

Country Survey

Canada

Mining for Tax Incentives: The Rise of Flow-Through Share Offerings

Canada is one of the largest mining nations in the world, serving as the source of more than 60 different minerals and metals.¹ According to the Metals Economics Group, Canada has now become the number one destination for exploration investment in the world.² In 2004, exploration and deposit appraisal expenditures in Canada reached CDN \$1.09 billion and such expenditures are expected to surpass CDN \$1.12 billion in 2005.³

Two particular federal tax incentives have emerged as key features of Canada's internationally competitive climate for mineral capital: the flow-through share programme (a tax deduction measure) and the "super" flow-through share programme (a tax credit measure). This article outlines the key elements of Canada's flow-through and super flow-through share programmes and illustrates the considerable tax advantages that may be reaped by those that choose to invest in Canadian mining companies.

The Flow-Through Share Programme

Flow-through share offerings have proven to be an extremely effective way for mining companies to fund certain types of exploration and development activities in Canada. At the early stages of an exploration project, mining ventures typically do not generate sufficient taxable income to take advantage of the deductibility of exploration expenditures. The Canadian flow-through share regime permits mining companies to renounce certain types of exploration and development expenses to flow-through shareholders who may personally deduct the expenses when computing their incomes for Canadian tax purposes.

The ability to renounce expenses to shareholders with sufficient taxable income to make use of the resulting deductions is an extremely valuable benefit available to Canadian mining companies. As a result, it is not surprising that Canadian flow-through share offerings have raised over CDN \$1 billion since October 2000.

Flow-through shares are a creature of the federal *Income Tax Act* (Canada).⁴ Both shares and rights to acquire shares (*i.e.*, warrants) can qualify as "flow-through shares", provided the following three conditions are satisfied:

- The shares or warrants are issued by a "principal-business corporation";
- The shares or warrants are not "prescribed shares" or "prescribed rights" for the purposes of the Tax Act; and

- The shares or warrants are issued for consideration pursuant to a written subscription agreement that meets certain requirements.

Principal-Business Corporations

A flow-through share can only be issued by a "principal-business corporation". A "principal-business corporation" is defined as a corporation with a principal business that consists of one or more activities specifically enumerated in the Tax Act. In relation to mining, the relevant enumerated activities include: (i) mining or exploring for minerals; (ii) the processing of mineral ores for the purpose of recovering metals or minerals from the ores; (iii) the processing or marketing of metals or minerals recovered from mineral ores; and (iv) the fabrication of metals.

Although the Tax Act does not establish a precise process for determining whether a particular company is a principal-business corporation, the Canadian tax authority, the Canada Revenue Agency (the "CRA"), has asserted that a corporation's activities over an entire year are relevant in determining whether the corporation qualifies as a principal-business corporation in the year.⁵ The CRA has also stated that a corporation's Canadian operations cannot be examined separate and apart from any of its international operations when assessing whether it qualifies as a principal-business corporation.⁶

Prescribed Share/Prescribed Right Restrictions

The Tax Act strictly governs the permitted characteristics of a flow-through share. A share or warrant will not qualify as a flow-through share if it constitutes a "prescribed share" or a "prescribed right" for the purposes of the Tax Act (the "*Prescribed Share Restrictions*"). The Prescribed Share Restrictions are quite complex and stipulate that the terms of a share or warrant, or any agreement in respect of such securities, must satisfy a number of distinct criteria. The primary purpose of the Prescribed Share Restrictions is to ensure that only shares or warrants purchased with funds that are genuinely at risk qualify as flow-through shares.

Subscription Agreement Requirements

The issuance of flow-through shares must be made pursuant to a written agreement under which the investor agrees to provide consideration for the issuance of the shares. The agreement must provide that the corporation will: (i) incur certain qualifying expenses ("*Eligible Expenses*") during the period commencing on the day the agreement was entered into and ending 24 months after the end of the month that includes the commencement day (the "*Period*"); and (ii) validly renounce such Eligible Expenses to the holder of the share before March of the first calendar year after the Period. For example, if an agreement for the issuance of flow-through shares was executed on November 15, 2004, Eligible Expenses must be

incurred by the investee mining company between November 15, 2004 and November 30, 2006 and the required renunciation must take place before March 2007.

Eligible Expenses

The Eligible Expenses that a mining company may renounce to the holders of flow-through shares include certain “Canadian exploration expenses” (“CEE”) and “Canadian development expenses” (“CDE”), each as defined in the Tax Act.

The statutory definition of CEE captures expenses incurred for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada or bringing a new mine into production in reasonable commercial quantities. CEE also includes expenditures for prospecting, carrying out geological, geographical or geo-chemical surveys, drilling, trenching, digging test pits and preliminary sampling, clearing, removing overburden and stripping, and sinking a mineshaft.

The statutory definition of CDE captures expenses incurred in sinking, excavating or extending certain mineshafts, main haulage ways or similar underground works. The statutory definition of CDE also includes the cost of any Canadian mineral property or any right to, or interest in, such property.⁷

Renunciation

The renunciation of CEE and CDE by a mining company to the holders of flow-through shares is effective on the date the renunciation is made or such earlier date as set out in prescribed filings made by the company. The amount of CEE and CDE that a mining company can renounce to its shareholders is determined by specialised formulae set out in the Tax Act. In addition, the following three general limitations are imposed on the amount of CEE and CDE that a mining company may renounce: (i) a mining company can only renounce the amount of CEE and CDE that it would have otherwise been entitled to deduct in computing its income for Canadian tax purposes; (ii) the amount renounced cannot exceed the amount of consideration paid for the flow-through share; and (iii) the amount renounced in respect of a share cannot exceed the amount by which the cumulative amount of CEE or CDE incurred by the mining company on the effective date exceeds the total amount renounced in respect of any other shares of the company.

Where a corporation renounces an amount to the holder of a flow-through share, the CEE and CDE to which the amount relates is deemed to have been incurred by the relevant shareholder on the effective date of the renunciation. The

holder of a flow-through share is generally entitled to deduct 30 percent of renounced CDE each year (on a declining balance basis) and 100 percent of renounced CEE. On and after the effective date of the renunciation, CEE and CDE are deemed never to have been incurred by the renouncing corporation (see Diagramme below).

Retroactive Renunciation

Between January and the end of March of any year, a mining company that incurs or plans to incur expenses during the year may be entitled to renounce such expenses to an investor, effective as of December 31 of the previous year. Such retroactively renounced expenses are considered to have been incurred by the relevant shareholders during the previous calendar year and can be deducted when computing their taxable incomes for the previous year.

The retroactive renunciation of mining-related expenses is only available: (i) in respect of CEE incurred by a mining company for the purpose of determining the existence, location, extent or quality of a mineral resource in Canada; (ii) provided the investor and the mining company deal at “arm’s length” with one another throughout the Period; and (iii) so long as the agreement to issue the flow-through shares is entered into, and the consideration for the shares is received, by the company in the previous calendar year.

Special Tax Rules

The Tax Act establishes several additional, specialised computational rules relating to flow-through share ownership. For tax purposes, the cost of a flow-through share is deemed to be nil. Moreover, the holder of a flow-through share cannot elect to treat a flow-through share as capital property for the purposes of the Tax Act. Finally, special rules in the Tax Act provide for supplementary increases and decreases in the paid-up capital of classes of flow-through shares.

Procedural Requirements

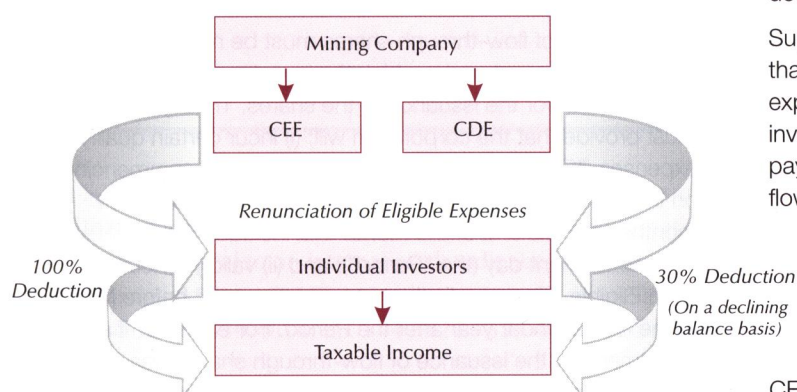
To ensure that the issuance of flow-through shares and all subsequent renunciations are valid, a mining company is required to make several prescribed filings with the federal Minister of National Revenue. Failure to make any of these filings on a timely basis may result in penalties or render a renunciation invalid.

The Super Flow-Through Share Programme

The second Canadian tax initiative designed to encourage investment in mineral exploration is the super flow-through share programme. The super flow-through share programme was introduced in October 2000 in response to a severe downturn in mineral exploration in Canada.

Super flow-through share offerings enable mining companies that incur expenses in connection with certain “grassroots” exploration activities to offer investors the right to claim an investment tax credit, deductible from federal tax otherwise payable, in addition to the tax benefits associated with regular flow-through shares. Where a mining company incurs and renounces Canadian grassroots mining expenditures between October 17, 2000 and December 31, 2005, individual investors (other than trusts) are generally entitled to claim a non-refundable investment tax credit equal to 15 percent of the amount of the renounced CEE. Grassroots mining expenditures include expenses

Diagram 1: Renunciation of Flow-Through Shares by a Canadian Mining Company



incurred in conducting certain mining exploration activity from or above the surface of the earth for the purpose of determining the existence, location, extent or quality of a "mineral resource".

Although all provinces and territories in Canada indirectly benefit from the super flow-through share programme, several provinces have introduced supplementary tax measures, some of which are harmonised with the federal incentive. Such measures generally provide investors residing in eligible provinces with the right to claim additional exploration incentives in respect of qualifying expenses incurred in a particular province. For example, the province of Ontario provides a refundable tax credit in the amount of 5 percent of the grassroots exploration expenses incurred in Ontario by a mining company with a permanent establishment in the province at the time the expenses are incurred.

Since its inception, the original three-year life of the super flow-through share programme has been extended twice, both times for an additional one-year period. Most recently, the expiry date of the programme was extended to December 31, 2005. The Canadian federal government has advised that it is uncertain at this time whether the programme will be further extended beyond the end of 2005.

- 1 Natural Resources Canada, Canadian Mining Fact Sheet, *The Importance of Mining to the Canadian Economy* (May 2004) available at www.nrcan.gc.ca/mms/pdf/econo04_e.pdf.
- 2 Jason Goulden, *Who is Spending What, and Where? Recent Trends in Exploration* (Metals Economics Group Lecture, Vancouver, January 24, 2005) available at www.metalseconomics.com/catalog/pages/trends.pdf.
- 3 Natural Resources Canada, Exploration Information Bulletin, "Canadian Exploration and Deposit Appraisal: Levels of Expenditures Are Impressive in 2004 and 2005" (March 2005) available at http://www.nrcan.gc.ca/mms/pdf/info-explor_e.pdf.
- 4 *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1, as amended (the "Tax Act").
- 5 M.N.R., Interpretation Bulletin IT-400, "Exploration and Development Expenses – Meaning of Principal Business-Corporation" (14 November 1977) at para. 6.
- 6 *Ibid.*
- 7 The cost of any Canadian mineral property or a right to, or interest in, such property only qualifies as CDE until 2007.

Michael Friedman is a tax lawyer and **Matthew B. Langford** is a student-at-law with the law firm of McMillan Binch Mendelsohn LLP in Toronto, Canada.

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