

# Flow-Through Shares | Mining Tax Canada

## Executive Summary

- Flow-through shares are a financing tool available to a Canadian resource company that allows it to issue new equity (shares) to investors at a higher price than it would receive for “normal” shares, thereby assisting it in raising money for exploration and development.
- Investors are willing to pay more for flow-through shares, because the investors are permitted to claim deductions for the issuing corporation’s CEE (and in some cases CDE). This reduces the investor’s Canadian taxes.
- Essentially, the investors and the corporation agree that the investors will purchase flow-through shares from the corporation, the corporation will incur certain expenditures on CEE within a certain time period, and the corporation will renounce that CEE in favour of the investors. CEE renounced by the corporation cannot be deducted by it.

In the mining business, it is quite common for mining companies (especially smaller ones) to have no net income for tax purposes. Since generally expenditures on exploration and development can only reduce taxes owing down to zero, such mining companies may find themselves with deductions for tax purposes that they will not be in a position to use for many years (if ever) because they are not generating enough income. Companies in such circumstances may also need to raise financing in order to fund ongoing operations. Flow-through shares (“FTS”) can provide mining companies with reduced-cost access to financing in this situation.

The basic principle behind flow-through shares, which are unique to the resource sector in Canada, is that a mining corporation willing to forego the tax benefit of certain CEE and CDE amounts that it incurs can “renounce” these expenditures to investors buying shares in the corporation in certain circumstances. The investors purchasing the FTS from the corporation are permitted to deduct the amount of CEE or CDE the corporation has incurred and renounced to them: in effect, they are treated as if they had incurred the CEE or CDE, instead of the corporation. The corporation benefits because it can issue the shares to the shareholders for a higher price than they would otherwise be willing to pay, due to the tax benefit associated with being able to deduct the CEE or CDE. The investors benefit by being able to reduce their incomes for tax purposes (and pay less income tax) by virtue of claiming deductions for the renounced CEE and CDE. While the corporation loses the ability to deduct the CEE or CDE renounced to the FTS investors, the net present value of those deductions may be quite small if the corporation is unlikely to have enough taxable income to utilize these deductions in the near future. In this way, FTS represent one of very few ways in which one taxpayer is permitted to monetize or sell the benefit of its tax deductions in favour of an arm’s-length person.

The mechanics of a flow-through share structure are illustrated below in Figure 1.

**FIGURE 1: FLOW-THROUGH SHARE ILLUSTRATION**



## Requirements

In order to create a valid FTS structure, the following basic requirements must be met:

- The mining company issuing the FTS must be a “principal business corporation” (“PBC”) at all relevant times. Essentially this means that the corporation’s principal business must be mining or exploring for minerals (processing of metals or minerals is also permitted). A corporation all or substantially all of the assets of which are shares or debt of principal business corporations will also qualify, meaning that a holding company that owns securities of operating companies that are principal business corporations may also meet this requirement.
- The FTS themselves issued to the investors by the PBC must meet certain conditions. While the relevant rules are complex, in essence the shares must be “ordinary” common shares that participate fully in the risks and benefits of the corporation’s activities, and cannot be the subject of terms or agreements that give the holder reduced risk otherwise associated from holding common shares. It is very important in structuring a FTS issue to observe the requirements of these complicated rules (particularly with respect to the subscription agreement referred to below). Note: rights to buy shares (“warrants”) rather than shares themselves can also be used in a FTS program, although rights are less common and not discussed here.
- There must be a written agreement (a “**subscription agreement**”) between the PBC and the investors governing the issuance of the shares. The agreement will provide that the PBC must incur qualifying expenditures (certain CEE and in some cases CDE) at least equal to the amount to be paid for the shares within a set time period, and renounce them in favour of the FTS investors by no later than a certain date. The subscription agreement must be carefully drafted not to give the investors indemnities or other protections that cause the FTS being issued to fail the test described in the preceding bullet. For example, it is permissible to include terms requiring the PBC to indemnify the investors for any federal or provincial income taxes they owe as a result of the PBC failing to incur the qualifying CEE or CDE that it promises to incur within the period specified. However, if the indemnity extends to interest on or penalties relating to such taxes, the shares may be disqualified from being valid FTS.

### ***Qualifying Expenditures***

The most common form of qualifying expenditure in a mining context is what is commonly described as “**grassroots**” exploration expenditures: expenses incurred to determine the existence, location, extent or quality of a mineral resource in Canada, including in the course of prospecting, geological/geophysical/geochemical surveying, drilling, trenching, digging test pits or sampling, but excluding any such expenses:

- included in CDE;
- included in the cost of depreciable property; or
- related to a mine already producing in commercial quantities (or any extension of such a mine).

“Grassroots” CEE is by far the most common form of expenditure relevant for FTS purposes, because essentially only “grassroots” CEE is eligible for the “look-back” rule described below, which is used in most FTS transactions. Most FTS transactions are structured on the basis that “grassroots” CEE will be renounced to the FTS investors.

In addition to this “grassroots” CEE, expenditures that qualify for FTS transactions (but not the “look-back” rule described below) also include:

- pre-production CEE, being expenses incurred for the purpose of bringing a new mine into production in reasonable commercial quantities (including expense for clearing, removing overburden, stripping, sinking a mine shaft or constructing an adit or other underground entry), if incurred before the mine comes into production in reasonable commercial quantities, but excluding the cost of depreciable property and expenses related to a mine in commercial production; and
- CDE that is any expense incurred in sinking or excavating a mine shaft, main haulage way or similar underground work for continuing use in a Canadian mineral resource (except to the extent included in the cost of depreciable property), if built after the mine has come into production, or any expense of extending any such shaft, haulage way or work. The cost of a mineral resource property (which is included in CDE, and generally includes staking costs) does not qualify for FTS purposes, nor does any expense that is included in the cost of depreciable property.

Certain types of expenses included in CEE or CDE called “Canadian exploration and development overhead expenses” are not eligible to be renounced under a FTS transaction. Essentially these are expenses of:

- the administration, management or financing of the mining corporation;
- employees whose duties are not entirely directed to exploration and development; or
- property not used exclusively for exploration and development activities.

Certain costs of “shelf” seismic data are also excluded from being FTS-eligible expenses. Note that pre-production revenue from “grassroots” CEE (e.g., proceeds from selling samples) also reduces the amount of CEE available to be renounced.

### ***Mechanics***

A number of rules govern the manner in which qualifying expenditures must be made and renounced. The basic rules are as follows:

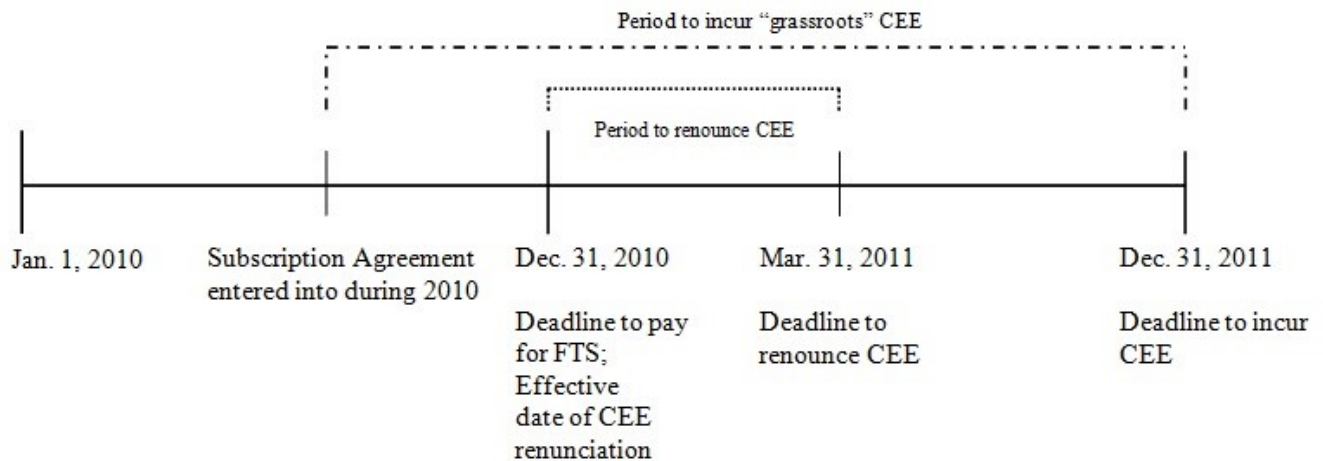
- *When to Incur Expenditures:* the time period during which the PBC must incur the qualifying expenditures begins on the date of the subscription agreement and ends 24 months after the end of the month in which the subscription agreement was made (the “24-month period”). Qualifying expenditures cannot be incurred before the date of the subscription agreement.
- *When to Renounce Expenditures:* the PBC must renounce the qualifying expenditures in favour of the FTS investors by no later than the end of February in the year following the end of the 24-month period. Expenses generally cannot be renounced until they are actually incurred by the mining corporation, subject to the “look-back” exception described below.
- *Maximum Renunciation:* the amount of qualifying expenditures renounced cannot exceed the amount of the PBC’s available CEE

or CDE (as applicable) or the amount paid by the investor for the FTS.

However, most FTS transactions are structured to take advantage of a special rule that allows the PBC to renounce CEE to investors effective as of *before* the time those expenses are actually incurred, which is not permitted under the normal rules. Only “grassroots” CEE is eligible for this special treatment, and only where the mining corporation and the investors deal at arm’s length.

If the mining corporation enters into a FTS subscription in one year (for example 2010) and incurs “grassroots” CEE in the immediately following calendar year (2011), and if the investor paid for the FTS under that agreement before the end of 2010, the mining corporation may renounce such “grassroots” CEE to the FTS investors during the first three months of 2011 (effective as of December 31, 2010). Where this happens, the mining corporation is deemed to have incurred the grassroots CEE on the last day of 2010, making them eligible to be renounced on that date. Hence, in these circumstances, it is possible to renounce expenses to FTS investors effective as of *before* the time the PBC actually incurs them. While this shortens the time period that the investor has to pay for the FTS and the time period that the PBC has to renounce and incur qualifying expenditures from the normal 24-month period, it accelerates the availability of the CEE deduction to the investor by not requiring the investor to wait until the PBC actually incurs the qualifying expenditures. The timeline of a “grassroots” FTS transaction is set out below in Figure 2. Note that where the “look-back” rule is used in respect of “grassroots” CEE, the PBC is liable under a special provision of the ITA to pay what is essentially a month-by-month time-value-of-money tax on expenses that have been renounced but not yet incurred, starting in February of the calendar year following the subscription agreement (2011 in the example above).

**FIGURE 2: GRASSROOTS FTS TIMELINE**



Note that it not necessary for the PBC to use the actual money received from FTS investors to fund the qualifying expenditures, as long as the requisite amount of qualifying expenditures are incurred and renounced by the PBC within the permitted time period.

For the CRA’s web page on issues relating to flow-through shares, see [here](#). There are prescribed forms that must be filed in a timely manner in order for a FTS transaction to successfully transfer the CEE or CDE to the investors, relating to both the selling documents provided to investors (see [here](#)) and the PBC’s renunciation of CEE or CDE (see [here](#)).

## ***Consequences***

### **1. Federal CEE Deduction**

Where the requirements of the FTS rules are met, the FTS are issued to the investors and the qualifying expenditures are renounced by the PBC in favour of the investors, the investors are treated as if they themselves had incurred the relevant CEE or CDE and may claim deductions in computing their incomes in the manner described [here](#). Thus, investors can use the renounced expenditures to reduce the amount of tax payable on income from other sources. The PBC is treated as having never incurred the CEE/CDE renounced in favour of the investors, and thus loses the benefit of taking any deduction from income for those amounts.

Only the first holder of the FTS (i.e., the one subscribing for the FTS with the PBC) is entitled to claim deductions for the qualifying expenditures, not any subsequent holder of the share. As such, it is important that the transaction be structured properly to ensure that the intended persons are the first holders of the FTS issued by the PBC. The first holder does not need to continue to be the holder of the FTS at the time the expenditures are incurred or renounced, as long as he is the first owner of the FTS.

While normally the amount paid by an investor becomes the cost for tax purposes of the property he acquires, in the case of a FTS the investor is deemed to acquire the FTS at a cost of zero, to take into account the fact that by acquiring the FTS the investor is thereby acquiring CEE/CDE that is deductible from income. As a result of having a FTS cost of nil for tax purposes, whenever the FTS is sold the investor will generally realize a gain equal to the full amount of the sale price. Since in most cases that gain will be treated as a capital gain ([only 50% of which is included in income for tax purposes](#)), it is still quite advantageous to an investor to receive \$100 of renounced CEE /CDE that can be used to shelter \$100 of other income: the accrued capital gain on the FTS will only be realized if the

FTS investor sells the FTS, and even then only half of the capital gain will be included in income.

Table 1 sets out a simple example illustrating the consequences to a FTS investor who purchases 10,000 FTS of a mining company at a \$1/share premium over the trading price of the “ordinary” (non-FTS) common shares of the company, and later sells them into the market at the prevailing trading price.

**TABLE 1: FTS CASH-FLOW EXAMPLE**

<b>Assumptions</b>		
Flow-through shares purchased		10,000
Price per FTS		\$10
Mining company regular common share trading price		\$9
FTS premium per share		\$1
Investor’s federal /provincial tax rate		46%
CEE renounced per FTS		\$10
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	<b>Investor Cash Out</b>	<b>Investor Cash In</b>
Cost of FTS (\$10/share)	\$100,000	
Tax savings from \$100,000 renounced CEE		\$ 46,000
Investor’s proceeds from selling FTS in market		\$ 90,000
Tax owing on capital gain from sale of FTS	\$ 20,700	_____
	\$120,700	\$136,000
Investor’s positive cash flow		\$ 15,300

## 2. Federal Investment Tax Credit

FTS investors who are natural persons (not corporations) may also be entitled to an “investment tax credit” (“ITC”) equal to 15% of certain qualifying expenditures flowed-through to them under a FTS. In general terms, the expenses that qualify for this so-called “super-flow-through” tax benefit are those included in CEE incurred before 2013 in conducting mineral exploration activity from or above the surface of the earth to determine the existence, location, extent or quality of a mineral resource other than coal (certain preliminary sampling expenses are excluded).

The amount of the ITC reduces the investor’s taxes owing (not merely taxable income) on a dollar-for-dollar basis, and so is quite valuable. For example, a \$15 ITC generated by \$100 of renounced CEE eliminates \$15 of tax owing by the investor on other income. The federal ITC is non-refundable, meaning that it cannot be used to reduce taxes owing below zero so as to create a refund (any portion not used in the year can be applied in future years). This federal ITC has been renewed on a yearly basis for the past several years.

Federal ITCs claimed on CEE renounced to the investor on a FTS for a particular year are deducted from the investor’s CCEE in the following year. Since a negative CCEE balance at year-end is added back to the investor’s income, there could be a net income inclusion for the investor if no additional CCE is incurred in that later year. Also, it is important to note that the amount of provincial ITCs (see below) relating to CEE renounced to an investor under a FTS is deducted from the investor’s CCEE in the year the incentive is granted (typically the year in which the investor files the tax return claiming the provincial credit). Again, unless the investor has or incurs other CEE, this reduction to CCEE could create a negative CCEE balance and cause an income inclusion in the later year. This is illustrated in the chart at the link at the bottom of this page.

## 3. Provincial Investment Tax Credits and Deductions

In general, CEE deductible for federal income tax purposes will also be deductible for provincial income tax purposes. Beyond that, certain provinces (Ontario, British Columbia, Saskatchewan, and Manitoba) offer analogous ITCs for provincial income tax purposes in respect of comparable “grassroots” exploration activity carried out within the province, while Quebec offers additional deductions from income instead of a tax credit. In most cases the provincial incentive offered is limited to individuals resident in that particular province.

In the case of Quebec, in addition to the basic deduction of 100% of CEE renounced to the FTS investor, an investor that is a natural person is permitted to deduct in computing income a further 25% of the CEE renounced by a qualifying corporation if these expenditures relate to exploration activities carried out in Quebec. For these purposes, a qualifying corporation is essentially a corporation whose activities are limited to resource exploration and development, and is not itself (and is not related to a company that is) exploiting a mine in reasonable commercial quantities. A further 25% deduction is permitted if the exploration is conducted by a qualifying corporation above ground (surface exploration), for a total potential deduction of 150% of CEE renounced to the investor. Moreover, the capital gain realized on a sale of the FTS may be exempt from tax in Quebec. For further information see [here](#).

In Ontario, a natural person resident in Ontario who acquires FTS may claim an ITC for provincial tax purposes of 5% of CEE

renounced to that investor that also qualifies for the 15% federal ITC, to the extent that such CEE relates to exploration activities carried out within Ontario. In addition, the PBC conducting the exploration activities must have a “permanent establishment” (e.g., fixed place of business) in Ontario. See [here](#) for additional details.

Manitoba offers a very generous 30% ITC for CEE that also qualifies for the 15% federal ITC renounced to FTS investors that are individuals, to the extent relating to exploration carried out in Manitoba by qualifying corporations. See [here](#) for more information on the Manitoba Mineral Exploration Tax Credit.

The Saskatchewan Mineral Exploration Tax Credit is a 10% ITC available to natural persons who acquire FTS for expenditures that qualify for the federal ITC, to the extent carried out in Saskatchewan. In order to generate CEE that qualifies for the Saskatchewan ITC, the corporation undertaking the activity must apply for and receive approval from the provincial government. For more information see [here](#).

Finally, British Columbia offers a 20% ITC to natural persons acquiring FTS who have renounced to them essentially the same CEE as is eligible for the federal ITC on exploration activities within B.C. More information on the British Columbia Mining Flow-Through Share Tax Credit is available [here](#).

The Prospectors and Developers Association of Canada has prepared a very helpful chart showing the effect of federal ITCs and provincial super flow-through share incentives, including the potential income inclusions for federal and provincial ITCs in subsequent years. To view the chart, see [here](#).