Demand for flow-through shares to rise with new tax credit and commodities rally

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TODD KOROL/REUTERS

Advisors are revisiting the risks and rewards of flow-through shares (FTS) for clients following the introduction of a new tax benefit in the recent federal budget aimed at boosting the green economy.

Last month, the federal Liberal government introduced the Critical Mineral Exploration Tax Credit (CMETC), a 30-per-cent credit for investors who purchase FTS from companies exploring metals and minerals such as copper, nickel and rare earth element needed to advance clean energy technologies. The government also said it will phase out FTS for companies that explore for fossil fuels by March 31, 2023.

"[Ottawa] is taking away from the oil, gas and coal sector and giving extra benefits that didn't previously exist to the new form of flow-through shares that they want to see specific to the mining of critical metals," says Ethan Astaneh, wealth advisor at Nicola Wealth Management Ltd. in Vancouver.

Canadian resources companies use FTS to issue new equity to investors at a higher price than they would normally receive, typically to raise money for exploration and development, says Steve Suarez, a mining tax law specialist and partner in the Toronto office of Borden Ladner Gervais LLP.

He explains the financing tool in a detailed summary published online, in which he notes investors are willing to pay a premium for FTS because they can claim deductions and credits that reduce their taxes.

Basic FTS allow an investor to claim deductions for Canadian exploration expenses (CEEs) and Canadian development expenses (CDEs) incurred by resource companies and flowed through or "renounced" to the person subscribing for the FTS, Mr. Suarez says.

CEEs acquired are immediately 100-per-cent deductible to the FTS investor, while CDEs are 45-per-cent deductible in the first year, with the remainder over time, he says. Also, he notes that many FTS offerings are structured so that the type of CEEs renounced to investors qualifies for a further 15-per-cent mineral exploration tax credit "claimable by individual investors, increasing the premium such investors are willing to pay the company issuing them and reducing its cost of capital."

The 2022 federal budget announced a new 30 per cent CMETC for qualifying CEEs renounced to FTS investors over the next five years.

Benefits and risks of investing in FTS

Mr. Astaneh of Nicola Wealth says FTS are best suited for investors in the highest tax bracket – as long as they understand the risks.

"If you have limited [registered retirement savings plan (RRSP) contribution] room and limited other deductions available to you, and you want to bring your taxable income down, flow-through shares are a reasonable option to consider provided the risk profile is suitable for you," he says.

The main risks are the investment losing value, but he notes that can be offset by the significant tax break.

"In effect, it's like making an RRSP contribution from the perspective that it functions like a deduction," he says. "As long as that speculative investment combined with the tax benefits is delivering a positive after-tax outcome, it provides an advantage."

The other risk is that the company whose shares are bought might not use the funds for purposes that are eligible for flow-through to the investor, which he says is rare but has happened.

"It's not a fun experience when you receive a letter from the [Canada Revenue Agency] five years after you've bought a flow-through share saying, 'We're having a look at it now and it turns out that company didn't apply all its expenses properly.'"

Mr. Astaneh says his firm has worked with several clients who have purchased FTS directly or through investment vehicles. In some cases, he says, exempt-market dealers will package them into a limited partnership, which is illiquid until they're turned into a mutual fund months later.

"The reason why that's advantageous for the investors is that you're diversified," he says. "It's not just one exploration company that you're picking, but instead you're picking a basket of them."

How FTS work for charitable donations

Some investors also choose to buy FTS to make a charitable donation, often through specific companies that provide the charitable vehicle. Some Canadian companies that do FTS donation finance include Sprott Capital Partners LP, PearTree Securities and Wealth Creation Preservation & Donation Inc. (WCPD).

WCPD says its clients buy the public flow-through shares and then donate them immediately to charities of their choice and receive another 100-per-cent tax deduction for the donation. The charities then sell the FTS immediately at a discount to an institutional buyer or liquidity provider for cash.

WCPD says the cash is the value for the charitable tax receipt. The liquidity provider takes on the stock market risk, not the donors or the charity.

Peter Nicholson, founder and president of WCPD in Ottawa, says the FTS market has picked up alongside a recovery in commodities in recent years and the new CMETC is expected to increase it further.

"Advisors who haven't done flows in 10 or 12 years because of the bear market are saying, 'I think now is the time to start revisiting it,'" he says.

Mr. Nicholson notes the CRA has offered a 100-per-cent tax deduction on FTS since 1954 to fund drilling and exploration. The tax incentive recognizes the role mining plays in the economy, including jobs for Indigenous Peoples.

"You need the 100-per-cent deduction because it's a venture-capital-like business," Mr. Nicholson says. "Nine times out of 10, the drilling doesn't result in anything, but you need that one out of 10 to find the potential mine."

The good news for the government is that every time, jobs are created.

WCPD says it doesn't facilitate FTS related to coal, gas and oil exploration.

Why due diligence is important

Warren MacKenzie, head of financial planning at Optimize Wealth Management in Toronto, doesn't have clients with FTS currently but has in the past. He says advisors and investors should understand how they work before they buy.

"Flow-through shares provide an immediate tax deduction for the amount invested," he says. "However, later, when the security is sold, its cost will be deemed to be zero, so 100 per cent of the proceeds would be taxed as a capital gain."

That compares to a regular investment in which a capital gain would only exist if the investment is sold for more than what it costs, Mr. Mackenzie explains.

"It's why this type of investment is best suited for individuals who are in a high tax bracket and who can afford to lose the entire amount invested," he says.

Investors should also know that there is a two-year holding period for FTS and during this period there is no opportunity to sell the shares, Mr. Mackenzie adds.

FTS are also risky as the proceeds are used to fund exploration and resource development from companies that might never make a profit, he says.

"The immediate tax write-off is only offered because the risk is so high that it would be difficult for the company to find investors without this immediate deduction for the full amount invested," Mr. Mackenzie says.

He adds shareholders who hold existing FTS being phased out will have already deducted the cost of the shares, so they will be unaffected by the changes announced in the budget.

Meanwhile, Mr. Astaneh says FTS are a useful planning tool but suggests advisors and investors do their homework on the companies and the dealers offering them – especially now that the rules are changing and new companies will be issuing them.

"This change introduces an element of risk at the end of the day for the investor, albeit one that can be managed with due diligence," he says. "If I'm going to be considering flow-through shares for clients, I'm going to be asking more questions."

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