Understanding Flow-Through Shares: A Capital Device for Investors Interested in Canadian Resource Exploration

What are Flow-Through Shares?

Flow-through shares are a unique financial instrument widely used in Canada, particularly in the mining sector. They have been a cornerstone of capital raising for resource companies, especially those engaged in mineral exploration. The model allows companies to transfer certain tax deductions related to exploration and development expenses to investors, making it an attractive option for both companies and investors.

Historical Context and Evolution

Flow-through shares were first introduced in Canada in 1954, three years before the RRSP. They have been a key financial policy instrument for junior mining companies to raise capital. In 2007, the Canadian government enhanced this model with the introduction of the charitable flow-through model, allowing investors to receive not only tax deductions but also the added benefit of charitable giving.

How Do Flow-Through Shares Work?

Basic Structure:

- Companies issue flow-through shares, allowing investors to receive a 100% tax deduction on the amount they invest. These funds are exclusively used for exploration activities in Canada.
- Investors are required to hold these shares for at least four months. During this period, the stock price may fluctuate, posing a risk.

The Charity Flow-Through Model:

- The charity flow-through structure mitigates the risk for investors by involving a liquidity provider—an institutional buyer of shares who understands the mining business. This buyer purchases the shares at a discount, typically around 30%.
- Investors immediately donate the shares to a charity, which sells them to the liquidity provider. The investor retains the initial 100% tax deduction and receives a second 100% tax deduction on the cash value of the donation, making this a highly tax-efficient method of charitable giving.

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Key Benefits:

For Investors: The dual tax deductions significantly reduce the cost of investment, making it possible to achieve substantial tax savings while supporting charitable causes.

For Companies: Flow-through shares allow companies to raise capital at a premium, minimizing shareholder dilution. This is especially advantageous for companies listed on the Exchanges with critical mineral projects in Canada. Recently, companies on the ASX have been accessing this incentivized investment option for capitalizing drilling programs in Canada.

For Charities: The charity receives the full cash value from the sale of shares to the liquidity provider, enabling more substantial contributions to their causes.

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Why Are Flow-Through Shares Attractive?

Tax Efficiency: Flow-through shares provide a direct tax deduction to investors, reducing their taxable income. For Canadian critical mineral projects, an additional 30% Critical Mineral Exploration Tax Credit (CMETC) is available, further incentivizing investment.

Risk Mitigation: The charity flow-through model removes the typical stock market risk associated with holding shares, as the liquidity provider assumes this risk.

Support for Exploration: This financing mechanism is crucial for junior mining companies, particularly those exploring critical minerals, which are essential for green energy technologies.

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Eligibility and Use Cases

- To issue flow-through shares, a company must be a "principal business corporation" under Canadian tax laws, meaning it must be primarily engaged in mining or exploring for minerals.
- Australian companies with Canadian exploration projects, particularly those listed on the ASX, can leverage flow-through shares to raise capital efficiently, benefiting from Canada's favorable regulatory environment.

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Critical Considerations

- **Environmental Impact:** Modern mining exploration, particularly for critical minerals, is essential for Canada's transition to a low-carbon future. The government's Critical Minerals Strategy, introduced in 2022, supports this effort with new laws, regulations, and tax incentives.
- **Potential Risks:** While the charity flow-through model mitigates most risks, companies must ensure that the funds are used exclusively for exploration to comply with tax regulations. Any misuse could lead to reassessment, though indemnification agreements typically protect investors.

Conclusion

Flow-through shares, particularly in their charitable form, represent a powerful capital-raising tool for companies engaged in resource exploration in Canada. For investors, this model offers a unique opportunity to invest in the future of critical minerals, enjoy substantial tax benefits, and contribute to charitable causes—all while mitigating the traditional risks associated with mining investments.