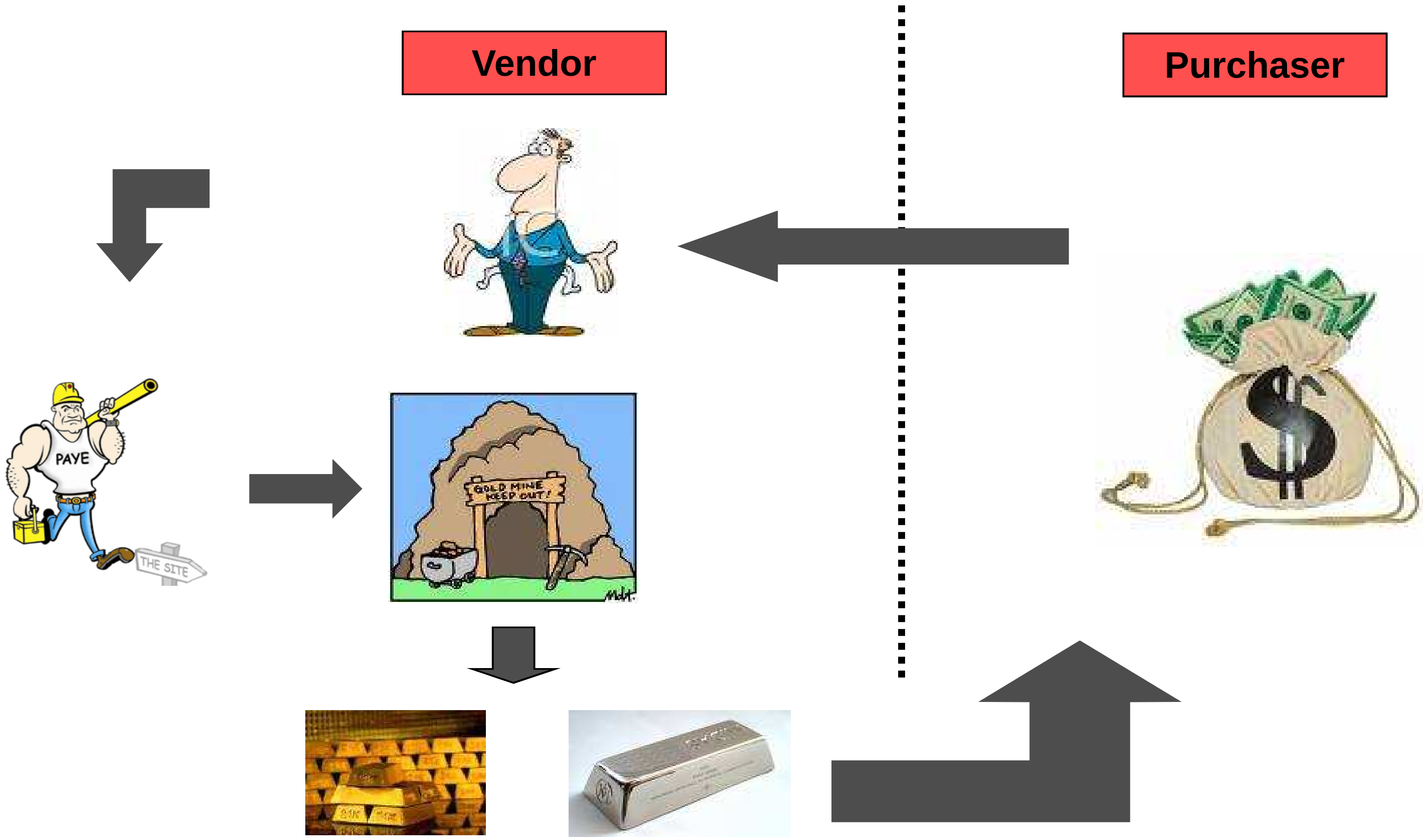
- Overhang on takeover or asset premium if escalating metal prices because the forgone revenue increases in-step with the increase in silver price.

Commercial Considerations (3)

- The possibility that the contract will be presented as a derivative on the producer’s financial statements.

- Depending on the structure, the producer may be subject to immediate tax on the upfront payment, or to income tax based on the spot price for the metal instead of the fixed price plus a portion of the upfront payment which means that the producer is subject to tax on phantom income or losses will not be tax-effected. These issues may affect pricing (and overhang).

The “Symbiotic Relationship”



Basic Contractual Terms—General

- Purchase and sale agreement
- Vendor and Purchaser enter into agreement pursuant to which:
  - Vendor agrees to sell to Purchaser a percentage of mineral (e.g., Au or Ag) mined from a particular property. Could be up to 100% of production. Usually not specific number of ounces (or else could be a derivative).
  - Purchaser agrees to: (1) make a substantial up-front payment to Vendor (usually in form of a deposit); and (2) purchase the agreed-upon metal on a set per-ounce price

Basic Contractual Terms—General

- Usually purchase of refined metal but there are some exceptions (i.e., where 3rd party off take agreement in place).
- No obligation to deliver metal from the particular mine.
- Agreement is property specific.
- Usually by-product or non-core metal.
- Specific term. Potential for extension at the option of the Purchaser.

Basic Contractual Terms – Purchase Price

- Recall: Purchaser agrees to: (1) make a substantial up-front payment to Vendor; and (2) purchase the agreed-upon metal on a set per-ounce price

- Upfront payment is generally structured as a deposit- used by Purchaser at will. Refundable if do not deliver specified number of ounces or if processing thresholds (if applicable) not met.

- Technically: The purchase price is structured in two phases—prior to depletion of deposit and after depletion of deposit.

  – Prior to depletion of deposit the per-ounce purchase price is equal to spot. This is paid by adding to the set contractual purchase price a portion of the deposit equal to the difference between spot and the contractual price.

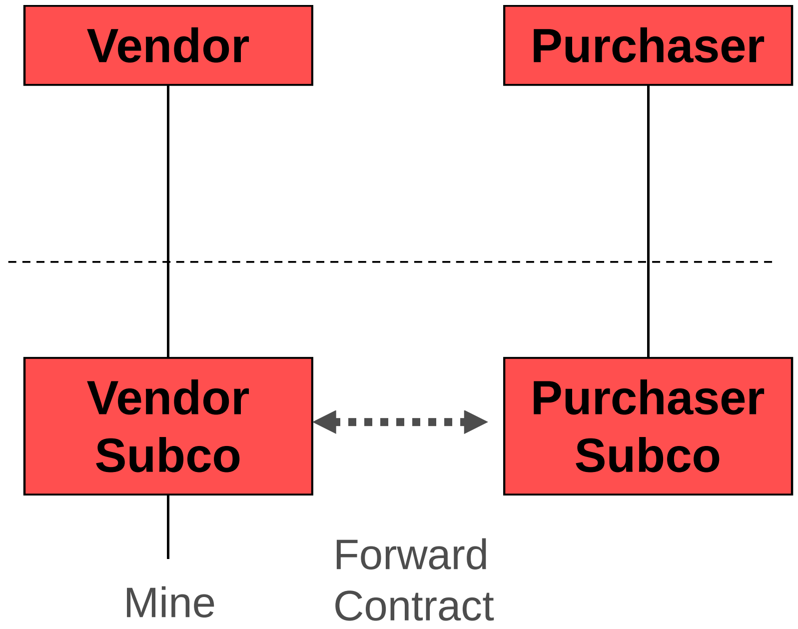
  – After depletion of deposit the per-ounce purchase price is equal to the contractual set price.

Transaction Structuring – Offshore: Structure

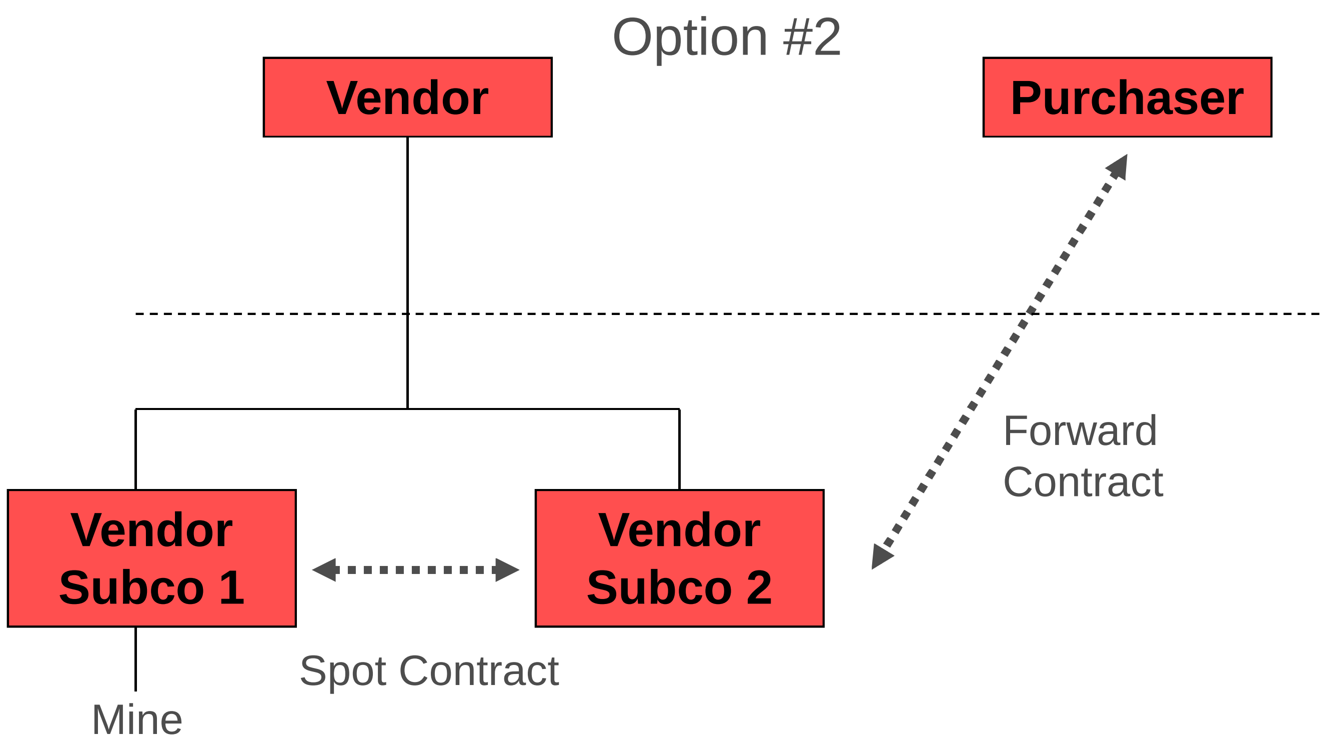
Used where no tax to Vendor Subco on upfront payment

Fwd K: Sell minerals to Purchaser Subco at lesser of spot and contract price. Upfront payment to Vendor Subco

Option #1



Transaction Structuring – Offshore: Structure

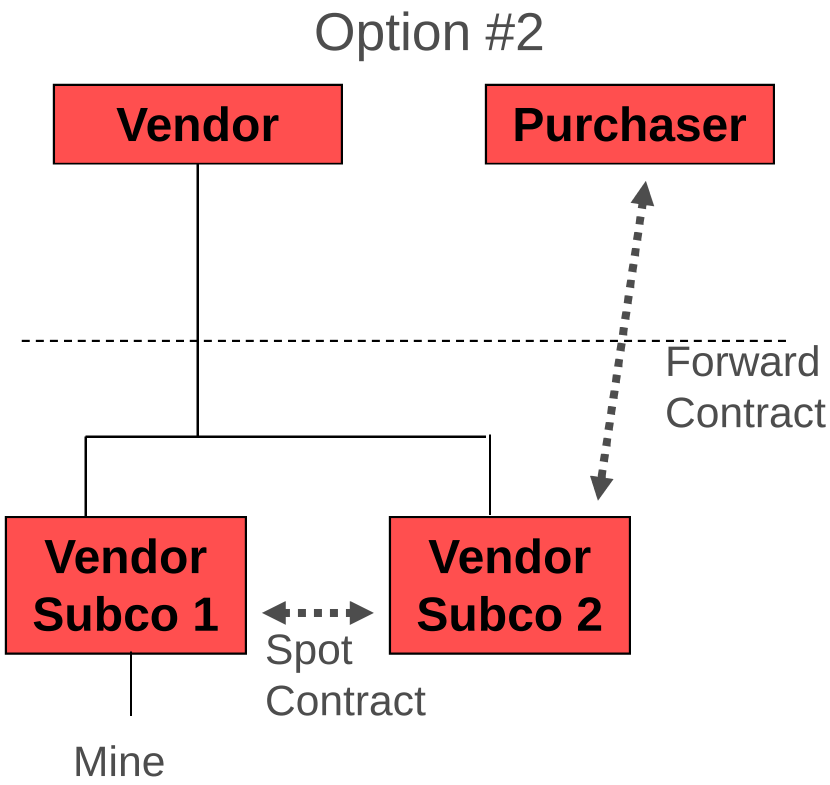


Used where otherwise impossible to avoid foreign tax on upfront payment to Vendor Subco 1

Spot K: Sell minerals to Vendor Subco 2 at Spot

Fwd K: Sell minerals to Purchaser at lesser of spot and contract price. Upfront payment to Vendor Subco

Transaction Structuring – Offshore: *Income Tax*



Spot K: Sell minerals to Vendor Subco 2 at Spot

Fwd K: Sell minerals to Purchaser at lesser of spot and contract price. Upfront payment to Vendor Subco

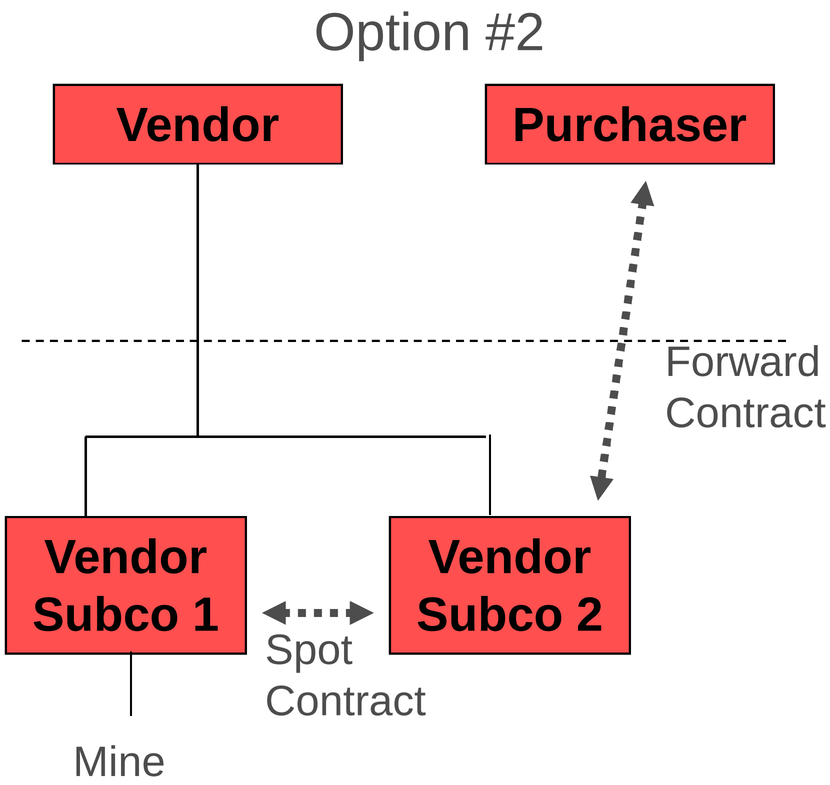
Income Tax Results:

- Vendor: No FAPI (i.e., no current imputation).
- Vendor Subco 1: No FAPI; consider location (surplus repatriation)
- Vendor Subco 2: No FAPI; consider location (surplus repatriation)

Foreign Tax:

- Vendor Subco 2: Consider foreign tax on upfront payment and ongoing per ounce purchase price.
- Vendor Subco 1: Consider foreign tax on per ounce purchase price.
- Consider commodity taxes.

Transaction Structuring – Offshore: *Income Tax*



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Foreign Tax:

- Vendor Subco 2: Consider foreign tax on upfront payment and ongoing per ounce purchase price.
- Vendor Subco 1: Consider foreign tax on per ounce purchase price.
- Consider commodity taxes.

Transaction Structuring – Offshore: *Commodity Tax*

- General principles similar to Canadian principles (underlying thinking – do not tax precious metals because it is inherently not a consumable).