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Flow-Through Shares in the Renewable Energy Sectors

May 2012

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So what, then, are flow-through shares and how do they work?

Nature of Flow-Through Shares

A flow-through share is a common share to which certain contractual rights attach. These rights obligate the issuer to renounce (flow through) qualifying expenses to the share subscriber, which expenses cannot exceed the particular subscriber's subscription amount. The subscriber may then deduct those qualifying expenses for income tax purposes.

Since flow-through rights are contractual and do not inhere in the share itself, those rights are enjoyed only by the subscriber. If the flow-through shares are sold, the subscriber will retain the right to deduct renounced qualifying expenses. That right cannot be sold.

Issuer Benefits

Flow-through shares allow the issuer to obtain a premium for its shares since the subscriber will be able to deduct the issuer's qualifying expenses. This is of particular benefit to a capital-intensive start-up with a distant profit horizon since losses that are of no immediate use to the issuer may be thereby converted into cash.

Investor Benefits

Assuming the combined Federal and Ontario top marginal tax rate applicable to individuals in 2012, the value of a flow-through share to a subscriber is 46.41% of the subscription price[1] plus the future growth on the underlying common share. Such accrued value is realized upon a subsequent share sale and, provided that the shares are held as capital property rather than inventory, only half the sale proceeds are taxable. Liquidity may, however, be an issue for private placement shares. The cash flow may be illustrated as follows:

Share price with 20% premium	($12.00)
CRCE deduction	$12.00
Adjusted cost base	$0.00
Share proceeds without premium	$10.00
Tax on capital gain	$2.32
Net proceeds	$7.68
Cost of flow-through share	($12.00)
Value of CRCE deduction (46.41% of $12.00)	$5.57
Net proceeds	$7.68
Net cash flow ($)	$1.25
Net cash flow (%)	10.4%

Canadian Renewable and Conservation Expenses

In order to qualify for renunciation in the renewable energy context, expenses must qualify as "Canadian renewable and conservation expenses" (CRCE). CRCE are certain expenses payable to an arm's length person in respect of certain qualifying projects.

A project qualifies if at least 50% of the capital cost of all depreciable property used in such project is included in Classes 43.1 or 43.2 under the regulations to the Income Tax Act (Canada). While these classes are detailed, extensive and subject to qualification, they include, in general terms and in the renewable energy context:

- active solar heating equipment;
- hydro-electric installations; and
- wind energy conversion systems.

If the project qualifies, as above, then CRCE includes expenses incurred in respect of such project for the following purposes:

[1] As described under *Timing of Renunciation*, the full tax benefit can be obtained in the year in which the shares are purchased if the "look-back" rule is applied.

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- to make service connections for the transmission of electricity;
- to construct temporary access roads to the project site;
- for rights of access before the commercial operation date;
- to clear land;
- to collect and analyze site data;
- to calculate energy, mass, water or air balances;
- to simulate and analyze the performance and cost of process design options;
- to select the optimum process design; and,
- for a test wind turbine that is part of the taxpayer's wind farm project.

Timing of Renunciation

The general rule is that CRCE must be incurred within two years following the end of the month in which the flow through shares were issued. However, to make these shares more attractive to investors, there is a further rule which provides that the full two years of CRCE can be renounced in the first year if certain conditions are met. Briefly stated, cash consideration must have been paid for the shares in the first year, the subscriber and the corporation must deal at arm's length throughout the second year and the CRCE must be renounced between January 1 and March 31 of the second year. Necessarily then, the subscription agreement will include the issuer's covenants to spend all subscription amounts upon CRCE by the end of the second year and to indemnify and hold harmless the subscribers from the consequent tax payable by the subscribers if the issuer fails to do so. Failure to incur CRCE that has already been renounced results in a (deductible) Part XII.6 tax upon the issuer.

Part XII.6 tax is levied monthly and is generally equal to the month-end balance of unspent subscription amounts, multiplied by an interest rate. The interest rate is equal to 1/12 of the annual prescribed interest rate, which is currently 3%. If funds remain unspent at the end of the year of renunciation then an additional charge applies in December equal to 1/10 of the unspent balance at the end of that month.

Feed-In Tariff Program

As indicated above, flow-through shares are available in respect of certain renewable energy project costs. Given that the new FIT Rules (2.0) under Ontario's Feed-In-Tariff Program provide significant benefits to those renewable energy projects of which co-operative corporations ("Co-Ops") own at least 15%, it is worth briefly considering whether members of a Co-Op could benefit from the flow-through share regime.

Flow through shares can only be issued by either a "principal business corporation" or a corporation all or substantially all of the assets of which are shares or indebtedness of a principal business corporation and that is related to the principal business corporation. A "principal business corporation" is a corporation whose principal business is—in the renewable energy context—the development or operation of renewable energy projects using certain classes of capital assets. In order to be able to issue flow through shares, then, the Co-Op must either be the development company or must own at least 51% of the voting shares of the development company. It is unlikely that a project developer would surrender control for the sake of issuing flow-through shares.

The question then becomes whether the project developer could be a member of the Co-Op. If so, the development company could simply qualify as a Co-Op under the developer's control. Unfortunately, this arrangement is not feasible as a result of a requirement under the FIT Rules and FIT Contract that all Co-Op members must be natural persons resident in Ontario.

There is, then, a practical, if not absolute, prohibition to offering a Co-Op the benefit of flow-through shares.

Documentation

The documents required to issue flow-through shares are the same as for non-flow-through shares inasmuch as they consist of an agency agreement to be entered into with the underwriter and a subscription agreement to be entered into with each subscriber. However, the subscription agreement for flow through shares also functions as a 'renunciation agreement' and, as such, contains several representations, warranties and covenants to be made by the issuer in respect of the matters described above.

Conclusion

Flow-through shares present a significant opportunity for Canada's renewable energy sectors. Their ability to trade future expenses for current investment ensures that they will be increasingly common as these sectors mature and domestic investment therein increases.

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