

When a flow-through share is not a flow-through share



This article deals with flow-through shares (FTS), and the risk of a share not being a FTS, where rights negotiated in the best interest of subscribers could have

an unforeseen (or undesired) effect.

FTS are shares issued by a principal business corporation under a flow-through shares agreement, pursuant to which the subscriber has agreed to pay the subscription price (the Subscription Price) in cash, and the corporation has agreed to incur Canadian exploration expenses (CEE) and/or Canadian development expenses (CDE) in an amount not less than the Subscription Price within a period of time (usually by the end of the following calendar year to benefit from a deduction in the year the FTS are subscribed for) and, finally, to renounce to the subscriber an amount of CEE (or CDE) so incurred.

One of the features of a FTS is that the subscriber's adjusted cost base is deemed to be nil. Presumably, it is intended that the holder's tax benefit result from the deduction of CEE (or CDE) renounced to such person, and

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there should therefore be no

need for the realization of a loss on the disposition of the FTS.

Excluded from the definition of FTS are "prescribed shares," which is a reference to certain rights and conditions considered to be unacceptable, such as an indemnity given by the issuing corporation to the subscriber to ensure, directly or indirectly, that any loss that the subscriber may sustain by reason of the holding, ownership or disposition of

a FTS is limited in any respect. It is, however, acceptable to provide for an indemnity that does not exceed the amount of tax payable by a holder under the *Income Tax Act* (Canada), or a provincial statute, and which arises as a consequence of the corporation's failure to renounce an amount or the reduction of the amount renounced.

In other words, a subscriber to a FTS must not benefit from any indemnity to limit that person's exposure to the risk of losses from holding a FTS, except an indemnity for additional income tax payable by the subscriber in certain circumstances.

A decision of the Federal Court of Appeal (FCA)¹ handed down on October 26, 2007 highlights the importance of proper drafting of such an indemnity. In that case, the issuing company had not only failed to incur the appropriate amount of CEE, and therefore its renunciations were invalid, but the company went into received ship and its shares became worthless.

The taxpayer sought to claim a capital loss in respect of the shares. However, as mentioned earlier, if such shares were FTS, their cost would be deemed to be nil, thus eliminating any possibility of claiming a loss.

The FCA held that the relevant time to determine whether a share is a FTS is the time at which it is issued, and thus the shares remain FTS even if the issuing company fails to live up to its end of the bargain.

However, the subscription agreement in this particular case had, in addition to the usual covenants to incur CEE and renounce same to the subscribers, the following indemnity (the Indemnity):

"The Corporation hereby agrees to indemnify and save harmless the

Subscriber from and against any liability, loss, damage, cost, or expense which the Subscriber may sustain or incur arising out of or in any way connected with the expenditure of the Subscription Amount."

The taxpayer argued that the presence of this indemnity disqualified the share from being a FTS, and therefore the taxpayer should benefit from a capital loss. Canada Revenue Agency, interestingly enough, was arguing that such an indemnity was a typical clause and somehow did not strip the shares from FTS status.

The FCA was of the view that the indemnity came within the ambit of the broad language of the provision, which included rights that are "contingent," rights that are effective "either immediately or in the future," rights that "directly or indirectly" provide assurances and rights to loss limitation protection "in any respect."

Consequently, the shares in question were not, in the FCA's view, a FTS, and the taxpayer could therefore benefit from a capital loss from their disposition.

While in this case it was in the taxpayer's interest to disqualify the shares from being FTS, this will not always be the case. It is important to keep in mind that an indemnity cannot go beyond the income tax liability arising from the failure of the corporation to renounce an amount or the amount renounced is reduced.

This case serves as a reminder that while counsel zealously negotiates in the best interests of their clients, and it may be tempting to try and improve the situation of a subscriber of FTS, we must keep an eye on the limits imposed by the ITA, failing which the shares could lose their FTS status, with disastrous consequences. **EM**

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¹ *The Queen v. JES Investments Ltd.*, FCA, A-474-06, October 26, 2007 (2007 FCA 337).