BRITISH COLUMBIA

MINISTRY OF EMPLOYMENT AND INVESTMENT

INFORMATION LETTER **MTA6**

RESOURCE REVENUE BRANCH
MINERAL TAXATION SECTION

SUBJECT: REPORT ON THE TREATMENT OF HEDGING GAINS AND LOSSES UNDER THE *MINERAL TAX ACT*

BACKGROUND

Under the provisions of *Mineral Tax Act (*the *"Act"),* gains and losses associated with hedging activities are excluded from the income of a mine for the purpose of determining a fair share of the resource for the Province. In early 1995, in view of recent changes in Revenue Canada's assessing policies in this area, the Deputy Minister of Energy, Mines and Petroleum Resources requested that a study be done to review the treatment of hedging gains and losses under the *Act.* The purpose of the study was to determine whether the legislation should be amended to include gains and losses from hedging activities in the provincial mineral tax base.

TERMS OF REFERENCE

The study was designed to achieve the following objectives:

- Define commodity price hedging and describe how it can be done.
- Research the business reasons for operators of mines to engage in commodity price hedging.
- Describe treatment of hedging gains and losses for mineral royalty or tax purposes in other provinces and countries, and under the *Income Tax Act (Canada)* and the *Income Tax Act (B.C.).*
- Evaluate the impact of including hedging gains and losses in the income of a mine for mineral tax purposes on Crown revenues and their administration.
- Recommend what sorts of hedging gains and losses, if any, should be included in the income of a mine for Mineral Tax purposes.

SUMMARY OF THE REPORT

The study involved a considerable amount of research, including interviews with officials of several mining tax jurisdictions, financial officers from the mining industry, and investment experts. The results, summarized below, are contained in a detailed 64-page report.

The report explains that the essence of hedging is an attempt to reduce exposure to some of the risks normally associated with the production and marketing of mineral products. The primary risks sought to be avoided through hedging activities are fluctuations in mineral prices and currency values. The report notes that there are numerous types of hedging instruments available and describes the ten most frequently used.

The report provides a detailed analysis of the business reasons for hedging and explains why some producers choose to limit hedging activity or not to hedge at all. The need to satisfy conditions for financing, a desire to avoid any risk of operations closing due to cash shortfalls, and assurance that sufficient funds will be available to carry out development plans were found to be most the important reasons for hedging. Capturing gains by locking in high prices that are not expected to persist was also found to be a consideration.

The report notes that the *Income Tax Act (Canada)* does not contain provisions specifically dealing with commodity price hedging transactions, but analyses the Echo Bay Mines decision, which has determined Revenue Canada's policy to include hedging gains and losses from non-speculative forward sales contracts in resource profits. The study found that the only issue with respect to hedging gains and losses under the *United States Internal Revenue Code* has been their characterization as income or capital.

The report summarizes the treatment by other provinces' mining tax legislation of hedging gains and losses. The *Ontario Mining Tax Act* and the *New Brunswick Metallic Minerals Tax Act* include gains and losses from hedging without reference to reduction of risk as a necessary characteristic. The *Quebec Mining Duties Act* excludes gains and losses from financial operations, whether hedging or speculative in nature. The mining tax statutes of the other provinces and territories do not specifically address hedging gains and losses.

With respect to impacts on Crown revenue from including hedging gains and losses in income for mineral tax purposes, the report considers two aspects. One is the effect of hedging on the income of mine operators, for which the report concludes that no definite statement can be made. Income from gold and silver would tend to be higher because forward prices for these metals include an interest factor, which results in their usually exceeding the spot price at the time the contracts are closed out. For base metals the relationship between forward prices and spot prices is quite unpredictable.

The other aspect considered with respect to the impact on Crown revenue is the difficulty of verification and enforcement, which the report concludes would probably result in lower revenue or higher costs for the Crown. The study found that hedging programs are usually undertaken as a treasury function that is somewhat removed from the direct operating functions of a mine. It predicted that resulting difficulties with allocations between jurisdictions and between mines would add to the administrative burden connected with verification programs. The report also warned that the Province might be found to exceed its powers if it attempts to tax gains that result from activities undertaken outside its boundaries.

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MINISTRY POLICY

The Ministry agrees with the report's conclusion that the *Act* should not be amended to include gains and losses from hedging activities. These activities are more closely affiliated with the producers' business in a broad sense than the direct activity of producing minerals. The purpose of provincial mining statutes is to share in the economic rent derived from a mine. Inclusion of hedging gains and losses yields an inequitable result, as projects with equal net values of production would pay differing amounts of taxes depending on the results of their hedging efforts.

Furthermore, including hedging activities in the tax base would add to the ministry's costs of verification, and attempts to tax hedging gains arising from activities outside of the Province may be subject to constitutional challenges. Given the mix of minerals produced in British Columbia, it is likely that hedging gains and losses would neither add to nor reduce the income of mines in the long term. All other things being equal, their exclusion for mineral tax purposes should be of no consequence for the industry or the Crown.

COPIES

Copies of the report, entitled *"The Treatment of Hedging Gains and Losses under the Mineral Tax Act"* are available at a cost of $16.25 each for photocopying. To order a copy, please send your cheque payable to the Minister of Finance and Corporate Relations to:

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