

Metal Streams in Foreign Affiliates

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Over the last decade, metal streams have evolved as a popular and tax-effective source of financing for Canadian mining companies. Recent trends in streaming transactions include streams to finance an earlier stage of mine development (not just the final construction stage as with most earlier deals), streams over a wider variety of commodities (no longer confined to by-product precious metals such as gold and silver), larger syndicated streams with multiple streaming company participants, and streams as partial consideration for mining property dispositions.

Streaming deals typically have commercial and economic characteristics that are similar to a royalty, but take the legal form of agreements for the future purchase and sale of specified quantities of metal based on production from the seller's mining properties. This results in tax consequences for the mining company under a stream financing transaction that are generally more favourable than would apply if the financing were instead structured as a royalty. A number of specialized streaming companies have expanded into this maturing market to provide metal stream financing to mining companies, and it can now fairly be said that streaming deals are more broadly available and less niche than was originally the case. This has been a positive development for the Canadian mining industry – particularly with the current low commodity price environment in which many mining companies (and especially junior mining companies owning properties in development) are unable to access conventional financing on acceptable terms.

This article considers the principal features of the typical metal stream transaction that are relevant from a tax perspective. The focus is on the common situation of a Canadian parent company owning a non-Canadian mining property through a foreign affiliate, and selling a metal stream based on the future production from that foreign affiliate's mining property. The benign tax consequences under the Canadian foreign affiliate rules in the *Income Tax Act* (Canada) (the "ITA")¹ are soundly based from a technical perspective, contributing to the increasing popularity of metal stream deals and the global competitiveness of Canadian mining companies that can access tax-effective metal stream financings as an alternative funding source.

Commercial Objectives of Metal Streams

From the mining company's perspective, one of the main objectives of selling a metal stream is to maximize the upfront payment received from the purchaser. Fundamentally a metal stream is a financing transaction in which the seller is effectively monetizing a portion of its expected mining production. Often the metal sold is a by-product of the core mine production, and often the up-front payment is intended to be used to finance the construction of the particular mine.

¹ R.S.C. 1985, as amended. All statutory references are to the ITA unless indicated otherwise.

From the stream purchaser's perspective, one of the main objectives is to participate in the production from the mine and any potential upside benefits, including increases in the commodity price, and possible production increases that exceed estimates at the initial time of the stream, for example from higher ore grades or successful exploration and drilling on the mining property.

The traditional and most direct transaction to achieve these broad commercial objectives is for the mining company to grant a royalty to the purchaser. The operating mining company would receive an up-front payment as the consideration for granting a royalty entitling the purchaser to receive a specified percentage of metal produced from the particular mining property of the seller. Depending on the jurisdiction, the royalty rights would typically constitute a registered real property interest with the royalty-holder considered to have an ownership interest in the mineral resource *in situ*.

However, foreign affiliates in many mining jurisdictions would, generally, be subject to taxation in their local countries on the up-front payment received for the grant of a true royalty. Depending on the jurisdiction, the up-front payment received by the foreign affiliate might be treated as income from mining operations, or proceeds of an immediate sale of the specified amount of mineral resource, or be taxed in some other way in the year of receipt. Moreover, the future outbound royalty payments, whether made by in-kind metal deliveries or in cash, might be subject to withholding tax in the local country if paid to a non-resident.

The above-noted foreign tax treatment for royalties would be consistent with the Canadian tax treatment that would apply in the analogous circumstances of a Canadian-resident mining company that grants a royalty. In the Canadian domestic context, a royalty interest acquired by the purchaser would typically constitute a "Canadian resource property"², the up-front payment received by the Canadian mining company for granting the royalty would be treated as proceeds of disposition of Canadian resource property³, potentially resulting in an income inclusion⁴, and the royalty payments would be subject to Canadian withholding tax if paid to a non-resident of Canada.⁵

Consequently, metal streams have evolved as an alternative to a royalty, and take the form of metal purchase and sale arrangements that, unlike a royalty, should generally not be taxed in the foreign country where the mine is located.

Key Features of Typical Stream Agreements

Canadian-based mining companies entering into a stream agreement with respect to mineral production from a mine in one foreign affiliate will generally use another entity as the

² See ITA s. 66(15)"Canadian resource property"(e).

³ For example, see CRA documents 2006-0174351R3 (ruling B) and 2006-0172361I7.

⁴ The proceeds of disposition of Canadian resource property are deducted by item F in computing the taxpayer's cumulative Canadian development expense in ITA s. 66.2(5), and if that balance is negative at the end of the year, the negative amount is included in the taxpayer's income by ITA s. 66.2(1) and s. 59(3.2)(c).

⁵ See ITA s. 212(1)(d).

contracting party – usually another foreign affiliate established in a different (low-tax) jurisdiction. The foreign affiliate that owns the mine is generally not even a party to the stream agreement, and the stream purchaser does not acquire any real property interest in the underlying mineral resource or mining assets.

Unlike a royalty, a stream agreement requires the seller to sell and deliver a specified quantity of metals computed by reference to production from the particular mine, as and when the metals are produced over the term of the contract. Thus, the fundamental character of the arrangement is a metal purchase and sale contract. Title to the sold metals and risk of loss passes at the future times of delivery. Typically the metals to be sold are not required to be the actual production from the particular mine, but rather a quantity of fungible metals equivalent in amount to the specified percentage of production from the particular mine.⁶ The seller may enter into a separate metal purchase and sale contract with its related operating mining company so that it can acquire the required quantity of metals produced from the mine, generally at the current spot price at the time of purchase (reflecting transfer pricing requirements in the mining jurisdiction).

Consistent with a purchase and sale contract, a stream agreement specifies the price to be paid by the purchaser for each ounce of metals delivered over the term of the contract. Typically the purchaser pays a large up-front deposit or advance payment to the stream seller at the time the contract is entered into. This deposit is then applied over time in partial satisfaction of the purchase price for each ounce of metal delivered. In addition, the purchaser is required to pay a specified cash payment to the seller for each ounce of metal purchased, over the term of the contract. This ongoing required cash payment is typically much lower than the spot metal price at the time the contract is entered into, and may reflect or be loosely based on the mining company's costs of production, sometimes with an inflation adjustment. The contract typically specifies that while there remains a positive deposit balance, the purchase price for each ounce of metal delivered is equal to the spot metal price, paid by the purchaser to the seller in cash to the extent of the ongoing cash payment, with the balance, if any (the excess of spot price at the time of delivery over the required cash payment) being paid by reducing the balance of the deposit previously paid to the seller.⁷ After the deposit balance has been reduced to nil, the purchase price for each delivered ounce of metal is typically the lesser of the spot price and the specified cash payment.

Typically, stream agreements have a long term that broadly reflects the expected duration of mining operations at the particular mine, with options to extend the term to accommodate possible future extensions to the life of mine plan. Generally there will be some negotiated

⁶ In cases where the stream purchaser is a foreign affiliate of a Canadian parent corporation, it is common for the seller to covenant that it will not acquire the specified quantity of metals on a commodities exchange or commodities futures exchange. This is to ensure that the metals sold to the stream purchaser are not "investment property" as defined in subsection 95(1), so that the stream purchaser's profits from its purchase and sale of metal constitute active business income and not income from an "investment business" as a result of the sale of "investment property".

⁷ Some stream agreements instead have not expressly applied the initial advance payment to the purchase price of metals as delivered over time, and instead provide that the purchase price for all ounces is merely the required cash payment made by the purchaser as metal deliveries are made. This may have the effect of accelerating recognition of the up-front advance payment in income of the selling foreign affiliate, with corresponding consequences for the timing of surplus recognition.

treatment of any unapplied deposit funds at the end of the contract term. In addition, as a commercial matter the stream purchaser generally requires extensive covenants respecting the timing and manner in which the mining project will be developed and mined, and some form of security package in case the seller defaults in performing its metal delivery obligations. Since the stream purchaser does not have a direct ownership interest in the mineral resource, alternative forms of security can include, among other things, security interests in the mining assets⁸, a pledge of the shares of the stream seller and the foreign affiliate that owns the operating mine, and a guarantee given by the parent mining company with respect to performance of the seller's metal delivery obligations and the mining operations of the mining company foreign affiliate.

Tax Treatment of Metal Streams

Foreign tax considerations in the country in which the actual mining operations are located are paramount. The typical stream transaction is generally not expected to engage those foreign tax rules and should not affect the foreign affiliate that owns the mining property. The stream seller is typically a separate foreign affiliate interposed in a different, low-tax jurisdiction, and consequently the tax consequences in the stream seller's jurisdiction are usually straightforward to determine.⁹ The company owning the mining property is typically not a party to the stream agreement, and consequently has no contractual relationship with the stream purchaser. From the perspective of the mining company, its future mining production will be sold at the spot price, perhaps in part to the related stream seller and in part to other arm's length purchasers. Consequently, the taxable income of the mining company will generally be the same, regardless of the stream transaction situated outside the local jurisdiction, with income taxes, royalties, sales taxes, metal export duties and any other taxes payable to the local country with respect to mining operations in the usual manner, stream or no stream.

From a Canadian tax perspective, the principal issue is the characterization of the stream arrangement. Has the stream seller granted a royalty? Is it a loan transaction with the up-front payment treated as debt? Does it substantively result in an immediate sale of a portion of the unmined mineral resources *in situ*? Is it perhaps a financial derivative contract? Or is the stream transaction, as intended by its legal form, an agreement for the future purchase and sale of the specified quantity of metals?

The key features of the typical metal stream arrangement support the intended metal sale characterization consistent with the legal form, and are inconsistent with any alternative characterization. It is generally unambiguous that the legal relationship intended to be created by the parties is that of vendor and purchaser. Title and risk of loss to the purchased metals pass at

⁸ Usually, and depending on the jurisdiction, providing the stream purchaser with direct security interests in the mining assets is avoided, as that would require the operating mining company to be a contracting party with the purchaser. In many cases, the stream purchaser accepts more indirect forms of security from the seller (a separate entity) and/or the parent company.

⁹ Generally the jurisdiction of the stream seller is determined so that there is no local corporate income taxation of the up-front deposit / advance payment and subsequent metal sales, and no withholding taxes, sales taxes, import or export duties or other taxes on the purchase, resale and delivery of the streamed metals. Commonly, the stream seller is incorporated in the Cayman Islands, Barbados, British Virgin Islands or similar jurisdiction.

the future times of delivery, not when the contract is initially made. The metals to be sold are not required to be delivered out of the actual production from the mine – instead the quantity of metals required to be delivered is computed by reference to production from the mine, but can be obtained from other sources. Neither the seller nor the purchaser typically has any ownership interest in the mining properties, and the mining company is generally not a party to the stream agreement and has no independent contractual relationship with the stream purchaser. The purchaser is required to pay a specified price for each ounce of metal delivered under the contract, and must pay a not-insignificant portion of the purchase price in cash on an on-going basis as deliveries are made (which is inconsistent with a royalty arrangement). Moreover, the initial up-front payment is tied to future metal deliveries and is typically advanced as partial payment for future sales of metal.

Generally, for purposes of the ITA the income or loss of the stream seller under the metal stream arrangement will constitute income or loss from an active business of metal trading. The stream seller will purchase the required metals from available sources (often from the related mining company at spot price) and on-sell the purchased metals to the stream purchaser at the contracted price (initially the spot price, and subsequently – after the up-front deposit is fully credited – the lesser of the required cash payment and the spot price).¹⁰ The sold metals will not constitute "investment property" as defined in subsection 95(1), paragraph (e), because the metal will be a commodity that is extracted and processed by a related foreign affiliate, namely the mining company. Consequently, the stream seller cannot be said to have an "investment business" as defined in subsection 95(1) because it will not have a principal purpose of deriving profits from the disposition of investment property.

Accordingly, the up-front payment received by the stream seller will not constitute foreign accrual property income ("FAPI").¹¹ The initial payment is received as a deposit or advance payment on account of future sales of specified quantities of metals as part of an active business, and not as income from property or from a disposition of non-excluded property.¹² Even if the up-front payment were treated as FAPI, the amount of such FAPI would, under paragraph

¹⁰ If, after the deposit is fully credited, the future spot price exceeds the required cash payment to be received by the stream seller, it would be expected to incur losses on those subsequent metal sales. On the other hand, the stream seller typically receives the up-front deposit or advance payment at the initial time when the contract is entered into, and has the use of those funds to invest and earn profit throughout the term of the contract and beyond. Consequently the stream seller has the opportunity for both profit and loss, depending on numerous factors including its use of the up-front payment, the length of time until the deposit is fully applied, the extent to which the commodity price rises above or falls below the parties' expectations at the time the contract is entered into, the extent that the mine production over the contract term exceeds or falls short of the parties' initial expectations, and the negotiated disposition of any residual unapplied deposit at the end of the contract term.

¹¹ As defined in subsection 95(1).

¹² Arguably the only plausible FAPI treatment of the up-front payment could arise if the stream arrangements were characterized, contrary to their legal form, as the grant of a contractual royalty by the stream seller. In this improbable characterization, the grant of the "royalty" might possibly be treated as the disposition of property (the newly created contractual rights) by the stream seller, and such property would in many cases generally not qualify as excluded property of the stream seller for purposes of subsection 95(1). This is in part why it is critical to establish the "metal purchase and sale" characterization of the typical stream arrangement.

95(2)(f), be determined under Canadian rules as though the foreign affiliate were resident in Canada, in which case subparagraph 12(1)(a)(i) would include the deposit or advance payment in income, but subparagraph 20(1)(m)(i) would permit an offsetting deduction as a reserve to the extent of metal deliveries that would be required after the particular taxation year, resulting in an appropriately deferred recognition of income over the term of the contract as the up-front payment is applied in satisfaction of the purchase price of delivered metals.¹³

Importantly, the Canadian tax treatment of the typical metal stream transaction (in particular, deferral of Canadian tax on the up-front payment received by the stream seller) is equivalent to the Canadian treatment that would apply if the mining company simply granted a royalty to the purchaser. The royalty rights acquired by the purchaser would constitute "foreign resource property" as defined in subsection 66(15), with reference to paragraph (e) of the "Canadian resource property" definition in subsection 95(1), because the mining company granting the royalty would have a direct interest in the underlying mineral resource. Consistent with the domestic tax treatment of a grant of a royalty by a Canadian taxpayer as described above, the up-front payment received by the mining company as consideration for granting a royalty would be treated as proceeds of disposition of a foreign resource property, and this would generally constitute excluded property under paragraph (a) of the definition in subsection 95(1) as property used or held by the mining company for the purpose of gaining or producing income from its own active business. Consequently, the royalty proceeds would not be FAPI.

Summary

Metal streams are effected as metal purchase and sale agreements, typically with the stream seller being a foreign affiliate of a Canadian mining company, and an entity separate from the foreign affiliate that owns the mine. Although their economic features are similar to those of a royalty, metal streams are not royalties, and consequently they should not result in any additional foreign tax in the mining company foreign affiliate's jurisdiction (where the mine is located), or in the jurisdiction of the stream seller. From a Canadian tax perspective, a Canadian parent mining company with offshore properties held through a foreign affiliate is effectively neutral as between selling a stream and granting a royalty, as neither will generally result in FAPI treatment for the initial up-front payment. This treatment is consistent with the scheme and policy underlying the Canadian foreign affiliate rules – and when coupled with the generally more favourable foreign tax consequences of a stream compared to a royalty, the benign Canadian and foreign tax treatment facilitates the increasingly widespread adoption by Canadian mining companies of metal stream transactions as alternative financing structures.

¹³ The subparagraph 12(1)(a)(i) / 20(1)(m)(i) inclusion and reserve mechanism also applies directly when the stream seller is a Canadian corporation, as has been the case in several recent streaming deals.