Federal and Quebec Incentives for Resource Exploration—Flowthrough Shares

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Abstract

The issuance of flowthrough shares has been, for a number of years, the cornerstone in the financing of exploration expenses in Canada, and particularly in Quebec. The popularity of this financing mechanism is attributable to tax incentives offered by both the Canadian and the Quebec governments. While the two tax regimes are to a large extent harmonized, Quebec offers some incentives that are not provided under the federal regime, making the province a destination of choice for carrying out exploration activities.

The treatment of gains on the disposition of flowthrough shares has always been unique, given that their cost base is nil for tax purposes. In addition, until recently, a generous tax exemption has been available for donations of flowthrough shares to charities. The author reviews the federal and Quebec incentives, and discusses recent amendments relating to the taxation of gains resulting from the disposition or donation of flowthrough shares.

Keywords: INCENTIVES ■ RESOURCES ■ EXPLORATION ■ EXPENSES ■ FLOWTHROUGH ■ SHARES

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INTRODUCTION
This article deals with certain incentives for resource exploration in Canada—in particular, those relating to the issuance of flowthrough shares. The federal government has provided such incentives through the Income Tax Act¹ (“the ITA”) for more than 30 years. Quebec has enacted similar provisions, as well as a number of other incentives, under the province’s Taxation Act² (“the QTA”).

The federal incentives generally refer to those connected with a subscription for flowthrough shares, whereby an investor may access the deduction of Canadian exploration expenses (CEE) incurred by the issuing corporation. One of the features of a flowthrough share is that the subscriber’s adjusted cost base is deemed to be nil. Presumably it is intended that the tax benefit resulting from the deduction of CEE (or Canadian development expenses [CDE]) would be renounced to the subscriber, and there should therefore be no need for the realization of a loss on the disposition of the share.

In 1982, the Honourable Marc Lalonde, then Canada’s minister of finance, stated that the purpose of the flowthrough share provisions in the ITA was to encourage Canadians to make equity investments in corporations engaged in exploration for and development of the country’s oil, gas, and mineral resources.³ Recently, Sheridan J of the Tax Court of Canada offered the following perspective on the underlying objectives of the CEE regime in light of the flowthrough share provisions:

The CEE regime achieved at least three objectives: first, it relieved the government from funding exploration directly from its own coffers. Meanwhile, it provided exploration companies with a source of working capital, often in short supply for such risky ventures. And for investing taxpayers, it ensured (at the very least) a tax deductible loss, with the possibility of a gain upon the disposition of the acquired shares.⁴

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1 RSC 1985, c. 1 (5th Supp.), as amended.
2 RSQ, c. I-3.
3 Canada, Department of Finance, “‘Prescribed Shares’ for the Purposes of Flow-Through Shares,” News Release 82-149, December 29, 1982, on the draft of a proposed amendment to part LXII of the Income Tax Regulations relating to the oil, gas, and mining resource sectors.
4 JES Investments Ltd. v. The Queen, 2006 TCC 508, at paragraph 8; aff’d. 2007 FCA 337. Given the several tax benefits that arise in favour of a subscriber of flowthrough shares, it is crucial to correctly qualify a share as such for the purposes of the ITA. JES Investments illustrates the risk of a share not being a flowthrough share where rights negotiated in the best interest of subscribers could have an unforeseen (or undesired) effect. (Note, however, that in that case the failure to qualify resulted in a benefit: since the share was not a flowthrough share, its adjusted cost base was not nil, and a loss could be realized on disposition of the share.)
The concept of a flowthrough share is central to both the federal and the Quebec incentive regimes for resource exploration. This article highlights the main incentives relating to exploration expenses in Canada and their “transfer” to individuals who subscribe to flowthrough shares. The incentives exist at both the corporation and the investor levels.

- **Issuing corporation.** A corporation may either deduct CEE or choose, for both federal and Quebec tax purposes, to renounce CEE to subscribers of flowthrough shares issued by the corporation.

  In addition, for Quebec tax purposes, a corporation may choose either to renounce CEE in favour of investors or to retain CEE and claim a refundable resources tax credit (RTC) in respect of such expenditures. In renouncing CEE, the corporation also gives up the possibility of claiming an RTC in respect of those expenditures.

- **Investor.** By subscribing to a flowthrough share, the proceeds from the issuance of which serve to finance the corporation’s CEE, the investor can receive the benefit of the deduction of such CEE renounced by the corporation in favour of the shareholder.

  In addition to the deduction of CEE, the investor may be entitled to a 15 percent federal non-refundable tax credit.

  Where some expenditures are made in Quebec, the holder of a flow through share may be entitled to further deductions under the QTA.

**FEDERAL INCENTIVES**

The principal flowthrough share provisions relating to the renunciation of CEE and CDE are found in ITA subsections 66(12.6) through (12.75). The current regime has its origins in legislation introduced in 1986, replacing an earlier set of rules permitting the transfer of certain resource expenses to investors.

The prior regime had some awkward aspects, requiring, in essence, that the corporation incur exploration expenses as agent for the investors, with all the legal risks that such an activity and relationship could entail. This concern, among others, was addressed by substantially revised legislation, introduced as part of the February 26, 1986 federal budget, which provided for a phaseout of the old system.

**Deductibility Provisions**

As a general rule, a taxpayer is entitled to deduct 100 percent of its CEE and up to 30 percent of its CDE incurred in a year. Under the current system, a corporation can renounce CEE and CDE in favour of holders of flowthrough shares. As a result of this renunciation, the shareholder is entitled to a 100 percent deduction of the CEE.

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6 This is an oversimplification or general statement relating to a number of provisions of the ITA.
so renounced; CDE, however, is deductible at the rate of only 30 percent. In other words, a corporation incurring CEE can choose to effectively transfer its right to a deduction in respect of CEE and CDE, and consequently forgo any such deduction.

The ITA provides detailed definitions to clarify which expenses will qualify as CEE and which expenses will qualify as CDE. The distinction is important, since it directly affects the amount of the deduction that an investor may claim.

Despite this distinction, it is possible to transform CDE into CEE. In particular, subject to certain conditions, a corporation with taxable capital of $15 million or less can renounce up to $1 million of CDE, such that the person in favour of whom the expenses have been renounced will be deemed to have incurred CEE and thus will be able to claim a larger deduction.

**Investment Tax Credit in Respect of “Superflowthrough Shares”**

The term “superflowthrough share” is sometimes used to describe a flowthrough share that, in addition to entitling the subscriber to the basic deduction of 100 percent of CEE renounced by the corporation, also entitles the holder to a tax credit in respect of such CEE. The additional incentive is a non-refundable tax credit (described below) that must be applied against income tax payable under the ITA. The credit is computed at the rate of 15 percent on the CEE renounced pursuant to the flowthrough share agreement.

The investment tax credit is available to an individual (other than a trust), under ITA subsection 127(5), in respect of CEE that qualifies as a “flow-through mining expenditure,” as defined in ITA subsection 127(9). The credit was introduced as part of the 2000 federal budget. This measure must be re-enacted each year, owing to the manner in which the qualifying expenditures are defined.

Where a taxpayer is an individual (other than a trust), 15 percent of the taxpayer’s flowthrough mining expenditure for a taxation year is added to the taxpayer’s

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7 See ITA subsection 66.1(6), the definition of “Canadian exploration expense,” and ITA subsection 66.2(5), the definition of “Canadian development expense.”

8 ITA subsections 66(12.601) and (12.61). Also see the commentary in the Canadian Tax Reporter (Toronto: CCH Canadian) (looseleaf), at paragraph 8967.

9 Currently, the definition in ITA subsection 127(9) reads as follows:

“[F]low-through mining expenditure” of a taxpayer for a taxation year means an expense deemed by subsection 66(12.61) (or by subsection 66(18) as a consequence of the application of subsection 66(12.61) to the partnership, referred to in paragraph (c) of this definition, of which the taxpayer is a member) to be incurred by the taxpayer in the year

(a) that is a Canadian exploration expense incurred by a corporation after March 2012 and before 2014 (including, for greater certainty, an expense that is deemed by subsection 66(12.66) to be incurred before 2014) in conducting 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
investment tax credits for that year. This addition to the investment tax credit amount is intended to stimulate grassroots mining exploration activity.

To the extent that the available 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 payable in any of the 3 previous taxation years, or carried forward and applied against tax payable in any of the 10 subsequent taxation years.

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

QUEBEC INCENTIVES

Quebec levies its own income tax pursuant to the QTA. Many provisions of the ITA are mirrored in the QTA; however, the QTA also provides for different and sometimes more generous incentives. In the case of flowthrough shares, the QTA includes most of the measures contained in the ITA and also provides additional incentives for Quebec taxpayers.

The Quebec government has undertaken a series of reviews of the provincial regime over the past 10 years, and introduced a number of changes, in an attempt to improve the efficacy of the incentives. To provide the context for a description of the details of the current regime, a brief historical review is in order.

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10 ITA subsection 127(9), paragraph (a.2) of the definition of “investment tax credit,” and ITA subsection 127(5).

11 ITA subsection 127(9), paragraph (c) of the definition of “investment tax credit.”

12 ITA paragraph 12(1)(t) and the definition of “government assistance” in ITA subsection 127(9).
Evolution of the Provincial Regime

Incentive Measures Prior to 2001

Prior to 2001, the Quebec government had adopted a similar approach to that of the ITA; essentially, where a corporation issued flowthrough shares renouncing its entitlement to the deduction of CEE, the holders of such shares could claim a deduction of up to 100 percent of CEE incurred by the issuing corporation and paid out of the proceeds of the share issuance. At that time, the Quebec regime contained three basic elements: a deduction to the investor in the computation of income; a deduction to the corporation in respect of expenses relating to the issuance of flowthrough shares; and an exemption for gain on the disposition of such shares. The details of these measures were as follows:

1. **Deductions.** The investor was entitled to a basic deduction of up to 100 percent of CEE and expenses relating to Canadian oil and gas assets. If the investor was an individual resident in Quebec, the investor could also claim the following additional deductions:
   a. in the case of mining exploration expenses incurred in Quebec, an initial additional deduction of up to 25 percent of such expenses, and a second additional deduction of up to 25 percent of surface expenses; and
   b. in the case of oil and gas exploration expenses incurred in Quebec, an additional deduction of up to 50 percent of such expenses.

   Over time, the actual rate of additional deductions has varied.

2. **Deduction for expenses relating to share issuance.** A corporation that issued flowthrough shares could deduct expenses relating to the share issuance in computing its income over a period of five years. However, the corporation could choose to waive the deduction of such expenses. Where it did so, to the extent that the expenses related to shares or securities whose proceeds would be used to incur exploration expenses in Quebec, an additional deduction was available to the purchasers of the shares in an amount equal to the lesser of the issuance expenses incurred and 15 percent of the proceeds from the issuance.

3. **Capital gains tax exemption on disposition of shares.** To encourage investment in flowthrough shares, Quebec instituted a mechanism to exempt from tax the portion of the gain on the disposition of such a share attributable to the reduction of the cost of the share resulting from the renunciation of expenses.

   The QTA provides that the cost of acquisition (and thus the adjusted cost base) of a flowthrough share is deemed to be nil. Consequently, any proceeds relating to the disposition of a flowthrough share would generally give rise to a capital gain equal to such proceeds. (Under the current provisions

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13 **QTA section 419.0.1.**
of the QTA, 50 percent of such amount would be a taxable capital gain.)

To the extent that the flowthrough share qualified, the holder would not be subject to tax on the amount of the proceeds up to the original acquisition cost. Any proceeds of disposition that exceeded the acquisition cost would give rise to a capital gain, 50 percent of which would be subject to income tax in accordance with the usual rules.

Thus, where the holder of a flowthrough share had his or her cost of the share reduced through renounced exploration expenses, and as a result realized a capital gain on the sale of the share, then to the extent that the tax deductions were obtained because of the renunciation of Quebec exploration costs (and thus added to the “historical account” of expenses), the capital gain would be exempt from tax up to the original purchase price.

**Toward Reform of the Regime**

In the late 1990s, the Quebec government began to review the existing framework and to consider various options to improve the incentive package provided for exploration expenses.

In March 1997, the government announced that it would extend the availability of the above-described incentives until the end of 2000.

In March 1998, the government announced that a working group had been formed, consisting of representatives of the departments of Natural Resources, revenue, and finance, whose mandate was to consult industry members with a view to proposing new measures that would provide more efficient assistance in support of mining, oil, and gas exploration. In particular, the working group was to reassess the relevance of maintaining the existing tax incentives relating to flowthrough shares.

By late 2000, since the group had not yet completed its assignment, the government decided to continue the tax incentives until the end of 2001. Thus, investors would be entitled, for the 2001 taxation year, to claim a deduction of up to 125 percent or 175 percent, as the case may be, with respect to mining, oil, and gas exploration expenses incurred in Quebec prior to January 1, 2002. In addition, issuance expenses incurred in respect of flowthrough shares would continue to be deductible in computing the income of the issuing corporation. Finally, the gain on a disposition of flowthrough shares acquired prior to January 1, 2002 would continue to qualify for the capital gains exemption with respect to the difference between the price paid for the share and its adjusted cost base.

The government also indicated its intention to eventually replace all the tax benefits relating to flowthrough shares, including the basic 100 percent deduction, with a more direct assistance mechanism. Details of the proposed reform were announced in the March 29, 2001 budget speech. A new, refundable “resources tax

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14 QTA sections 231 and 231.0.1.
credit” would be introduced, which would be available to qualifying corporations in respect of qualifying exploration expenditures. Subject to a limited transition period, the RTC would replace the existing flowthrough share regime in its entirety.

It was thought that this new tax-assistance mechanism would attract more investors, since a corporation that, under the old system, would issue flowthrough shares, would receive the same amount for covered expenses through the RTC, whether the investors were individuals or corporations, and whether they were Quebec residents or non-residents. Furthermore, the proposed RTC was said to remove an irritant, namely, the risk of a downward adjustment by the tax authorities of the amounts forgone in favour of investors. (Under the flowthrough share regime, the amount of the renounced CEE might later be reduced by the tax authorities, causing a corresponding reduction in the deduction that could be claimed by subscribers to the shares.)

As originally proposed, the RTC would entitle an “eligible corporation” that incurred “eligible expenses” in a taxation year to claim a refundable tax credit for that year for up to 45 percent of the amount of such eligible expenses. The budget proposal was, however, modified in several respects as the government proceeded with implementation of the new measures.

**Implementation of the RTC, 2001-2004**

Only the corporation that incurs eligible expenses can claim the RTC. The credit is generally refundable—that is, any portion of the credit not applied against Quebec tax payable is paid to the taxpayer (the person making the eligible expenses). The RTC cannot be transferred to shareholders.

At the time the RTC was introduced, the basic rate was 20 percent, rising to 40 percent for eligible expenses incurred by a corporation that did not operate any mineral resource, or an oil or gas well, and that was not related to a corporation that operated a mineral resource, or an oil or gas well. The rates of 20 percent and 40 percent were raised to 25 percent and 45 percent, respectively, for eligible expenses incurred in Quebec's Near North or Far North. For expenses incurred in Quebec relating to renewable energy and energy conservation, a single rate of 40 percent was provided.

According to the original announcement, the old flowthrough share system was to continue to be used for the rest of 2001 before it would be completely replaced by the new tax credit. On implementation of the RTC, a corporation could claim the credit only with respect to eligible expenses that had not been renounced in favour of an investor under the old system. Moreover, the additional 25 percent deduction that a corporation could claim under the QTA and the Mining Duties Act with respect to certain exploration expenses incurred in Quebec's Near North and Far North would be eliminated as of January 1, 2002. However, for the remainder of

15 RSQ, c. D-15 (now titled the Mining Tax Act, RSQ, c. I-0.4).
2001, the expenses giving rise to this additional deduction could continue to be forgone in favour of an investor provided that the investor was a corporation and the expenses were financed with flowthrough shares.

It was thought that the continuation of the old regime to the end of 2001 would give the industry sufficient time to adapt to the new form of tax assistance. However, in September of that year, the government announced that the transition period would be extended to the end of 2003; and in the March 11, 2003 budget speech, a further extension was granted to the end of 2004. Accordingly, issuers of flowthrough shares that had renounced CEE could continue to renounce such expenses in favour of an investor under the old system during the calendar years 2001 through 2004.

Changes Since 2004

By the fourth year of the transition period, it became apparent that transition to the RTC was not possible for some corporations. Consequently, in the March 30, 2004 budget speech, the minister of finance announced that the flowthrough share regime would remain in place “permanently” and the RTC system would also remain in place. Henceforth, corporations would be allowed either to claim the RTC or to renounce expenditures to shareholders through the issuance of flowthrough shares. There is no overlap of benefits between the two systems: expenses renounced to shareholders for Quebec tax purposes under the flowthrough share regime cannot qualify for the RTC, nor can the RTC be claimed in respect of expenses that have been renounced.

As in the past, where a corporation renounces exploration expenses through the issuance of flowthrough shares, those shareholders can claim certain deductions in computing their Quebec income. The current deductions and other components of the present incentive system are as follows:

1. a basic deduction of up to 100 percent of CEE and expenses relating to Canadian oil and gas assets;
2. if the investor is an individual resident in Quebec, in addition to the basic deduction,
   a. in the case of mining exploration expenses incurred in Quebec, an initial additional deduction of up to 25 percent and a second additional deduction of up to 25 percent of surface expenses; and

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b. in the case of oil and gas exploration expenses incurred in Quebec, an additional deduction of up to 25 percent;
3. a limit on the deduction of investment expenses; and
4. a refundable tax credit (the RTC).

The text that follows describes in more detail several components of this system under the current rules.

**Additional Deduction in Respect of Quebec Exploration Expenses**

An investor in flowthrough shares who is an individual (or a personal trust) resident in Quebec may be entitled to certain deductions, in addition to the basic deduction for CEE, in respect of exploration expenses incurred in Quebec by the issuing corporation.17

Under the current rules, generally the investor can deduct, in computing taxable income for Quebec income tax purposes, an amount not exceeding the investor’s “exploration base” relating to certain Quebec surface mining, or oil or gas, exploration expenditures at the end of the year. The exploration base of a person essentially represents an amount equal to 25 percent of certain exploration expenses that have been incurred in Quebec by a qualified corporation and that have been renounced through the issuance of flowthrough shares.18

For these purposes, a “qualified corporation”19 is a corporation that meets the following conditions:

1. The activities of the corporation consist mainly of exploration for minerals, petroleum, or gas, or development of a mineral resource or an oil or gas well.
2. At the time the corporation incurred the expenses in respect of which an amount is renounced to a holder of a flowthrough share, and throughout the 12-month period preceding that time, the corporation
   a. did not operate any mineral resource or oil or gas well; and
   b. neither controlled another corporation that operated a mineral resource, or an oil or gas well, nor was controlled by such a corporation.

Notwithstanding the last two conditions, a qualified corporation may be a sister corporation to a corporation that operates a mineral resource.

For the purposes of this additional deduction, Quebec exploration expenses are essentially CEE that are incurred in Quebec.20 To be eligible for the additional deduction, the expenses must be incurred by a qualified corporation after March 31, 2004.

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17 See QTA sections 726.4.9 through 726.4.17.
18 See QTA section 726.4.10.
19 Defined in QTA section 726.4.15.
20 See QTA section 726.4.10.
If the investor is a corporation, the only deduction available is the basic 100 percent deduction for CEE.

Additional Deductions in Respect of Certain Other Expenses

An investor in flowthrough shares who is an individual (or a personal trust) resident in Quebec may also be entitled to claim an additional deduction, in computing taxable income for Quebec income tax purposes, of an amount not exceeding the investor’s “exploration base” relating to certain surface mining, or oil or gas, exploration expenses at the end of the year. The exploration base relating to surface mining essentially represents an amount equal to 25 percent of surface mining expenditures, and oil or gas exploration expenditures, incurred by a qualified corporation in Quebec. The expenditure can be incurred directly by the individual, or may be an expense incurred by a “qualified corporation” and renounced in favour of the holder of a flowthrough share.

Limits to the Deductibility of Investment Expenses

The March 30, 2004 budget introduced a new measure limiting the deductibility of investment expenses of individuals (including personal trusts). While this is not an incentive for exploration, its impact is sufficiently important to merit a brief discussion in this context.

Under this measure, 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 for deductibility). However, a taxpayer will be required to include in computing income the amount by which investment expenses exceed investment income, thus offsetting a portion of the deduction claimed.

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

Notion of Investment Income

Investment income, for the purposes of computing the limit on the deductibility of investment expenses, is described as all income from property and includes, in
particular, the following items that would otherwise be included in computing the investor’s cumulative net investment loss (CNIL):  

- taxable dividends of taxable Canadian corporations;
- interest from Canadian sources;
- the individual’s 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 capital gains exemption;
- 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.

Income from the rental of property is not considered 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 of such capital gain. The taxable portion of capital gains eligible for the capital gains exemption that exceeds the specified threshold is included in investment income for the purposes of the limit relating to the deductibility of investment expenses.

Taxable capital gains that are ineligible for the capital gains exemption (such as a gain on the disposition, by way of gift, sale, or otherwise, of a flowthrough share) constitute investment income for the purposes of both the calculation of CNIL and 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 the 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 calculating CNIL or for the purposes of the limit relating to the deductibility of investment expenses, even though such gains were otherwise ineligible for the capital gains exemption.

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25 See QTA sections 737.0.1 and 336.5.
26 The capital gains exemption was increased from $500,000 to $750,000 pursuant to measures included in the 2007 budget.
Notion of Investment Expenses

Investment expenses, for purposes of computing the limit on the deductibility of such expenses, are all the expenditures incurred to earn income from property other than rental income and include, in particular, the following items that would otherwise be included in calculating the investor’s CNIL:

- 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 a mutual fund trust; and
- the individual’s share 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 investment expenses for the purposes of this measure.

With respect to investments in flowthrough shares, investment expenses include all of the above items. In particular, 50 percent of CEE and CDE that are incurred in Canada but outside Quebec, and that have been forgone in favour of an investor under the flowthrough share regime, are included in computing investment expenses for the purposes of calculating CNIL and for the purposes of the limitation rule.

Refundable Tax Credit (the RTC)

As discussed above, a refundable credit mechanism was introduced as an intended replacement for the flowthrough share incentives and now coexists with those measures. The principal features of the RTC are as follows:

1. An eligible corporation may claim an RTC of up to 45 percent of the amount of eligible expenses.
2. An eligible corporation is a corporation that carries on a business in Quebec and has an establishment in Quebec (other than a tax-exempt corporation, a Crown corporation, or a wholly controlled subsidiary of such a corporation).28
3. Eligible expenses are expenses incurred in Quebec under the flowthrough share provisions that are either
   a. expenses relating to renewable energy or energy conservation, or
   b. exploration expenses that enable an individual to claim a 125 percent deduction under the flowthrough share provisions (that is, Quebec CEE).

As indicated above, a corporation is offered a choice between claiming the credit and renouncing the expense to a holder of a flowthrough share; in other words, a

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28 QTA section 1029.8.36.167.
corporation may not claim an RTC in respect of expenses renounced under Quebec’s flowthrough share regime.\(^{29}\) However, it may be possible for a corporation to renounce expenses in favour of holders of flowthrough shares for the purposes of the ITA and not renounce pursuant to the QTA, and thus retain the ability to claim the RTC in respect of such expenses. This would be particularly relevant where the subscribers to the shares are not resident in Quebec.

The current RTC rates are shown in table 1.

The carryforward period for the non-refundable portion of the RTC is 10 years. Accordingly, if during a taxation year the non-refundable portion of the credit exceeds income tax and tax on capital payable for that taxation year, the excess may be carried forward for the following 10 taxation years and carried back for the preceding 3 taxation years, and applied against income tax and the tax on capital payable for those years.

**DISPOSITION OF FLOWTHROUGH SHARES**

As noted above, both the ITA and the QTA deem the cost to the taxpayer of any flowthrough share that the taxpayer acquires to be nil.\(^{30}\) Therefore, the amount of the capital gain realized by the taxpayer on a disposition of a flowthrough share would generally equal the proceeds of disposition of the share net of any reasonable costs of disposition.

Prior to November 12, 1981, the ITA (and the QTA) deemed a flowthrough share to be inventory property acquired at a cost of nil.\(^{31}\) Consequently, any disposition of such a share would give rise to a full inclusion in income of the amount of the proceeds.

The ITA was then amended\(^{32}\) to, essentially, remove the mention of inventory property. As a result, since that time flowthrough shares have been treated like any other type of property; that is, the taxation of any gain on disposition of such a share will depend on whether or not the share is a capital property, which in turn will depend on the facts relating to both the acquisition of the share and the acquiror.

It is worth noting that the election in ITA subsection 39(4), whereby a Canadian security will be deemed to be a capital property, is not available in respect of a flowthrough share.\(^{33}\) Thus, as indicated above, it is the facts in the particular case that will determine whether capital gains treatment will apply on the disposition of such a share.

\(^{29}\) Ibid.

\(^{30}\) ITA subsection 66.3(3) and QTA section 419.0.1.

\(^{31}\) Former ITA section 66.3 and former QTA section 419.

\(^{32}\) The amendment was introduced as part of the federal budget of November 12, 1981. Similar amendments were made to the QTA (see sections 419 and 419.0.1).

\(^{33}\) See regulation 6200(d) to the ITA.
<table>
<thead>
<tr>
<th>Tax credit for eligible expenses</th>
<th>Corporations not operating any mineral resource or oil or gas well</th>
<th>Other corporations</th>
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<td>Refundable portion Non-refundable portion Total</td>
<td>Refundable portion Non-refundable portion Total</td>
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<td>Expenses relating to mineral resources</td>
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<td>In the Near North or Far North.</td>
<td>38.75 6.25 45.00</td>
<td>18.75 26.25 45.00</td>
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<td>Elsewhere in Quebec</td>
<td>35.00 10.00 45.00</td>
<td>15.00 30.00 45.00</td>
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<td>Expenses relating to oil and gas</td>
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<td>In the Near North or Far North.</td>
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<tr>
<td>Elsewhere in Quebec</td>
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Source: Quebec, Taxation Act, RSQ, c. I-3, sections 1029.8.36.167 through 1029.8.36.171.
In certain circumstances, a flowthrough share may qualify for a full or partial exemption from tax in respect of a capital gain realized on disposition. The ITA and the QTA provide different mechanisms to determine when and to what extent such exemption may be available. These are described in the sections that follow.

Donations of Publicly Listed Flowthrough Shares

Prior to amendments introduced in 2011, for donations to registered charities made after May 1, 2006, the gain realized on the donation of a share (including a flowthrough share), a debt obligation, or a right listed on a designated stock exchange was not subject to income tax under either the ITA or the QTA. This measure was adopted to encourage the donation of listed securities to charities.

As part of the March 22, 2011 federal budget, the Canadian government introduced a measure that would restrict the exemption from tax on capital gains arising from the donation of a flowthrough share to that part of the gain that exceeds the “exemption threshold” amount. The exemption threshold amount essentially represents the excess of the cost of a flowthrough share that was included in a flowthrough share class (that is, the actual cost of the share as opposed to its adjusted cost base) over any capital gain previously reported in respect of a flowthrough share of the same class. (Thus, assuming that no share of a flowthrough share class has previously been disposed of, the threshold amount will represent the cost to the taxpayer of the flowthrough share.) More specifically, when a taxpayer disposes of a flowthrough share by way of gift, the taxpayer is deemed to have a capital gain from a disposition of another capital property equal to, inter alia, the threshold amount.

These new provisions, applicable to dispositions arising from donations of publicly listed flowthrough shares made on or after March 22, 2011, do not affect entitlement to the deductions of CEE or CDE conferred on the acquiror of a flowthrough share.

As discussed below, Quebec subsequently harmonized its own rules with the ITA amendments, but with somewhat different results for taxpayers subject to the QTA.

Quebec’s Approach: Gain on Resource Property

In addition to the exemption relating to the donation of a listed flowthrough share, described above, the QTA provides a mechanism to exempt part of the taxable capital gain realized by a taxpayer on the disposition of a flowthrough share, where certain

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34 See ITA paragraph 38(a.1), ITA subsection 40(12), and QTA section 231.2, which apply to gifts made after May 1, 2006.

35 The March 2011 budget failed to pass. The measures described here were reintroduced in the June 6, 2011 budget; however, the effective date of the original announcement, March 22, 2011, was retained.

36 ITA subsection 40(12) and the definition of “exemption threshold” in ITA section 54.
conditions are met. Generally, the exemption applies where, among other conditions, an individual (other than a trust) who is resident in Quebec realizes a capital gain on the disposition of a “resource property.” For these purposes, a resource property\textsuperscript{37} includes

- a flowthrough share,
- an interest in a partnership that acquires a flowthrough share, and
- property substituted for such share or partnership interest that is received on certain transfers of such property by the individual or the partnership to a corporation in exchange for shares and in respect of which an election is made under the ITA.

The exemption is based on a historical expenditure account consisting of one-half of CEE incurred in Quebec that gives rise to the first additional 25 percent deduction for Quebec tax purposes.\textsuperscript{38}

Upon the sale of a flowthrough share (or other resource property), an individual resident in Quebec may claim a deduction in computing Quebec income in respect of the portion of the taxable capital gain realized that is attributable to the excess of the price paid to acquire the share (or other resource property) over its cost (which, as noted above, is deemed to be nil). In general, the amount of the deduction\textsuperscript{39} may not exceed the lesser of

1. such portion of the taxable capital gain realized, and
2. the amount of the expenditure account at the time of the disposition,

subject to certain other limits provided under the QTA. Any amount so claimed will reduce the balance of the expenditure account of the individual while any new deduction of CEE incurred in Quebec by the individual will increase that balance. The portion of the taxable capital gain represented by the increase in value of the flowthrough share (or other resource property) over the original price paid to acquire the share (or other property) will continue to be taxable, and the amount accrued in the account may not reduce this gain.

Figure 1 provides a simplified representation of the QTA treatment of gain on a disposition of a flowthrough share or other resource property.

\textsuperscript{37} QTA section 720.26.1, the definition of “resource property.”

\textsuperscript{38} See the discussion above under the headings “Additional Deduction in Respect of Quebec Exploration Expenses” and “Additional Deductions in Respect of Certain Other Expenses.”

\textsuperscript{39} QTA section 726.20.2.
Harmonization of Federal and Provincial Rules on Dispositions

On July 6, 2011, Finances Québec issued a bulletin dealing with the harmonization of Quebec tax legislation with certain measures contained in the federal budget of June 6, 2011.40 One of those measures was the amendment of the rules for donations to registered charities of publicly listed flowthrough shares.

As discussed above, prior to those amendments, a gain realized on the disposition of publicly listed flowthrough shares by a taxpayer by way of donation to a registered charity was exempt from income tax. The new rules limit the amount of the exemption by taking into account the original cost (the amount paid to acquire the flowthrough share) instead of applying the cost for tax purposes (which, under the usual rules, would otherwise be deemed to be nil). In effect, exemption from capital gains tax in respect of a donated share will be allowed only where the share has appreciated in value since the time of acquisition by the taxpayer, and only in respect of the portion of the gain realized that exceeds the exemption threshold.

Apart from the treatment of flowthrough shares gifted by charitable donation, Quebec’s approach to the taxation of gain realized on a disposition of a flowthrough share (a resource property) has traditionally been different from the federal approach. As discussed above, prior to harmonization, the amount of the deduction41 could not exceed the lesser of

1. the portion of the taxable capital gain realized that is attributable to the excess of the acquisition price over the cost of the share, and

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40 Finances Québec, Information Bulletin 2011-3, “Harmonization with Certain Measures of the June 6, 2011 Federal Budget and Other Fiscal Measures,” July 6, 2011; and QTA sections 262.3 through 262.5.

41 QTA section 726.20.2.
2. the amount of the expenditure account at the time of disposition (which is increased by any new deduction of CEE incurred in Quebec).

The portion of the taxable capital gain represented by the increase in value of the share over the original acquisition price continues to be taxable in accordance with the usual rules. Thus, where a flowthrough share that is listed on a designated stock exchange is gifted to a charity, the gain that relates to the portion that exceeds the original price paid should qualify under the QTA for the exemption for donations of listed shares, whereas, under the new federal rules, the share would be deemed to have been disposed of, and a gain of up to the original price could be realized and be subject to tax.

The Quebec and federal tax positions prior to the 2011 federal amendments, and prior to harmonization, are illustrated in figure 2.

With full harmonization, the gift of a flowthrough share would give rise to proceeds of disposition, and thus the realization of a gain that must be included in income, for both federal and Quebec income tax purposes. However, Finances Québec decided to maintain the availability of the resources capital gains deduction in respect of donated shares.42 The coexistence of this tax measure and those emanating from the 2011 federal budget provides the results illustrated in figure 3.

THE FUTURE

The preceding discussion has reviewed some of the past and present rules applicable to flowthrough shares. To conclude, I will speculate on the future of flowthrough shares and related incentives.

- **The 100 percent basic deduction for CEE.** Given the importance of the use of flowthrough shares in raising capital for exploration corporations, it is unlikely that this feature would be tampered with.

- **Additional deductions.** Quebec has used the provision of additional deductions as an enticement. Presumably, if times get harder for capital, the rates may go up.

  There appears to be little prospect that further deductions will be introduced, other than perhaps the adoption by the federal government of an approach similar to Quebec’s; for example, the federal investment tax credit might be replaced by an additional deduction.

- **Federal investment tax credit.** The investment tax credit is a unique measure in that it is renewed annually. It may be time, out of concern for stability, to consider extending the period of renewal beyond one year.

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42 See Information Bulletin 2011-3, supra note 40, at 4, note 7, where Finances Québec confirmed that the incorporation of a measure harmonizing the QTA with the federal amendments would not restrict the application of the deduction in QTA section 726.20.2 with respect to the additional capital gains exemption in respect of resource properties.
Capital gains. The recent approach of taxing a portion of the gain on a charitable donation of flowthrough shares should satisfy critics who saw the juxtaposition of two unrelated tax measures as an “offensive” combination. The provision of the benefits associated with an acquisition of flowthrough shares and the capital gains tax exemption for gain on a donation of publicly listed shares are measures that have quite distinct justifications and policy objectives. It is difficult to understand the objections raised. Exploration corporations and charities were the principal beneficiaries of the popularity of this unique combination.

Given the recent federal amendments with respect to donations of flowthrough shares, no additional movement in that direction should be expected (though only time will tell).