Chapter 9
Department of Natural Resources and Energy
Mining Taxes and Royalties

Contents

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Background

9.1 Our last detailed review of the Metallic Minerals Tax Act was in 1984. Potash royalties were last reviewed in 1987. In those reviews we had concerns about the vagueness of the accounting definitions in the Act as well as about the adequacy of the audit coverage of the two revenue sources. Given the length of time since our last audit, our findings at that time and the significance of mining revenue in the current year, we decided to review this area once again.

9.2 For 1997 revenue from mining taxes and royalties is approximately $18.9 million. This total is up significantly since 1987. Although the revenue from the Metallic Minerals Tax Act has remained relatively constant, potash revenue has increased by about three times to over $12 million per year.

9.3 This chapter presents the detailed discussion and recommendations separately for these two revenue sources starting with the Metallic Minerals Tax Act. The section entitled Results in Brief, however, applies to both revenue sources.

Scope

9.4 Our review focused on revenues received under the Metallic Minerals Tax Act and royalties pertaining to potash mining since 90% of the Department's mining taxes and royalties comes from these sources. Our objective was to ensure the systems in place are adequate to guarantee compliance with legislation and that the required amount of dollars are collected from mining activities in New Brunswick. Our report covers the taxation years since 1991 although not all years were examined with the same level of detail.

Results in brief

9.5 The Department has taken steps to enhance the credibility of its review of mining tax revenue since our last review.

9.6 Some improvements in audit coverage and approach are necessary for both revenue sources.

9.7 The Metallic Minerals Tax Act and Regulations need updating.

9.8 Revisions to the potash leases, which have been under negotiation since 1989, should be finalized and the Department should ensure the two potash producers compute royalties on the basis of the signed leases.

9.9 Once the current potash leases expire, the Department may be able to improve cash flow under the potash leases by moving to monthly remittances.

9.10 The Department should analyze alternative potash royalty rate models prior to exercising the Ministerial option in 2002.

Metallic Minerals Tax Act

Positive steps taken by the Department since last review

9.11 The Department has taken some significant steps to enhance the credibility of its review of Metallic Minerals Tax since our last review. The Mine Assessor position is now filled by a professional accountant. The Mine Assessor now reports to the Director of Finance rather than the Mining Division. This minimizes the potential problems with one section of the Department trying to promote the industry and tax it at the same time.

Failure to use proper forms

9.12 We noted one case of non-compliance with the Act and Regulations. Regulation 84-185 under the Metallic Minerals Tax Act prescribes the forms that must be submitted with the yearly reconciliation of tax owed. Presumably these forms were added to the Regulations to facilitate the Department's process of checking taxpayers' compliance with the Act.

9.13 The only taxpayer filing under the Metallic Minerals Tax Act (MMTA), has not been submitting all of the specific forms required under Regulation 84-185. In our opinion the working papers the taxpayer does provide make it difficult to check for compliance with the Act. Our field auditor performed a detailed examination of the most recent tax return and noted a number of areas that must be reviewed with the taxpayer to ensure that the company has paid the correct amount of taxes.

9.14 We have discussed these problems with the Department. We understand that the new Mine Assessor has been working with the company on developing electronic tax forms and schedules to replace those in Regulation 84-185. The intent is that these forms will make the Assessor's review process more effective.

9.15 We encourage this development. Once the new package is complete, it would seem appropriate to revise Regulation 84-185 to reflect these changes.

Recommendation

9.16 The Department should continue its efforts to improve the Metallic Minerals Tax submission forms and it should ensure the Regulations are revised as appropriate.

Departmental response

9.17 *The Department is in agreement with this recommendation. The Department will continue its efforts to improve the Metallic Minerals Tax submission forms and this continuing project will result in the incorporation of the electronic version of the forms in the Regulations.*

9.18 *The Department is currently reviewing the Metallic Minerals Tax Act (MMTA) and regulations and these changes will be completed by March 1998 to be incorporated in the legislative package for the fall session in 1998.*

Changes to Act required

9.19 The Act and Regulations have remained basically unchanged since inception in 1977. The Legislation needs updating. It is showing its age in some areas such as referring to the Mine Assessor as a "he" and referring to "actual and proper costs". But of more concern from our perspective is the lack of an audit requirement in the Act. This is especially relevant given the inherent difficulty in auditing under the MMTA.

Difficulty in auditing under MMTA

9.20 In our opinion the taxpayer's MMTA tax return is difficult to audit. We performed a detailed examination of the most recent tax return and noted a number of areas that were difficult to reconcile. We provided the Mine Assessor with a copy of our working paper showing a number of examples of taxpayer deductions to follow-up on and possible problem areas to review when the Department does its next tax audit.

9.21 One main reason for this difficulty is that the costs and revenues from mining related activities are difficult to separate from the taxpayer's non-mining related activities. Transfer pricing between related parties brings an added dimension of difficulty to the process.

9.22 As well, since the company does not classify its revenue or expenditures in the same way as the Act requires, each relevant account must be reconciled to the allowable deductions named in the Act . One example is transportation costs.

9.23 A deduction is permitted for transportation costs in subsection 2.1(5)(a) of the Metallic Minerals Tax Act. The company does not appear to have a financial statement line item to gather transportation costs. Instead, it makes adjustments to its "marketing costs" to arrive at a figure for transportation costs in its MMTA submission. Sales commissions are included in this claim, however, they do not appear to meet the definition of a transportation expense. To audit for compliance with the Act the auditor would have to do extensive vouching and reclassification of costs to verify the claim for transportation costs.

Mines assessor needs to begin with audited figures

9.24 The Department has typically used two or three of its own personnel over a two to three week period to perform an audit of two to four taxation years for this tax. The Department may find that the effectiveness of its MMTA tax audit would be improved if it started the process with audited figures.

9.25 There does not appear to be any requirement for the company's New Brunswick operations to have audited financial statements. In our opinion, this makes the Mine Assessor's task even more difficult as she begins the reconciliation process with unaudited figures. This may add considerable time and complexity to the Department's audit process. A preferred approach is to add an audit requirement to the Metallic Minerals Tax Act.

9.26 The parent company is audited annually by a firm of independent auditors. Part of this audit would already require verifying the tax expenses incurred by the company. The increased costs of having the company's auditors provide an opinion to the Province on the accuracy of the Metallic Minerals tax calculation may not be significant.

9.27 This option would allow the Mine Assessor to reconcile the various figures in the tax return to an audited statement. The Mine Assessor's approach could be more oriented towards investigating difficult areas such as transfer pricing on inter-company transactions.

Recommendation

9.28 We recommend that the Department amend the MMTA to include a requirement that the taxpayer provide an audited statement of its operations in New Brunswick or an audit opinion on a statement of taxes payable under the MMTA.

Departmental response

9.29 *We agree and will take steps to include the requirement in the forthcoming legislative package to be completed by March 1998.*

No reference to GAAP

9.30 We noted the Act uses terms such as "actual and proper costs" and "in the opinion of the Minister" to allow for various accounting interpretations. The Act makes no reference to GAAP. In our opinion, this oversight should be corrected.

9.31 Generally Accepted Accounting Principles (GAAP) provide guidance for determining costs and revenues. GAAP is also updated to take into account new or evolving accounting issues. Reference to these principles in the Act would ensure financial statements provided to the Department had an appropriate basis of accounting. We noted the revised leases with potash producers include a reference to GAAP.

Recommendation

9.32 The MMTA should be amended to indicate the basis of accounting is Generally Accepted Accounting Principles. Where the Act does not specifically address an accounting issue, these principles will then apply.

Departmental response

9.33 *We agree and a reference to Generally Accepted Accounting Principles will be incorporated in the legislative package to be completed by March 1998.*

Potash mining leases and royalties

9.34 There are two potash producers in New Brunswick. Each company operates under a mining lease. Both mining leases were signed in 1978 and are for 21 years with a renewal. In accordance with the mining leases, the companies are required to pay royalty on any salt or potash which is sold. Royalties in excess of $12 million are collected annually from the two producers.

Updating mining leases

9.35 In the late 1980s the Department and the producers agreed to amend the leases. The amendments were to clarify what could be used for deductions for determining the selling price. Depending on whether potash was sold f.o.b. mine site, f.o.b. the ship or delivered, certain deductions would apply. There was also a need to clarify the treatment of sales through any affiliated company of the lessee. The 1978 signed leases required that royalty be computed on a monthly basis and paid quarterly while the proposed change is that the royalty will be calculated quarterly and paid quarterly.

9.36 The proposed leases appear to contain some significant improvements. The main improvement is that selling price is more clearly defined and includes a reference to Generally Accepted Accounting Principles. Quarterly sales, rather than monthly sales, are assessed to reduce monthly fluctuations.

9.37 The revised leases have never been signed. Despite this, one of the companies has been using the new quarterly average formula since March of 1993. The other company has continued to compute its royalty monthly based on the signed lease.

9.38 We requested the Mine Assessor to perform a recalculation of royalties on a sample basis for the company using the formula in the unsigned lease. The Mine Assessor was able to get information from the company to analyze three quarters. The results ranged from an overpayment of $257,000 to an underpayment of $110,000. It appears the overpayment was the result of an unusual price fluctuation. The net effect on potash royalties can only be determined by full recalculation from 1993 to the present.

9.39 We believe it is important from the point of consistency that both producers compute royalties on the same basis. As the Mine Assessor's sample recomputation shows, there may be financial implications as well.

Recommendation

9.40 **The Department should finalize the revised unsigned potash leases.**

Departmental response

9.41 *We are in agreement with this recommendation and we are working on finalizing the leases in conjunction with our solicitor at the Department of Justice. These negotiations are complex and time consuming therefore we are targeting a time frame of three to six months to complete this exercise (i.e. by March 31, 1998).*

Recommendation

9.42 The Department should ensure both producers compute royalties on the basis of the signed leases.

Departmental response

9.43 *Your recommendation is noted and steps are being taken to ensure both companies comply with the existing leases notwithstanding the current negotiations. However we do note that with the quarterly basis of reporting versus monthly, because of the fluctuations in selling price and production, that there would be an opportunity cost in the amount of approximately $280,000 which operates in the Province's favour. This figure is based on information supplied by the company for the period of July 1995 to March 1997.*

Revisions to consider when mining leases expire

9.44 Both the signed and the 1991 proposed leases call for quarterly royalty payments. It appears that both companies tender their payments promptly. Cash flow, however, would be improved by treating these royalties in the same way as tax payments are treated under the Metallic Minerals Tax Act. The MMTA calls for monthly payments based on an estimate of tax owed. Since the potash leases and the royalties are estimated at $12 million the province could reduce its borrowing cost by approximately $55,000 per year if payments were made on a monthly as opposed to a quarterly basis.

9.45 Consideration could also be given to using yearly sales rather than quarterly or monthly sales for royalty computation. This may reduce the work requirement for the company to calculate royalties and the verification work that must be done by the Department. In addition, the audited annual financial statements could then be supplied to assist the Mine Assessor's audit.

Recommendation

9.46 When the present leases expire the Department should improve cash flow by requesting monthly remittances from potash producers.

Departmental response

9.47 *Your recommendation is noted and will be reviewed by both parties during the negotiations for renewal of the leases in 2001.*

Royalty rate

9.48 The Minister has the option to unilaterally establish a new royalty rate in the year 2002. In our opinion, the Department should consider establishing a royalty rate based on a fixed rate per tonne mined rather than on sales. The trend in the industry is to have increasing sales to related parties. This makes it more difficult for the Department to establish a fair market price for potash sales in order to verify royalty calculations.

9.49 A rate based on production volume would be more easily verifiable. It would remove the problems associated with trying to establish a fair market value for related party sales. We recognize the Department would have to consider the financial and employment implications of such a change for the companies.

Recommendation

9.50 We recommend the Department develop an analysis of the various royalty alternatives prior to the Minister's option to unilaterally change the royalty in 2002. We recommend that a royalty based on production be one of the alternatives.

Departmental response

9.51 *Your recommendation is noted and we agree that alternatives for royalty determination will be explored in advance of the renewal of the leases in the year 2001.*

Departmental audit should be better documented

9.52 We reviewed the latest audit of one of the potash producers. The last audit was done in February of 1996 by the former Mine Assessor and the present incumbent. The file lacked any documentation of planning the audit, no audit program was provided and no opinion was expressed. There was an observation that a related party transaction cost had been erroneously deducted from the royalties owed to the Province. This matter has yet to be settled.

9.53 In two days of field work the Mine Assessor checked two quarterly returns. Since the period between audits has been tentatively set at five years, this review represents the audit of $20 to $30 million in royalties revenue. There was no indication of whether two days of field work could sufficiently cover this much revenue. We understand extenuating circumstances may have prevented a more extensive audit at that time.

9.54 In our opinion the Department's royalty audits should be more formally documented. Some guidance may be available from publications such as the CICA's *Standards for Assurance Engagements*. Specifically, evidence of proper planning and adequate documentation should be on file. Errors discovered should be quantified. An opinion on the accuracy of the royalties collected could be provided based on the results of the audit.

9.55 The Department has informed us that it has contracted with an experienced Mine Assessor from another jurisdiction to assist in its next royalty audit. We support this initiative and are pleased to see the Department adopting this approach.

Recommendation

9.56 The Department should improve its approach to the audits of potash producers. This would include more formal documentation of the planning, conducting and reporting of the audit.

Departmental response

9.57 *We agree with this recommendation and have just recently developed and carried out a significantly strengthened audit approach to potash audits which addressed your recommendation for a more formal documentation of the planning, conduct and reporting of the audit.*