# What Foreign Mining Corporations Need to Know About Canadian Tax

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There is certainly no doubt that Canada is at the forefront of the global mining industry with more mining companies listed in Canada than any market in the world. This is the case even though many of such listed companies have all or substantially all of their assets and mining operations located outside of Canada with no other affiliation or nexus to Canada (other than its listing and place of incorporation).

Given that taxes are typically one of the most significant considerations for companies listing in Canada, we thought it would be beneficial to discuss the Canadian tax considerations that are applicable in a typical fact situation: one or more non-Canadian shareholders wanting to use a Canadian incorporated entity (Canco) as a listing entity with such entity holding no assets other than the shares of a top-tier foreign holding corporation (Holdco) which, in turn, holds the shares of separate foreign mining subsidiaries (each a MineCo).

In a typical fact situation, the MineCos tend to carry on the mining operations in the non-Canadian jurisdictions and are generally formed under the laws where the mining assets are located. Holdco is typically formed under laws of a tax neutral jurisdiction, such as the Cayman Islands.

## Establishing the Structure

Prior to Canco listing its shares on a Canadian stock exchange, all of the non-Canadian assets, namely the shares of the Holdco, will need to be transferred to the Canadian listing vehicle, Canco. While the ultimate manner in which this transfer will occur depends, to a great degree, upon the taxation of laws of the jurisdiction where the mining assets are located, there are two structures which are commonly utilized.

### Share Exchange

From a Canadian perspective, the simplest manner to create the structure is to incorporate Canco under the federal laws of Canada (or a province or territory therein) and have the shareholders of Holdco transfer their shares to Canco in exchange for a proportionate number of Canco shares (the Share Exchange).

Under the Share Exchange, the non-Canadian shareholders of Holdco will generally not be subject to any Canadian tax on such transfer as the shares of Holdco typically do not derive their value from real or resource properties located in Canada. Moreover, Canco will acquire the Holdco shares at their fair market value and such amount will be the cost base of such shares to Canco. Consequently, if Canco were to subsequently dispose of its shares of Holdco at a profit, it will only recognize a capital gain based on any accrued value in the shares that arises after the time of the Share Exchange.

Canadian tax law contains a concept called “paid-up capital” (PUC). In general, PUC is the amount of equity that has been invested by shareholders in a corporation and can be returned to shareholders as a tax-free return of capital (without the imposition of withholding tax, in the case of non-Canadian shareholders). However, once a corporation is listed on an exchange, its ability to return PUC to its shareholders is limited to extraordinary situations such as distributions derived from undistributed sale proceeds or upon the winding-up, discontinuance or reorganization of its business. In the context of the Share Exchange, subject to the “foreign affiliate dumping” (FAD) rules applying (which are discussed below), the PUC of the Canco shares issued should be equal to the fair market value of the Holdco shares on the date of the exchange.

## Continuance

Unfortunately, there may be situations where the Share Exchange is not possible as it may cause a taxable event (as a result of the exchange) in the jurisdiction where the mining assets are located and/or where the non-Canadian shareholder is resident. If this is the case, a common alternative structure is a corporate continuance, as this may minimize the capital gain that otherwise will be recognized in the non-Canadian jurisdiction.

With a corporate continuance, Holdco will migrate to the Canadian corporate jurisdiction (the Continuance) and the continued corporation will then be listed on a Canadian Stock Exchange. A continuance is a process under corporate law that facilitates corporate migration and is possible only where the corporation is incorporated under a statute which permits a continuance. If so permitted, the corporation may continue to Canada under federal or provincial legislation. Generally, where a corporation is continued into a new jurisdiction, it is considered to be the same corporation for Canadian corporate law purposes and, as such, this may facilitate the shareholders of Holdco not being considered to have disposed of their shares under the tax laws of the applicable non-Canadian jurisdiction.

Upon the Continuance, Holdco is deemed to be a resident of Canada for Canadian tax purposes and, in effect, is treated as if it was incorporated in Canada from the time of its continuance. Moreover, in very general terms and subject to the FAD rules applying, the Canadian tax consequences in respect of the Continuance are similar to that under the Share Exchange. In particular, non-Canadian shareholders are not subject to any Canadian tax in respect of the Continuance, Holdco is deemed to have an adjusted cost base in respect of the shares of the MineCos equal to their fair market value and Holdco should have PUC in respect of its shares equal to the fair market value of its net assets.

## FAD Rules

If Holdco is controlled by a non-resident corporation, such that it is anticipated that Canco will be controlled by a non-resident corporation following the Share Exchange (or, that Holdco will continue to be controlled by a non-resident corporation following the Continuance), then Canco (or Holdco, post-continuance) will be subject to the FAD rules. If this is the case, the Canadian tax consequences described above, as they relate to PUC, on the Share Exchange or the Continuance will be different than as described above.

The FAD rules are designed to curtail arrangements in which foreign multinationals cause shares of, or investments in, related foreign corporations to be directly or indirectly transferred to their Canadian-resident subsidiary corporations as a means of either leveraging the Canadian subsidiaries or repatriating their funds on a tax-free or deferred tax-basis. Such arrangements, among others, are considered by the Canadian government to inappropriately erode the Canadian tax base.

In the context of the Share Exchange, if the FAD rules apply, the PUC of the shares issued by Canco will be reduced to nil (instead of remaining at fair market value) as Holdco (and each of the MineCos) will each be considered a “foreign affiliate” of Canco as Canco will typically hold: (i) directly or indirectly at least 1% of the equity of Holdco and the Minecos, and (ii) together with related persons, at least 10% of the equity of Holdco and the MineCos. This PUC that is reduced under the FAD rules can subsequently be “reinstated” in certain specific circumstances, such as where the shares of Holdco (or dividends from Holdco or proceeds from such shares) are distributed by Canco. However, in the context of a listing transaction, the reduction of the PUC (and subsequent ability to reinstate) is not typically a critical consideration as a listed Canadian corporation can, as discussed earlier, only return PUC in exceptional circumstances.

The FAD consequences described above (namely, the reduction of PUC to nil) is generally the same in the context of the Continuance as it is in the Share Exchange. However, there are two noteworthy exceptions. The first exception is there is no reinstatement rule in respect of a continuance, therefore, any PUC which is reduced is permanently removed from the Canadian tax system. As discussed above, this may not be a material consideration in the context of a listed Canadian corporation. The second exception is that if Holdco has any debt or any other obligation to pay an amount, then Holdco may be deemed to pay a dividend to its controlling non-resident shareholder (which will be subject to Canadian withholding tax). Therefore, this should be carefully considered prior to implementing the Continuance.

## On-Going Tax Considerations

Once the applicable listing structure is established, a Canadian entity will own the shares of the non-Canadian mining companies, the MineCos. As discussed earlier, this Canadian entity could be either Canco or Holdco depending upon whether the transaction is effected by way of Share Exchange or Continuance. For simplicity, in this section we refer only to Canco as the Canadian entity as the tax consequences do not differ in any material respect should Holdco be the Canadian entity.

### Distributions to Canco

Canco will be resident in Canada for Canadian tax purposes and, as such, will be subject to Canadian income tax on its worldwide income. The applicable rate of tax will, in most circumstances, generally depend on which province Canco designates as the location of its registered office. Currently, the lowest combined federal and provincial tax rate in any Canadian province is 26%. However, as discussed below, it is likely that Canco will not pay any material Canadian taxes in respect of such structure.

Distributions from Holdco and the MineCos will likely be subject to Canada’s foreign affiliate regime. Under Canada’s foreign affiliate regime, any distributions received by Canco must be included in Canco’s income. However, a number of complex tax rules then apply to determine the extent to which Canco may claim a deduction with respect to such distribution. In general, distributions received by Canco from Holdco will be considered to have been paid out of one of four “surplus pots”– exempt surplus, hybrid surplus, taxable surplus, or pre-acquisition surplus.

Exempt surplus includes the after-tax earnings of an affiliate that is resident in a “designated treaty country” (DTC) from an active business carried on by the affiliate in a DTC. Dividends considered to be paid out of exempt surplus are fully deductible to a recipient Canadian corporation. Exempt surplus also includes exempt surplus dividends received from a foreign affiliate from another foreign affiliate. As such, Holdco is able to pay exempt surplus dividends to Canco to the extent that it has previously received exempt surplus dividends from the MineCos.

Assuming that the MineCos are resident in and carry on active mining operations in a DTC, such active business income can be repatriated from the MineCos as a dividend from exempt surplus without any incremental level of Canadian mainstream tax.[1] For these purposes, a DTC means a country with which Canada has an income tax treaty or a tax information exchange agreement. Mining companies are fortunate in this respect as Canada has a wide treaty network including many Latin American and African countries.

### Distributions from Canco

Any dividends paid by Canco to a non-Canadian shareholder, will be subject to Canadian withholding tax. The general Canadian withholding tax rate applicable to dividends is 25%. However, many of the bilateral tax treaties with which Canada has entered into reduce this rate to 15% (or 5%, most typically in circumstances where a corporate recipient owns at least 10 percent of the voting stock of the Canadian payer).

If Canco has a significant non-Canadian shareholder base (as is commonly the case), consideration will need to be given to the likelihood of distributions from the MineCos as the interposition of the Canco will often result in an incremental layer of withholding tax (ie. Canadian withholding tax in addition to foreign withholding tax at the MineCo Level).

Once Canco is listed, it is likely that Canco will have many Canadian resident shareholders. In general, Canada provides a favourable tax regime in respect of the receipt of dividends from a Canadian corporation to a Canadian shareholder. In particular, individual shareholders are entitled to access the gross-up and dividend tax credit regime which lowers the effective rate of tax payable by such shareholders on the dividend. Similarly, corporate shareholders are generally entitled to deduct any dividends received in computing their income, subject to a refundable tax being paid under the Canadian tax rules.

### FAD Rules

If Canco continues to be controlled by a non-Canadian corporation post-listing, it will remain subject to the FAD rules. As a result, any “investment” by Canco in either Holdco or the MineCos will require Canco to take certain steps to reduce its PUC and, if it has insufficient PUC to reduce, Canco will be deemed to have paid a dividend to its non-Canadian controlling shareholder (which will be subject to Canadian withholding tax). For these purposes, “investment” is defined broadly and includes any equity investment, contribution of capital, loan or any other benefit conferred upon either Holdco or the MineCos.

As discussed earlier, the PUC of Canco following the Share Exchange will be nil as a result of the FAD Rules. Therefore, if Canco is to provide any additional financing to either Holdco or the MineCos it will need to ensure that it has created additional PUC which can be reduced once the funds are transferred to the non-Canadian subsidiaries. As a practical matter, this means that Canco should be able to issue equity but will be restricted from borrowing or issuing debt at the Canco level. In other words, any non-equity financing will need to occur at the non-Canadian level, namely by Holdco or the MineCos.

## Exit Considerations

A non-Canadian shareholder should generally be entitled to sell their shares of Canco without the imposition of Canadian tax as such shares will not derive more than 50% of the value from real or resource properties located in Canada.

Canadian resident shareholders will generally realize a capital gain or loss to the extent that the proceeds from the sale exceeded (or were less than) the adjusted cost base in the shares. Canada has a preferential tax regime in respect of capital gains as only one half of any capital gain is included in income.

[1] In order to be resident in a DTC, the MineCos will need to ensure that they are resident in such jurisdiction for purposes of the applicable treaty or agreement and that their “mind and management” is in such country (which typically is considered to be where the board of directors operates assuming that it is the board who has the actual authority over the company).