

# FEDERAL AND QUÉBEC INCENTIVES FOR EXPLORATION: FLOW-THROUGH SHARES AND OTHERS

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## INTRODUCTION

The federal government provides, in provisions of the *Income Tax Act*<sup>2</sup>, for incentives relating to exploration expenses.

The Province of Québec levies its own income tax (personal and corporate) and sales tax. In its *Taxation Act (Québec)*<sup>3</sup> (the “**Taxation Act**”), it provides for incentives similar to those of the ITA and, in addition, provides for a number of other incentives.

In this, and future installments, we propose to review and comment on the various incentives available.

The federal incentives generally refer to those connected with a subscription for flow-through shares (“**Flow-Through Shares**”), whereby an investor may access a deduction for Canadian exploration expenses (“**CEE**”) incurred by the issuing corporation.<sup>4</sup>

In this article, we will highlight the main incentives relating to exploration expenses in Canada, and set the backdrop for future installments dealing with more specific issues relating to Flow-Through Shares.

The incentives are found at both the corporation and investor levels:

- **Corporation**

*Federal and Québec:*

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<sup>1</sup> The author gratefully acknowledges the contribution of Ms. Marie-Hélène Fontaine, however, please note that any errors and omissions are those of the author.

<sup>2</sup> R.S.C. 1985, c. 1 (5th Supplement), as amended (the “**ITA**”).

<sup>3</sup> R.S.Q., c. I-3, as amended.

<sup>4</sup> We will review the Flow-Through Shares structure in our next installment.

A corporation may either deduct CEE or choose, both for federal and Québec purposes, to renounce such CEE to subscribers for Flow-Through Shares issued by the corporation.

For Québec purposes, a corporation must choose between renouncing CEE in favor of investors, and retaining such expenditures and claiming a resources tax credit (“RTC”) in respect of such expenditures. In renouncing such CEE, the corporation also gives up the possibility of claiming a RTC.<sup>5</sup>

- **Investors**

***Renunciation and deduction by Investor:***

By Subscribing for Flow-Through Shares, the proceeds from the issuance of which are used to finance CEE carried out by the company, the investor can receive the benefit of the deduction of such CEE renounced by the corporation in favor of the holders of the Flow-Through Shares.

***Federal tax credit***

In addition to the deduction of CEE, investors may be entitled to a 15% non-refundable tax credit.

***Québec additional deductions***

In addition to the deduction of CEE, where some of the underlying expenditures are made in Québec, these may entitle the holder of Flow-Through Shares to additional deductions.

## **FEDERAL INCENTIVES**

As a general rule, a taxpayer is entitled to deduct 100% of its CEE expenses and up to 30% of its Canadian development expense (“CDE”) incurred in a year.<sup>6</sup>

A corporation can renounce CEE in favor of holders of Flow-Through Shares, thus entitling the holder to a 100% deduction of the CEE so renounced. Generally, CDE, however, would only be deductible at the rate of 30%.

CEE and CDE are defined in a rather complete manner in the ITA.

Considering the difference in deductibility, it is therefore important to distinguish between CDE and CEE.<sup>7</sup> This distinction has a direct influence on the amount of deduction an investor may claim.

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<sup>5</sup> Federally, corporations which do not renounce CEE may be eligible for a non-refundable tax credit of 10% in respect of CEE which qualifies as a pre-production mining expenditure.

<sup>6</sup> This is an oversimplification or general statement relating to a number of provisions.

Despite this distinction, it is nonetheless possible to transform CDE into CEE<sup>8</sup>. In fact, it is possible for some corporations (having a taxable capital of less than \$15 million) to renounce up to \$1,000,000 of CDE and the person in favor of whom it has been renounced is deemed to have incurred the more fiscally advantageous CEE.

### **Super-Flow-Through Shares**

The words “super-flow-through shares” are sometime used to describe Flow-Through Shares that, in addition to entitling the subscriber to the base deduction of 100% of CEE renounced by the corporation, entitle the holder to a tax credit computed on the CEE.

The additional incentive is a non-refundable tax credit, thus it must be applied against tax payable under the ITA. The credit is computed at the rate of 15% on the CEE renounced on Flow-Through Shares acquired no later than March 31, 2008.

The CEE which qualifies for purposes of computing this tax credit can be incurred until the end of 2008 (thus until the end of 2009 using the “look back rule”).

To the extent the tax credit is not entirely used up and applied against tax payable for the current year, the unused portion can be carried back and applied against tax as payable in the three previous taxation years and forward and applied against tax payable in the next ten taxation years.

As is the case for most tax credits provided by the ITA, the 15% tax credit is treated as governmental assistance and must be included in computing income for the taxation year following the year during which the credit was earned.

### **PROVINCIAL – QUÉBEC**

The Province of Québec levies its own income tax pursuant to the Taxation Act and provides, in the case of Flow-Through Shares, more generous incentives than those found in the ITA. The Province of Québec offers the largest potential incentives for Flow-Through Shares in Canada.

A brief review of historical context is relevant. While the Taxation Act has always provided for a Flow-Through Share system which, essentially, mirrored that provided by the ITA, Québec reviewed and considered several options to improve on the incentive package provided for exploration expenses.

In the March 29, 2001 Budget Speech, the Québec Minister of Finance announced the eventual replacement of the Flow-Through Share system with a sometimes refundable resources tax credit.

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<sup>7</sup> The differences between CEE and CDE will be explored in a future installment.

<sup>8</sup> Subsection 66(12.601) ITA; Canadian Tax Reporter Commentary, s. 66(12.6), Canadian exploration expenses to flow-through shareholder (CCH Tax).

The RTC is a tax credit, sometimes refundable (i.e. any portion of the refundable credit not applied against Québec tax payable is paid to the taxpayer), to which the person making exploration expenses is entitled (but which cannot be passed on to shareholders).

As originally announced, the RTC was perceived as a more direct assistance mechanism and was intended to quickly replace all tax benefits relating to Flow-Through Shares.

After a transition period of four years, it became apparent that the transition to the new RTC was not possible for some corporations.

Consequently, in the March 30, 2004 Budget Speech, the Minister of Finance of Québec announced that the Flow-Through Share system would remain in place “permanently” and the RTC system would also remain in place. Corporations are thus entitled to choose to benefit from the RTC or may renounce expenditures to shareholders through the Flow-Through Share system.

Essentially, with the RTC, where an eligible corporation incurs exploration expenses which under the Flow-Through Share system could have been renounced (resulting in a deduction in computing income for the investor), the corporation can instead claim a refundable RTC in respect of such expenditures.

Expenses renounced to shareholders for Québec purposes under the Flow-Through Share system cannot qualify for the RTC.

If, instead of claiming the RTC, the corporation renounces these expenses to its shareholders, then the holders of Flow-Through Shares can claim a number of deductions in computing their Québec income. The relevant Québec incentives and related rules are the following:

1. Flow-Through Share regime:

A basic deduction of 100% of CEE and expenses regarding Canadian oil and gas assets; and

If the investor is an individual, in addition to the basic deduction of 100%;

- In the case of mining exploration expenses incurred in Québec:
    - An initial additional deduction of 25%;
    - A second additional deduction of 25% for surface expenses; and
  - In the case of oil and gas exploration expenses incurred in Québec, an additional deduction of 50%.
2. Deduction for issue expenses;
3. Partial exemption for capital gains on Flow-Through Shares;

4. Deductibility of investment expenses;
5. Refundable Tax Credits rates.

#### **1. FLOW-THROUGH SHARES REGIME**

The basic elements of the Québec Flow-Through Shares regime are summarized below. As presented below, an individual can claim a deduction of 125% of certain CEE and a deduction of 150% in respect of Québec surface mining exploration and oil and gas exploration expenses as follows:

- A basic deduction of 100% of CEE and expenses regarding Canadian oil and gas assets; and
- If the investor is an individual, in addition to the basic deduction of 100%;
  - In the case of mining exploration expenses incurred in Québec:
    - An initial additional deduction of 25%;
    - A second additional deduction of 25% for surface expenses; and
  - In the case of oil and gas exploration expenses incurred in Québec, an additional deduction of 50%.<sup>9</sup>

#### **Additional deduction in respect of Québec Exploration Expenses**

In addition to the base deduction in respect of CEE, an individual (or a personal trust) resident in Québec may be entitled to certain additional deductions in respect of exploration expenses incurred in Québec by the corporation.

An individual (or a personal trust) resident in Québec may be entitled to deduct, in computing taxable income for Québec income tax purposes, an amount not exceeding the person's exploration base relating to certain Québec surface mining or oil and gas exploration expenses at the end of the year.

The exploration base of a person essentially represents an amount equal to 25% of certain exploration expenses (which, in general terms include oil and gas exploration expenses) incurred in the Province of Québec by a qualified corporation, and which are renounced with respect to Flow-Through Shares acquired after March 31, 2004.

The expenses must be incurred after March 31, 2004 by a qualified corporation, and are essentially defined as Québec Exploration Expenses, which correspond, in most terms, to CEE that are incurred in Québec.

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<sup>9</sup> The 50% rate, in fact, represents the total of the 25% additional deduction for Québec exploration expenses and the 25% additional deduction for Québec surface mining and oil and gas exploration expenses.

For these purposes, a “**qualified corporation**” is a corporation all of the activities of which consist mainly in exploring for minerals, petroleum or gas or developing a mineral resource or an oil or gas well and which, at the time the expenses in respect of which an amount is renounced to a holder of Flow-Through Shares are incurred, and throughout the 12-month period preceding that time, fulfils the following conditions:

- (a) The corporation does not operate any mineral resource or oil or gas well;
- (b) The corporation neither controls another corporation that operates a mineral resource or an oil or gas well nor is so controlled by such a corporation.

### **Québec Exploration Expense**

For the purposes of this additional deduction, a Québec exploration expenses is an expenditure which is CEE incurred to such extent as that expense is

- (a) Any expense including an expense for a geological, geophysical or geochemical survey, other than an expense incurred in drilling or completing an oil or gas well or in building a temporary access road to, or preparing a site in respect of, any such well, incurred by the taxpayer for the purpose of determining the existence, location, extent or quality of an accumulation of petroleum or natural gas, other than a mineral resource, in Québec;
- (b) Any expense incurred in drilling or completing an oil or gas well in Québec, or in building a temporary access road to, or preparing a site in respect of, any such well if
  - (i) The drilling or completing of the well resulted in the discovery of a natural underground reservoir containing petroleum or natural gas, where
    - (1) Before the time of the discovery, no person or partnership had discovered that the reservoir contained either petroleum or natural gas, and
    - (2) The discovery occurred at any time before six months after the end of the year;
  - (ii) The well is abandoned in the year or within six months after the end of the year without ever having produced otherwise than for specified purposes;
  - (iii) The period of 24 months commencing on the day of completion of the drilling of the well ends in the year, the expense was incurred within that period and in the year and the well has not within that period produced otherwise than for specified purposes; or
  - (iv) The certificate referred to in subparagraph iv of paragraph d of the definition of “Canadian exploration expenses” in subsection 6 of section 66.1 of the ITA, in respect of a well has been filed with the Minister, in respect of the well, on or before the day that is six months after the end of

the taxation year of the taxpayer in which the drilling of the well was commenced;

- (c) An expense incurred to determine the existence of a mineral resource in Québec, to locate such a resource or to determine the extent or quality thereof, including any expense incurred in the course of prospecting, carrying out geological, geophysical or geochemical surveys, drilling and trenching or digging test pits or preliminary sampling, other than an expense incurred in drilling or completing an oil or gas well or in building a temporary access road to, or preparing a site in respect of, any such well, and other than any CDE or any expense that may reasonably be related to a mine which has come into production in reasonable commercial quantities or to an actual or potential extension of such a mine;
- (d) An expense incurred to bring a new mine in a mineral resource in Canada into production in reasonable commercial quantities, including clearing, removing overburden and stripping, sinking a mine shaft and constructing an adit or other underground entry, to the extent that these expenses were incurred prior to the commencement of production from the new mine in reasonable commercial quantities;
- (e) Any Canadian renewable and conservation expense incurred by the taxpayer;
- (f) The taxpayer's share of the expenses described in paragraphs (a), (b) or (c) incurred by a partnership in a fiscal period thereof, if at the end of the period the taxpayer is a member thereof.

If the investor is a corporation, the only deduction available is the base 100 % deduction for the exploration expenses in Canada.

### **Additional deduction in respect of certain surface mining or oil and gas exploration**

An individual (or personal trust) resident in Québec may also be entitled to claim a deduction, in computing taxable income for Québec income tax purposes, of an amount not exceeding his exploration base relating to certain surface mining or oil and gas exploration expenses at the end of the year.

The exploration base relating to surface mining essentially represents an amount equal to 25% of surface mining expenditures and oil and gas exploration expenditures incurred in Québec.

The expenditure can be incurred directly by the individual, or may be an expense incurred after March 2004 by a qualified corporation (see above for the definition) and renounced in favor of the holder of Flow-Through Shares.

## **2. EXPENSES OF ISSUE**

Flow-Through Shares issue expenses can be deducted in computing the income of the issuing corporation over a period of five years. However, the corporation can waive the deduction of issue expenses and, to the extent such expenses relate to shares or securities

whose proceeds will be used to incur exploration expenses in Québec, an additional deduction is granted to purchasers of such shares in an amount equal to the lesser of the issue expenses incurred and 15% of the proceeds of the issue of the Flow-Through Shares.

### **3. CAPITAL GAINS OF FLOW-THROUGH SHARES**

To encourage investment in Flow-Through Shares, Québec instituted a mechanism to exempt from taxation the portion of the gain on the sale of Flow-Through Shares resulting from the reduction of the cost of those shares from renouncing expenses.

The Taxation Act provides that the cost of acquisition (and consequently, the adjusted cost base) of a Flow-Through Share is deemed to be nil.

Consequently, any proceeds relating to the disposition of a Flow-Through Share would generally give rise to a capital gain equal to such proceeds (based on current provisions of the Taxation Act, 50% of such amount would be a taxable capital gain). To the extent the Flow-Through Shares qualify, the holder would thereof not be subject to tax on the amount of the proceeds up to the original acquisition cost. Any proceeds of disposition which exceed the acquisition cost would give rise to a capital gain, 50% of which would be subject to income tax in accordance with the usual rules.

### **4. LIMITS TO THE DEDUCTIBILITY OF INVESTMENT EXPENSES**

A measure limiting the deductibility of investment expenses of individuals (including personal trusts) was also part of the Budget measures of March 30, 2004, as clarified on March 11, 2005, to ensure, *inter alia*, that it was understood that these limitations to investment expenses apply to exploration and development expenses.

Briefly stated, the deductibility of investment expenses incurred by an individual is allowed in accordance with the usual principles (thus the expenses must have survived the usual tests and are deductible). However, a taxpayer will be required to include in computing income the amount by which the investment expense exceeds the investment income (thus offsetting a portion of the deduction claimed).

Two key concepts come into play, the notion of investment expenses and the notion of investment income.

#### **Notion of Investment Income**

The notion of investment income for purposes of computing the limit on the deductibility of investment expenses is described as all income from property and, includes, in particular, the following elements that would otherwise be included in computing the cumulative investment loss (“CNIL”):

- Taxable dividends of taxable Canadian corporations;

- Interest from Canadian sources;
- The share of the income of a partnership of which the individual is a specified member;
- Gross foreign investment income;
- Taxable capital gains not eligible for the exemption on taxable capital gains;
- Benefits received as a shareholder of a corporation;
- Royalties from Canadian sources;
- Accumulated income of a life insurance policy;
- Income from a trust; and
- Income from property attributed to shareholders.

Investment income included in calculating the limit relating to the deductibility of investment expenses includes items otherwise included in the calculation of CNIL (except for income from the rental of an asset).

Income from the rental of property is not considered as investment income for the purposes of this measure.

An individual who realizes a capital gain on the disposition of eligible small business shares, eligible farming assets or eligible fishing assets, may claim a cumulative exemption of up to \$750,000<sup>10</sup> of such capital gain.

Taxable capital gains that are ineligible for the capital gains exemption constitute investment income both for the purposes of the CNIL and the limit relating to the deductibility of investment expenses.

Similarly, the portion of the capital gain eligible for the capital gains exemption that exceeds the \$750,000 threshold now forms part of investment income for the purposes of the limit relating to the deductibility of investment expenses .

Investment income for the purposes of the limit relating to the deductibility of investment expenses includes taxable net capital gains attributed by a trust to a beneficiary of such trust that are not otherwise taxable capital gains eligible for the capital gains exemption. This change was necessary in that taxable net capital gains realized by a trust and attributed to a beneficiary were not considered investment income for the purposes of the

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<sup>10</sup> The capital gains exemption was increased from \$500,000 to \$750,000 as per the 2007 Budget measures.

CNIL and the limit relating to the deductibility of investment expenses, even though they were otherwise ineligible for the capital gains exemption.

### **Notion of Investment Expenses**

The notion of investment expenses for purposes of computing the limit on the deductibility of investment expenses, includes all expenditures incurred to earn income from property, other than rental income, and include in particular the following investment expenses that would otherwise be considered in calculating the CNIL, were it not for this limitation:

- Investment administration or management expenses;
- Stock or securities custody expenses;
- Fees paid to investment advisers;
- Interest paid on borrowings contracted to acquire bonds, stock, or units of mutual fund trust; and
- The portion of the loss of a partnership of which the individual is a specified member.

Losses suffered on the rental of an asset are not considered as investment expenses for the purposes of this measure.

The notion of investment expenses of a taxpayer includes , in particular, 50% of exploration expenses and development expenses incurred in Canada, but outside Québec, that have been renounced to the taxpayer under the Flow-Through Share system.

In other words, non-Québec exploration expenses and development expenses incurred in Canada, that have been foregone in favor of an investor under the Flow-Through Share system were meant to be included in the measure, while Québec exploration expenses are not included in computing investment expenses.

## **5. REFUNDABLE TAX CREDITS**

As discussed in our previous articles,<sup>11</sup> a refundable credit mechanism was introduced as an alternative incentive (and now co-exists with the Flow-Through Shares incentives) as follows:

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<sup>11</sup> For a detailed review of the proposed changes to the Flow-Through Shares system, please see Claude E. Jodoin, "Quebec Incentives for Exploration Expenses" (2003) 1 *Resource Sector Taxation* 33 and Fred Purkey, "Quebec Incentives for Exploration - Part II" (2003) 1 *Resource Sector Taxation* 71 and Claude E. Jodoin and Fred Purkey, "Quebec Incentives for Exploration - Part III: Advantages to Non-Quebec Investors Flowing From Quebec Resources Incentives"

- An eligible corporation may claim a RTC of up to 45% of the amount of eligible expenses;
- An eligible corporation is a corporation that carries on a business in Québec and has an establishment in Québec (other than a tax-exempt corporation, a Crown corporation or a wholly-controlled subsidiary of such a corporation); and
- Eligible expenses are:
  - Québec expenses under the Flow-Through Share system that are either attributable to:
    - Expenses incurred in Québec, relating to renewable energy or energy conservation; or
    - Exploration expenses that enable an individual to claim 125% deduction under Flow-Through Share system (i.e. Québec CEE).

The rates of the credits are currently as follows:

Tax Credit regarding eligible expenses	Corporation Not Operating Any Mineral Resource or Oil or Gas Well			Other Corporations		
	Refundable Portion	Non-refundable Portion	Total	Refundable Portion	Non-refundable Portion	Total
Relating to mineral resources						
In the Near North or Far North	38.75	6.25	45	18.75	26.25	45
Elsewhere in Québec	35	10	45	15	30	45
Relating to oil and gas						
In the Near North or Far North	38.75	n.a.	38.75	18.75	n.a.	18.75
Elsewhere in Québec	35	n.a.	35	15	n.a.	15
Relating to renewable energy and energy conservation	35	n.a.	35	30	n.a.	30
Relating to other natural resources (cut stone)	15	n.a.	15	15	n.a.	15

The carry-forward period of the non-refundable portion of the tax credit is ten years. Accordingly, if during a taxation year, the non-refundable portion of the tax credit exceeds income tax and tax on capital payable for such taxation year, the excess may be

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(2004) 2 *Resource Sector Taxation* 126, and Claude E. Jodoin “Quebec Incentives and Investment Expenses Deductions” (2005) 4 *Resource Sector Taxation* 239. See also the provisions of section 1029.8.36.167 to 1029.8.36.178 of the Québec Act.

carried forward for the following ten taxation years and carried back for the preceding three taxation years and applied against income tax and the tax on capital payable for such taxation years.

## **CONCLUSIONS**

As can be seen, incentives from investing in Flow-Through Shares are more than just a 100% deduction for CEE. A properly structured transaction can maximize the benefits.

The following table provides a useful summary of investor level benefits:

	<b>Federal</b>	<b>Québec</b>
Flow-Through Shares Exploration and Development in Canada expenses	100% deduction	100% deduction
Super-Flow-Through Shares	15% tax credit	-----
Share issuance expenses	-----	Deduction equal to the lesser of the investor's share of issuance expense and 15% of proceeds of issuance
Capital Gains Exemption		Up to the cost of acquisition
<b>Mining exploration expenses</b>		
- Exploration incurred in the Province of Quebec		25%
- Surface mining exploration incurred in the Province of Quebec		25%
<b>Petroleum and gas exploration expenses</b>		
- Exploration incurred in the Province of Quebec		50%