

Ryan Sharp

Flow-Through Shares



To promote resource exploration, Revenue Canada [CRA] allows resource companies to deduct exploration expenses from income as a Canadian Exploration Expense (CEE).

Many resource companies, especially junior exploration companies, don't have an income to deduct those expenses against. Instead they are permitted to issue new shares of the company, flow-through shares, where the tax deduction is passed on to the risk-tolerant purchaser of those shares.

This deduction can be at 100 percent of the investment or less, depending on the terms of the issue. Investors write off this investment, then adjust the cost base of the shares, to zero or higher depending on the issue. When the investor sells the shares, he or she takes the difference between the sales price and the adjusted cost base as a capital gain (or loss) for tax purposes.

"Super" Flow-Through Shares

In addition to Canadian Exploration Expenses (CEE), certain mining flow-through shares are eligible for a nonrefundable investment tax

credit (Canadian Mineral Exploration Tax Credit) equal to 15 percent of the qualified CEE. For companies conducting mineral exploration in BC, there can be an additional 20 percent nonrefundable provincial tax credit.

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The Market

Because of the tax deductions, flow-through shares are usually priced at a premium to common shares when issued. This premium is heavily dependent on the risk involved with the company issuing the shares. In many cases, it is directly related to the size of the company.

Many flow-through share issues are done as private placements, available only to accredited investors. Most private placement shares are

restricted from sale for 4 months from the date of purchase.

Limited Partnerships

Investors can also purchase limited partnerships of flow-through shares. Limited partnerships are similar to a mutual fund where an investment manager will invest in a number of flow-through shares, thereby spreading the risk.

Depending on the structure, fees, and leverage, the investor will receive tax credits up to 100 percent of his or her investment. The biggest difference is that most limited partnerships have a 2-year hold period before the funds are returned to the investor or converted into a fund.

Charitable Giving

A recent change in the tax act allows a person to donate shares to registered charities without realizing the capital gains he or she may have. In other words, a risk-tolerant investor buys flow-through shares and gets the tax deduction. Instead of selling the shares, the investor donates them to charity, receiving another tax deduction without realizing a capital gain!

Considerations

When buying flow-through shares or investing in limited partnerships, you are receiving tax credits for exploration expenses, thus they are

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inherently risky investments. The companies you are investing in may not find anything or resource prices may go down.

I would recommend working with an advisor when making this type of investment, with the following considerations.

- Diversify among a number of companies through multiple investments or limited partnerships.
- Consider flow-through shares as part of your overall investments and only invest what would normally be considered the “high risk” portion of your portfolio in flow-through shares.
- Only invest in flow-through shares if you are in a high marginal tax bracket after other deductions have been taken into account.
- If you don’t have a thorough understanding of your personal tax situation and the impact an investment in flow-through shares will have, consult a professional. ▲

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