Commentary: Deciding whether or not to use flow-through shares in Quebec

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Mineral exploration in Canada has attracted widespread interest over the past few decades and is today considered by most as a sector in its own right. This has been made possible in no small part by a tax system that supports mining projects.

In particular, flow-through financing has helped raise significant capital for preliminary exploration and development activities which, given their various negatives — including the low probability of success, large capital requirements and the extended length of time before reporting positive cash flow — have not generally been favoured by investors.

But let's focus on Quebec and the principal tax incentive schemes available to mineral exploration activities in the province, as well as the costs and intricacies associated with flow-through share financing by operating mining corporations.

To help mining corporations jumpstart their often risky operations, the federal and Quebec governments have set out tax incentives for mineral exploration and mine development. However, we will limit our comments to those available with respect to Canadian exploration expenses (CEE) incurred by mining corporations.

Subject to some statutory exceptions, CEE typically include, but are not limited to, any expense for the purpose of determining the existence, location, extent or quality of mineral resources, the cost of certain environmental studies and those of community consultations carried out to facilitate physical exploration.

Under the Canadian federal *Income Tax Act* and the *Quebec Taxation Act*, an operating mining corporation can deduct 100% of its cumulative CEE account in computing income. Under the Quebec *Mining Tax Act*, CEE has a similar effect and grants the corporation an exploration allowance, equal to the value of the CEE incurred, for application against the corporation's annual profit. For most operating mining corporations, annual profits are subject to a 16% duty under the Mining Tax Act. An operating mining corporation that sustains an annual loss for the purpose of the Mining Tax Act may claim a 16% "refundable duties credit for losses."

Operating mining corporations carrying on activities within Quebec are also entitled to the refundable credit relating to mining, petroleum, gas or other resources of 12% (the "12% Quebec Income Tax Credit"). This 12% credit constitutes governmental assistance under federal and Quebec tax legislations, which reduces by the same amount: cumulative CEE accounts for federal and Quebec income tax legislations purposes; and the exploration allowance under the Quebec Mining Tax Act.

Flow-through's appeal

Flow-through share agreements help raise equity by enabling mining corporations to issue shares with particular tax benefits in favour of their subscribers at a premium. In a flow-through share agreement, the issuing corporation

agrees to incur certain expenses eligible for tax breaks, such as those mentioned above, in an amount equal to the consideration received, and to renounce to those same eligible expenses in favour of their subscribers. This renunciation is what is most alluring to investors, since it allows eligible expenses to be deemed, for income tax purposes, the expenses of the investor, not those of the mining corporation.

As a result, investors pay a higher price for flow-through shares than they would have been otherwise willing to pay for ordinary, non-flow through common shares. In fact, depending on the general market and the prestige of the miner, flow-through share offerings can be priced at a considerable premium to the corporation's ordinary non-flow through common share price.

If a miner foregoes its CEE-related tax incentives, for every $1,000 of CEE financed by flow-through shares, it relinquishes $498 of tax savings. First, it would have received the 12% Quebec Income Tax Credit, which in this case would have amounted to $120. Then, for the rest of its CEE expenses, i.e., $880, it would have been entitled to combined federal/Quebec tax deductions of $378, as under the Canadian Income Tax Act, the Quebec Taxation Act and the Canadian *Mining Tax Act*, corporations are taxed at rates of 11.9%, 15% and 16%.

However, such amounts only account for direct losses. When evaluating the suitability of a flow-through financing, the operating corporation must also assess the discounted value of the tax deductions it intends to forgo. This discounting helps the corporation better appraise their current worth and more accurately evaluate the premium it needs to make flow-through financing economically advantageous.

For example, if an operating corporation accumulates annual losses, it must take into account the length of time before it can use the tax deductions, which may be significant in some cases. The tax deductions' discounted value is inversely related to that time frame. Hence, the longer it takes for the corporation to record annual profits, the more the value of these tax deductions diminishes, and the more the premium attached to the flow-through shares becomes economically interesting.

Similarly, if a corporation is profitable, the premium paid by the investors of flow-through shares must be high to offset the tax incentive losses. It will likely be too high to attract such investments.

Furthermore, we should stress that, in opting for flow-through share financing, the corporation's opportunity cost could escalate if we accounted for the fiscal incentives that would naturally arise if $498 was reinvested into the mining corporation's operations in the form of CEE. They too would generate tax incentives, and the total opportunity cost could rise to $991.

Evaluation

Resorting to a flow-through share scheme undoubtedly involves trade-offs and uncertainties. The scheme's impact and effectiveness will highly depend on the context in which the mining corporation finds itself when making the decision, but also on its future prospects. Its benefits may not always outweigh its costs.
The corporation will need to determine the premium it is willing to accept. If the corporation would have no difficulties financing its ongoing operations without issuing flow-through shares, the premium that it would need to make such a manoeuvre worthwhile could be significant.

The corporation must also diligently evaluate the deductions value over time, given its circumstances.

From a strictly economic standpoint, a junior mining corporation, which has virtually no tax liability, will benefit from the flow-through share scheme because such shares help it monetize the tax deductions it cannot immediately take advantage of, and finance its ongoing operations.

Correspondingly, flow-through share financing may be ill-suited to a profitable operating corporation, given that the

premium paid by investors for such shares must offset the economic loss of the tax incentives provided for under the federal and Quebec legislations, which are positively linked with the corporation's profitability.

As seen in *The Northern Miner*.

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