

Flow-through shares

An overview for mining executives



What are flow-through shares?

A flow-through share (FTS) is a tax-based financing incentive that is available to, among others, the mining sector. A FTS is a type of share issued by a corporation to a taxpayer, pursuant to an agreement with the corporation under which the issuing corporation agrees to incur eligible exploration expenses in an amount up to the consideration paid by the taxpayer for the shares.

The corporation “renounces” to the taxpayer an amount in respect of the expenditures so that the exploration and development expenses are considered to be the taxpayer’s expenses for tax purposes. As a result of the corporation renouncing the expenses, the shareholder can deduct the expenses as if incurred directly.

What expenditures can be funded using such shares?

Only certain eligible expenses qualify for flow-through:

- **“Grass-roots” expenditures.**

Any expense, other than one made to acquire a depreciable property, incurred for the purpose of determining the existence, location, extent or quality of a Canadian mineral resource, otherwise referred to as “grass-roots exploration expenses”, including any expense incurred in the course of:

- Prospecting,
- Carrying out geological, geophysical or geochemical surveys,
- Drilling by rotary, diamond, percussion or other methods, or
- Trenching, digging test pits and preliminary sampling;

A taxpayer being renounced such expenses can deduct the full amount renounced from any source of income.

- **Pre-production expenses:**

Expenses incurred to bring a new mine into production in reasonable commercial quantities (general guideline: 60% mill capacity for a 90-day period), including an expense for clearing, removing overburden, stripping, sinking a mine shaft or constructing an adit or other underground entry. The nature and type of expenses contemplated here are mine development expenses incurred after the decision has been made to proceed with mine development. In other words, expenses incurred to determine whether to proceed with the development of a mine would not be encompassed by this paragraph, but might be considered “grass-roots” expenditures if they meet the above definitions.

A taxpayer being renounced such expenses will have to allocate such expenses into two categories as follows:

Year incurred	Exploration	Development
2014	100%	0%
2015	80%	20%
2016	60%	40%
2017	30%	70%
After 2017	0%	100%

For the expenses in the Exploration category, the taxpayer can deduct the full amount renounced. For the expenses in the Development category, the amount renounced is added to a pool called cumulative Canadian development expense (“CCDE”) and deductible at the rate of 30% on a declining balance basis.

- **Post-production expenses:** Expenses (other than an amount included in the capital cost of depreciable property) incurred in sinking or excavating a mine shaft, main haulage way or similar underground work designed for continuing use, for a mine in a mineral resource in Canada built or excavated after the mine came into production. This category also applies to expenses relating to an extension of such a shaft, haulage way or work. A taxpayer renounced such expenses will add them to the CCDE pool and may claim a deduction at the rate of 30% per annum on a declining balance basis.

Who is eligible to issue FTS?

The corporation issuing the FTS must be a principal business corporation or PBC. The definition of a PBC includes a corporation whose principal business is mining or exploring for minerals, the processing of mineral ores for the purpose of recovering metals or minerals from the ores, the fabrication of metals, or marketing of metals or minerals that were recovered from mineral ores that include metals or minerals recovered from mineral ores processed by the corporation or any combination thereof. PBCs can include holding companies, provided at least 90% of the assets of the holding company are shares and/or debt in a subsidiary that is a PBC.

What is a super flow-through share?

For “grass-roots exploration expenses” only (see definition above) incurred in respect of surface exploration (and are not associated with an underground exploration program), a super flow-through share (SFTS) provides an individual shareholder the 100% deduction for exploration costs renounced by the PBC, plus a 15% non-refundable investment tax credit (ITC) that can reduce the individual’s federal income taxes payable. Provincial tax credits (such as those in British Columbia, Manitoba, Ontario, and Saskatchewan) may also be available.





What are the general rules for renunciations?

To be eligible for FTS treatment, the eligible expenditures must be incurred in the period that begins on the day the relevant flow-through share agreement is entered into and ends 24 months after the end of the month that includes that day, and must be incurred on or before the effective date of the renunciation. Renunciation must occur before March of the first calendar year that begins after the 24-month period expires. The PBC

will be deemed to incur the expenditures within this period if it renounces the expenditures to the investor within 30 days after the period expires.

The amount renounced by the corporation cannot exceed the gross proceeds received by it from the investor for the share. To the extent that share issuance costs are deducted from the gross proceeds raised from the FTS, the PBC is still required to incur eligible expenditures in an amount equal to the gross proceeds raised.

How does the “look-back rule” work?

For “grass-roots exploration expenses” only (see definition above), the “look-back” rule allows a PBC to renounce eligible expenditures incurred within an entire calendar year (Year 2) effective on the last day of the preceding calendar year (Year 1) provided the following conditions all have been met:

- The FTS agreement was made in Year 1
- The FTS investor has paid the consideration for the FTS before the end of Year 1
- The FTS corporation and the FTS investor deal at arm’s length throughout Year 2
- In January, February or March of Year 2, the FTS corporation renounces an amount in respect of the eligible expenses and the effective date of the renunciation is the last day of Year 1

Renunciation Timeline – General Rules

J	F	M	A	M	J	J	A	S	O	N	D	J	F	M	A	M	J	J	A	S	O	N	D	J	F	M
Year 1						Year 2						Year 3						Year 4								

FTS agreement entered into

Eligible expenditures must be incurred by end of 24 month period

Renunciation must occur before March

Source: *Instructions For The Flow-Through Share Program*, Canadian Revenue Agency

Can you provide an overview of what common expense categories qualify for the FTS regime?

A determination of whether a particular expense incurred by a PBC qualifies as an eligible expense is a question of fact based on all the relevant information available. The following comments are not a definitive opinion of PwC as to whether any of the expenditures will qualify for FTS treatment and we cannot provide any assurance that any classification we provide will be accepted by the Canada Revenue Agency (CRA) on audit. The following is merely guidance on the CRA's current views and are not necessarily the views of PwC:

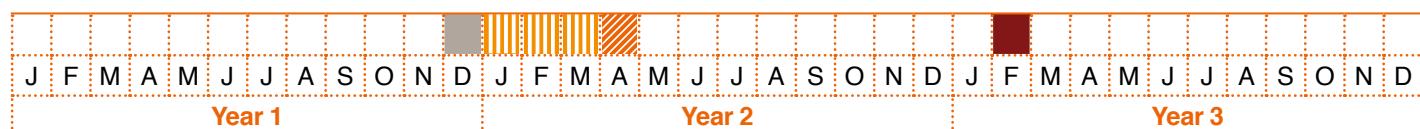
- Drilling, metallurgical testing and associated costs incurred to confirm reserves included in a National Instrument Rule 43-101 compliant report should qualify.
- Costs incurred that would be included in the capital cost of depreciable property (such as a road/drilling equipment/construction of housing facilities) will not qualify.
- Overhead expenditures do not qualify.
- Scoping study costs that relate to the assessment of mine development options and/or profitability of developing the deposit into a mine will not qualify.
- Costs associated with issuing shares, compliance with regulatory requirements and audit and legal fees are considered period costs and do not qualify.

What is the cost of using the "look-back" rule?

A deductible tax (called Part XII.6 tax) will apply in situations where, under the look-back rule, a PBC has not expended a portion or all of the amounts that it has renounced. The tax's purpose is to compensate the government for accelerating the FTS investor's deduction by one year. The tax is calculated in respect of each month in a calendar year (except for January) using a formula. If the expenditures have not been incurred by the end of December of Year 2, a penalty of 10% of the unspent amount will be payable.

In addition, the purchaser of the FTS will be reassessed to deny the deduction of the expenditures that the corporation purported to renounce. A tax return for the total Part XII.6 tax for Year 2 is due for filing, together with the payment of tax, on or before the last day of February of Year 3.

Renunciation Timeline – Look Back Rule



- Effective date of renunciation when using look-back rule – must be December 31 of Year 1
- Renunciation period when using the look-back rule – must be January, February or March of Year 2
- Latest date to file a renunciation using the look-back rule without being subject to penalties if the renunciation was made in March (note: Form T101A must be filed in the month following the month the renunciation was made.)
- Latest date to file Part XII.6 tax without being subject to penalties – before March of Year 3.

- Consultation costs to assess community attitudes/community information program undertaken prior to a decision to explore do not qualify.

- Expenses incurred in respect of a feasibility study to assist the company in its decision on whether to bring the mine into commercial production and to "map out" the process for developing the mine may qualify. However, feasibility study expenses not associated with this objective (e.g., geotechnical testing of land on which mining buildings will be built to determine if it is capable of supporting the structures or designing and costing a storage facility) may create grey areas and may need to be carved-out of the FTS expenditure pool.

- Costs associated with environmental assessments undertaken to meet a legal or informal requirement to obtain a permit will not qualify.

- Environmental assessment expenses, including costs of an environmental impact statement, are often an essential part of the process of bringing a mine into commercial production and as such, a PBC may have a good argument for asserting that such expenses qualify as FTS expenditures. However, expenses not directly related to the decision on whether to develop the mine, but related, for example, to how the property will be reclaimed after the minerals are exhausted, may be a grey area and may need to be carved-out of the FTS expenditure pool.

On September 19, 2007, the CRA issued guidance on its position on whether community consultation, feasibility and environmental study costs incurred by a mining company in the exploration stage are eligible expenses. The following is a summary of their comments:

Community Consultation:

- Consultation to assess community attitudes undertaken prior to a decision to explore will not qualify.
- Consultation undertaken to meet a legal or informal obligation under the terms of a permit, providing for the exploration process should qualify.
- Negotiation to secure surface access for exploration purposes (beyond the requirements for/of the permit) should qualify.
- Negotiation with local communities to secure certainty with respect to exploration operations (additional to requirement for/of a permit and where other party does not hold surface rights) should qualify.
- Other consultation undertaken at the taxpayer's discretion in respect of the exploration process should qualify.

Feasibility studies:

- Preliminary planning for a potential exploration activity undertaken prior to a decision to explore will not qualify.
- Planning for, and studies relating to, the conduct of an exploration activity or some part therefore should qualify.
- Physical and chemical assessments related to a deposit, with the objective of informing a decision on whether to undertake more advanced exploration at site should qualify.
- Assessing the physical and chemical characteristics of the deposit to assess its potential as a commercial deposit should qualify.
- Assessment of mine development options and profitability of developing the deposit into a mine will not qualify.

Environmental studies:

- Environmental assessments undertaken by a taxpayer to meet a legal or informal obligation under the terms of a permit providing for the exploration process should qualify.
- Other environmental assessments such as sampling and monitoring in relation to an exploration activity which is conducted at the discretion of the taxpayer should qualify.
- Other discretionary environmental assessments such as targeted environmental assessments conducted in conjunction with a specific exploration activity should qualify.
- General baseline environmental assessments undertaken prior to carrying out a specific exploration activity should not qualify.

Final thoughts

As you can see, the FTS rules are far from simple. Therefore, it is important for executives of companies that raise exploration funding using FTS to understand the rules, and in particular, become aware of how the CRA audits such offerings and what expenses qualify for flow-through, preferably before the shares are even issued. If a FTS offering fails because, for example, the expenses incurred by the company issuing the shares did not qualify, the issuing company may be subject to significant liabilities, including an obligation to compensate FTS holders for the loss of promised tax benefits.

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