

Forum on Mining Royalties – Consultation document

March 1, 2013

Here is an overview prepared by Lavery of the highlights of the consultation document (in French) released last Thursday by the Quebec government in connection with the forum on mining royalties to be held on March 15, 2013.

OVERVIEW OF THE CONSULTATION DOCUMENT ENTITLED: “LE RÉGIME D'IMPÔT MINIER DU QUÉBEC”

March 8, 2013

We have reviewed the consultation document entitled “*Le régime d'impôt minier du Québec – mars 2013*” posted on the Internet on March 8, 2013, in anticipation of the forum regarding mining royalties scheduled for March 15, 2013.

This memo is not intended to be a detailed review of all items raised in the consultation document but rather a summary of the salient information contained therein. This memo reproduces the titles of the relevant sections of the consultation document.

MESSAGE FROM THE MINISTERS

In 2011, half of the mining companies operating in Quebec did not pay mining royalties. The regime currently in place did not allow the community to benefit from the mining activities of public non-renewable resources despite the high prices of commodities around the world.

INTRODUCTION

The document is divided into five sections:

1. Overview of the mining industry in Quebec;
2. Overview of the mining tax regimes;
3. Analysis of the mining tax regime applicable in Quebec;
4. Quantitative analysis of the taxes levied on the mining companies together with tax subsidies for the mining industry; and
5. Feedback requested from the mining industry.

The review undertaken by the government is governed by two principles:

a) Any mining company that operates a mine in Quebec should pay a minimum mining royalty to the government in lieu of financial compensation for the exploitation of mineral resources owned by the community; and

b) When the profits of the mining companies increase the Quebecers in general shall be entitled to benefit from a larger portion of these profits.

The mining industry players are invited to provide comments in order to feed the reflection and discussion.

1. THE MINING INDUSTRY IN QUEBEC

1.1 Mineral development process

Section 1.1 provides an overview of the mining industry in Quebec, mostly information you are already aware of.

1.2 Mineral production

Section 1.2 of the document provides comparative data in respect of mineral production with other jurisdictions in Canada.

1.3 Comparative market data of mineral production in Quebec and other jurisdictions

Section 1.3 of the document provides comparative data in respect of mineral production with foreign jurisdictions.

1.4 Mining investments

Mining investments that occurred in Quebec amounted to \$4.8 billion in 2012, of which 14% (i.e. \$696 million) were incurred for mining exploration and development costs. These investments were made mostly in the regions of Abitibi-Témiscamingue, Côte-Nord and Nord-du-Québec. The mining investments for 2013 are forecasted at \$4.1 billion.

1.5 Labour matters in the mining sector

Section 1.5 provides market data on labour force in the Quebec mining industry.

1.6 Economical Environment

The demand for iron ore shall maintain the price of this commodity. In recent years, the prices of iron ore resulted in the development of significant mining projects in Quebec. In upcoming years, the world demand shall continue to grow but at a slower pace than the growth of the offer. The consultation document refers to an analysis of KPMG, November 2012.

Based on a consensus of 13 financial institutions, on a short term basis, the price of iron ore shall be around US \$130 per ton. Graphs 3 and 4 of this section set forth market data on iron ore.

2. MINING TAX REGIMES

2.1 Features of the types of mining tax regimes

The most common royalty regimes are the following:

a) Royalties based on specific units (by volume or weight)

This regime is generally suitable for bulk raw materials, materials of low value or requiring little

processing, such as surface mineral substances, sand, gravel, stone, etc. It ensures stable revenues for the government, has the advantage of being transparent and requires audits of limited scope to verify the accuracy of the amounts reported. It would not be applicable in the case of metallic minerals, especially because the latter cannot be sold on the market before having undergone a treatment to extract the marketable substance.

b) *Ad valorem* royalties based on the gross value of production

This regime provides the government with stable revenues since the mining companies pay royalties regardless of their level of profitability. It is fairly simple to administer, but the application of a single rate limits the incentive to invest in processing activities. This is why many countries and states modulate the rate depending on the level of treatment or define the base on which royalties are levied by taking into account certain costs incurred by mining companies. However, this type of regime is less efficient in terms of economic allocation. It nevertheless remains the most common royalty regime.

c) Royalties or taxes based on mining profits

This regime is based on the computation of a mining income to which are deducted operating costs and allowances, in order to establish the value of the resource at the extraction stage. It generates an unstable income stream for the government as royalties or taxes paid by mining companies may be low or nonexistent during the first years of operation. However, this regime is very efficient in terms of economic allocation and it adjusts to prevailing market conditions. On the other hand, a low level of transparency is associated to this regime. It is typically more complex to implement and monitor, which requires an effective administration by the tax authorities.

d) Royalties or taxes based on resource rent

This regime usually taxes a portion of income that exceeds a given return on investment threshold. It allows for a better distribution of income from the exploitation of the resource and has a very high level of efficiency in terms of economic allocation. Its implementation is complex and requires the development of underlying tax concepts with respect to the notion of rent.

e) Hybrid regimes combining *ad valorem* royalties and royalties or taxes based on profits or rent

Hybrid regimes usually combine minimum royalties and royalties or taxes based on profits or rent. The goal is to limit the risk that the government ends up receiving no revenue if a given mining company never becomes profitable. Hybrid regimes have the advantages and disadvantages of the regimes that compose them.

Table 4 at page 16 illustrates the performance of the different regimes with respect to the main governmental goals.

2.2 Overview of mining tax regimes outside of Quebec

Table 5 at page 17 presents an overview of the mining tax regimes of the other Canadian provinces and some foreign countries.

3. MINING TAX REGIME IN QUEBEC

Mining profits are currently taxed at a rate of 16% in Quebec. The regime applies a mine-by-mine approach, meaning that a loss in respect to a given mine cannot reduce earnings from another

mine.

The mining profits are calculated from the gross value of the annual production of a mine, to which are subtracted some expenses and allowances (including for depreciation, postproduction development, processing, exploration and pre-production development).

Table 6 at page 19 summarizes how the current mining tax regime works in Quebec.

4. MINING ROYALTIES AND OTHER TAXES

4.1 Evolution of mining royalties

Table 7 at page 23 sums up the financial results of mining companies from 2000 to 2011.

During this period, mining companies have reported a total gross value of production of \$43.7 billion. The gross value was relatively constant for the years 2000 to 2005, but has experienced a gradual increase from 2006. From 2006 to 2011, the gross value of the annual production has more than doubled, from \$3.1 billion to \$7.3 billion.

The industry profits have skyrocketed, particularly those of the four main producers. Between 2006 and 2011, with a gross margin of over 40%, the concept of excess profits has made its way. It is the responsibility of the government to ensure that Quebecers obtain their fair share.

4.2 Imperfect regime

Although mining royalties have increased, half of mining companies did not pay any in 2011. These companies did not have mining profits, either because they were not profitable or because they were at the beginning of commercial operation and they claimed deductions and allowances that had the effect of reducing their mining profits to nil. Indeed, to acknowledge the investments made by the mining companies, the current mining tax regime allows them to recover a portion of their investments before subjecting them to the payment of royalties.

Mining companies that paid mining tax in 2011 accounted for 81% of the gross value of annual production. These companies paid the government the equivalent of 5.9% of the gross value of production.

4.3 Taxes levied on the mining companies and tax subsidies for the mining industry

In addition to the mining tax, mining companies are also subject to corporate income tax and must contribute to the Health Services Fund. However, the tax on capital was abolished in 2010.

The refundable tax credit for resources is a direct assistance mechanism to support mineral exploration. The basic rate is currently 15%. As of January 1, 2014, the rate will be reduced to 10%.

The flow-through share regime aims to promote the financing of mining companies. It provides for a basic deduction of 100% of the cost of flow-through shares in the calculation of the investor's taxable income. An extra 25% deduction is granted if the expenses are incurred in Quebec by a non-operating company. An additional 25% deduction is allocated if the exploration is conducted from the surface, which gives a total possible deduction of 150% of the amount invested.

4.4 Taxes levied by governments

In total, taxable income of mining companies is taxed at a rate of 38.6%.

5. FEED-BACK REQUESTED FROM THE MINING INDUSTRY

5.1 Fundamental principles

The basic principle that will guide the government in the revision of the mining tax regime is clear: since the mineral resource belongs to the community and has a value, all companies exploiting a mine in Quebec will have to pay a royalty on the extracted resource.

In parallel, the government's decision with respect to mining taxation policy will have to take into account the following objectives:

5.1.1 Adequate sharing of the resource rent

The new mining regime will have to ensure a better sharing of the resource rent between Quebecers and mining companies.

When the price of commodities is very high so that the profits of mining companies increase beyond a certain threshold, the government has to collect a portion of the excess profits. Mining companies argue, rightly, that the periods of high profits are offset by periods when prices are down or during which they make major investments. The new regime will therefore have to maintain a balance between the taxation of excess profits and maintaining the attractiveness of Quebec to investors.

5.1.2 Optimal tax base

The tax base of the new regime will have to provide sufficient revenues from the exploitation of the collective resource. It should encourage the influx of additional capital for exploration and development of mining projects in order to eventually create a multiplier effect. As market prices will not always be high and the existence of excess profits is not guaranteed, the chosen tax base will have to be self-sufficient for periods when there will be no excess profits.

5.1.3 Efficiency of the tax system from an economical point of view

a) Stability of revenues

The new royalty regime must generate a stable income stream for the government. However, royalties based on profits or resource rent offer less stability than the other regimes.

b) Fairness

The concept of fairness will have to play at two levels in the new mining regime:

- a) Mining companies that generate the same amount of resource rent should be subject to the same tax rate;
- b) Mining companies should each pay royalties or taxes in proportion of their operating results, regardless of the level of resource rent.

c) Transparency and stability

The new regime should allow mining companies to accurately predict the long-term tax liability associated to their activities.

The new mining regime should also be transparent to Quebecers. In this regard, the new regime

could be inspired from the new disclosure rules that will be introduced soon in the United States as well as the Extractive Industries Transparency Initiative to which many countries participate.

d) Administrative efficiency

The administration of the new regime should be simple for both mining companies and the government. However, this should not be at the expense of economic efficiency.

On the other hand, administrative efficiency should not lead to an exploitation of the resource that is not beneficial for Quebecers as a whole, including the payment of mining royalties.

e) Competitiveness

The new system should enable companies operating in Quebec to be competitive. Many of them are also active in other parts of the world. They must remain competitive in Quebec to maintain their operations here and attract investments from their parent companies.

Although Quebec has recently tightened some requirements regarding mining tax, the tax burden of mining companies is lower in Quebec than in many other countries.

Many governments around the world have reformed their mining tax regimes or are considering doing the same. During the year 2010-2011 alone, at least 25 countries and states in the world have increased or announced plans to increase their mining royalties or taxes, including Australia, Peru, Tanzania, India, China, Zimbabwe, Chile, Congo, Mongolia, the Philippines, Poland and the United States.

On the basis of these principles and issues, the government of Quebec considers it important to establish a constructive dialogue with the mining industry.

5.2 Contemplated alternatives

The government of Quebec wants to improve the sharing of the wealth generated by the exploitation of mineral resources in the province. To do this, different options are contemplated.

Choosing a hybrid regime seems more appropriate in order to combine the advantages of each regime, namely (1) guaranteed minimum revenues and (2) an appropriate sharing of the resource rent.

5.2.1 Guaranteed minimum revenues: ad valorem royalties

To achieve the goal of guaranteed minimum revenues for the government, the ad valorem royalties constitute the best regime. It involves applying a given rate to the gross value of the annual production of mining companies. The royalties could be varied, for example, by adjusting the rate for value added products or by defining the tax base in order to avoid penalizing processing activities.

The royalties could be considered as a minimum amount that must pay any company that operates a mine in Quebec and thus ensure a revenue stream to the government at any time. Once this regime is established, it should be relatively simple to administer.

The ad valorem royalties could, according to the chosen approach, be deducted in the calculation of the second component of the regime.

5.2.2 Appropriate sharing of the resource rent

To ensure that mining companies pay more royalties when their profitability is high, several approaches can be considered.

a) Regime based on the profit margin

This regime would have the same tax base as the current one. However, the applicable rate would progressively increase once a certain level of profitability is reached. The profitability of a mining company would be determined by its profit margin.

This approach would progressively increase the amount of royalties paid by mining companies. It has a high degree of economic and tax efficiency and allows an optimal sharing of the resource rent. Under this approach, a mining company would be required to pay royalties corresponding to the highest of the ad valorem royalties and the mining tax calculated on the annual profits.

b) Regime based on resource rent

Here, the royalties would be based on resource rent, that is to say the profits that are beyond a threshold of acceptable return on investment based on risk.

This regime would have the advantage of maximizing governmental revenues when there are excess profits. It is very effective in terms of economic allocation and fairness. However, it must include clear definitions and a well-structured methodology in order to facilitate its administration.

The royalties would be applied only beyond the expected return on investment. In order to guarantee a return on investment to a mining company, the profits of its activities would be tax free up to the annual deductions representing the expected return on its investment, amortized over its lifetime.

If a mining company has excess profits once the ad valorem royalties are subtracted, a tax at the rate of 30% would be applied to these excess profits.

The proposed formula is independent of the financing structure, allowing mining companies discretion in this regard.

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