IFRS 9 and IAS 39: Flow-Through Shares from the Holder's Perspective

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Current Canadian tax legislation permits entities in mining or oil and gas exploration, and entities in certain emerging technologies, to issue flow-through shares to investors to finance qualifying expenditures.

The purchase of the flow-through share gives the investor rights to a common share of the issuer, and a future tax deduction, equal to the cost of the initial investment. The tax deduction may be taken once the issuer renounces the qualifying expenditures.

The investor typically pays a premium for the flow-through share, compared to a non-flow-through common share, because the investor also obtains the benefit of a future tax deduction.

There are two ways for an issuer to renounce the qualifying expenditures to the purchaser:

- General rule: The costs are factually incurred by the corporation and renounced at a later date within a 24-month period.
- Look-back rule: The costs are not incurred as at the renunciation date. The costs are "deemed" to have been incurred on the last day of the calendar year. There is a requirement to incur expenditures by the end of the next calendar year.

If the qualifying expenditures are not made by the timelines required under the tax legislation, tax authorities will deny the purchaser's tax deduction. However, in the flow-through share agreement, the issuer will typically indemnify the purchaser for the loss in tax benefit if the issuer fails to make the required qualifying expenditures.

The original purchaser can sell the underlying common share at any time (subject to any resale restrictions under securities legislation). However, the original purchaser of the flow-through share retains the tax benefit from the renounced expenditures. This tax benefit cannot be sold or transferred to the subsequent purchaser.

IFRSs do not explicitly address the accounting for flow-through shares. The accounting for flow-through shares from an issuer's perspective was discussed by the Group in November 2009 and September 2010. Also, two industry committees, the Oil and Gas Industry Task Force and the Mining Industry Task Force, have published non-authoritative Viewpoints on the accounting from an issuer's perspective.[1] However, limited guidance, if any, is available on the accounting from a holder's perspective.

1 See Viewpoints: Applying IFRS in the Mining Industry – Flow-Through Shares and Applying IFRS in the Oil and Gas Industry – Flow-Through Shares

Issue 1: When should the flow-through share be split into its component parts of an investment in equity securities of another entity and a tax benefit to the original investor?

View 1A – Upon renunciation by the issuer.

Under this view, the purchase of the flow-through share is in substance seen as the purchase of a single financial asset (investment in flow-through shares) in the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. The right to the tax benefit is recognized separately only upon renunciation by the issuer of the flow-through share.

Subsequent to renunciation, the investment continues to be accounted for in accordance with IAS 39 and the tax benefit is accounted for in accordance with IAS 12.

View 1B – Flow-through shares are split on initial recognition.

Under this view, the purchase of the flow-through shares is in substance seen as the purchase of two assets that have been bundled together, being:

- an investment in another entity (in the scope of IAS 39); and
- a purchase of a right to tax deductions.

On initial recognition of the transaction, these two components are recognized and accounted for separately. There are three sub-views for the measurement of the component parts at initial recognition:

View 1B.1 – The tax benefit asset is assigned a residual.

View 1B.2 – The tax benefit asset is assigned a relative fair value based on the purchase price.

View 1B.3 – Either residual value or relative fair values may be used as an accounting policy choice.

The Group's Discussion

Group members supported View 1B that the flow-through shares should be split into two component parts upon initial recognition observing that this approach creates symmetry with the issuer's accounting. However, Group members expressed mixed views regarding how to separate the transaction into the component parts.

Some Group members supported the residual approach (View 1.B.1) because the relative fair value approach (View 1.B.2) results in the initial recognition of the equity investment not at fair value, which is inconsistent with IAS 39 and would give rise to a day two gain. Also, some Group members did not support the relative fair value approach because of concerns over double counting the tax benefit. Other Group members supported that there is an accounting policy choice (View 1.B.3) noting that it is difficult to preclude either the residual or relative fair value approach because IFRSs do not include any specific guidance.

Issue 2: When are the effects of renunciation recognized?

Under the look-back rule, an issuer may renounce expenditures in one year (for example 20X2). However, investors are eligible to take the deduction in their prior year tax return, which is 20X1 in this example.

If the financial statements are authorized for issuance after the renunciation has occurred, are the effects of the renunciation recognized in the 20X1 or 20X2 financial statements?

View 2A – 20X1 financial statements (the renunciation is an adjusting event).

View 2B – 20X2 financial statements (the renunciation is a non-adjusting event).

The Group's Discussion

Group members commented that similar to an issuer's perspective, from the holder's perspective the issue becomes more complex when considering the look back provisions. Group members noted that the difference between the two views is whether to reflect the tax benefit as current or deferred.

Some Group members supported that the renunciation is an adjusting event (View 2A) because the shares were acquired prior to the end of the reporting period and contain the rights to the tax benefit. Some Group members supported that the renunciation is a non-adjusting event (View 2B) because at the end of the reporting period there could not be certainty over whether the renunciation would occur and the renunciation is a discrete event occurring after the reporting period.

Group members observed that a key fact from the issuer's perspective was that the renunciation is generally perfunctory and if it does not occur a penalty is imposed. However, Group members commented that the distinction between the issuer and holder perspectives is that the renunciation is controlled by the issuer. At the end of the reporting period, the holder does not know whether the underlying nature of the asset is a current tax benefit or a right to be made whole by the issuer. From the holder's perspective, the renunciation is a discrete event after the end of the reporting period outside of the holder's control.

Group members discussed whether to recommend the AcSB take any further action regarding this issue. Group members were reluctant to recommend referring this issue to the IFRS Interpretations Committee because it is unique to Canada and arises in a couple of industries only. The Group decided not to recommend further action to the AcSB regarding this issue.

An observer on the Oil and Gas Industry Task Force that published the non-authoritative Viewpoint on the accounting from an issuer's perspective, offered to raise the issue from a holder's perspective with that committee.