



# Flow-Through Shares and the Look-Back Rule

*The following explains the amendments to the look-back rule for flow-through shares announced in the 1996 federal budget. The text was written by the Minerals and Metals Sector of Natural Resources Canada and is published with its permission.*

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## Introduction

The flow-through share (FTS) mechanism has been a longstanding and unique feature of the Canadian regime for mining and oil and gas taxation. In its 1996 Budget, the federal government introduced a number of measures designed to improve the effectiveness of FTS-financed exploration.

For mining, the most significant change introduced is a technical amendment to the Income Tax Act affecting the so-called "look-back" rule. The rule was modified to allow exploration expenditures renounced under the look-back rule to be incurred by the issuer up to a full year (rather than only 60 days) after the end of the calendar year in which the funds were raised. Also, the budget introduced tightening measures to ensure that FTS be used only to finance more risky expenditures. The Canadian Development Expenses (CDE) that related to the cost of mining properties is no longer eligible FTS expenditures.



## Background

Flow-through shares facilitate the ability of exploration companies to raise equity capital, even in the absence of revenue producing assets. Companies are able to raise this money by "flowing-through" the tax deductions associated with their exploration expenses to their investors. In addition to receiving a tax deduction, investors stand to see their investment appreciate in value in the event of successful exploration activities.

Although quite simple, this mechanism gave rise to certain timing difficulties for companies issuing flow-through shares. Many investors waited until the end of the calendar year before seeking the tax deductions associated with flow-through shares. That left companies with

little time to spend the raised funds and pass on the tax deductions in time for them to be used on the investor's tax return. The "look-back" period was first introduced in 1985 to provide FTS issuing companies a period of grace in which to spend its funds. Initially, companies were given 60 days after the year in which the financing was raised to make the expenditures. If renounced, such expenditures are treated as having been incurred by the investor in the calendar year in which the consideration was given for the acquisition of the shares.



## The new "look-back" rule

Although the sixty-day look-back period gave companies more flexibility in planning their exploration projects, the exploration community suggested a longer grace period. Their argument was that extending the look-back would help prevent year-end "overheating", in which the rigid time requirements of exploration spending for tax benefit may lead to a misallocation of exploration and development resources. In its 1996 Budget, the federal government extended the "look-back" period to one year.

In order to be eligible to have expenses treated as having been incurred at the end of a calendar year under the new look-back rule, an investor must pay cash and agree to acquire a flow-through share by the end of that year. The issuer must incur eligible expenses by the end of the following year (rather than in the first 60 days of the following year). Because of the additional 10 months involved, there is a larger cost to the government associated with giving a deduction for an expense that has not yet been incurred. To compensate, the issuer is required to pay monthly interest charges for unspent funds.

These charges begin accumulating on March 1 of the year after the one in which the taxpayer claimed deductions for the deemed expenses. The amount of unspent funds at any time is equal to the amount renounced under the look-back rule, minus eligible expenses in respect to the renunciation. The interest rate, for a month, on unspent funds is one twelfth (1/12) of the rate used to determine refund interest under the Income Tax Act. The monthly charges are generally a deductible expense. In addition, a fee will be imposed if the share issuer has unspent funds at the end of the year of the renunciation. This fee recognizes the costs that will be incurred by the government in carrying on reassessments. The fee amounts to 10% of the unexpended amount. Individual investors are not subject to the charges on unspent funds and to the 10% fee. However, they will be reassessed if there is an unspent balance at the end of the year of the renunciation and will be required to pay interest to the government on any resulting underpayment of taxes. The charges to investors will start accruing after April of the calendar year that follows the renunciation (that is, in the second year after the taxpayer claimed the deduction, and in the year after the expenses were actually incurred).



## **Conclusion**

The extension of the "look-back" period from sixty days to one year will allow companies to conduct more efficient and more timely exploration activities. While not really different in application than the previous sixty-day rule, the 365 day rule introduces the concepts of interest charges for unspent funds after two months and fees for unspent funds at the end of the year of renunciation.