Types of Flow-Through: Canadian Development Expense and Canadian Exploration Expense Explained

The tax act allows Canadian natural resource companies to renounce exploration and development expenses and provide these deductions to investors via the issuance of flow through shares. Flow through shares are aptly named as the tax deductions flow from the company issuing the shares to the individual investors.

There are three types of flow through shares. Historically, most flow through has targeted Canadian Exploration Expenses (CEE) which afford the purchaser a 100% write-off in the year the expense is incurred. CEE qualifying expenses include successful wells into previously undiscovered reservoirs, imaging data (seismic) and unsuccessful wells.

Companies are also able to issue Canadian Development Expense (CDE) flow through shares, which provide the purchaser with a 100% write-off on their investment but on a 30% declining balance method over subsequent years. CDE expenses include certain expenses incurred while developing already identified oil and gas pools.

The third type of flow through is “Qualifying” CDE. “Qualifying” CDE allows eligible junior oil and gas companies to convert up to $1 million per year of CDE flow through into CEE flow through. Eligibility is related to the company’s size and restrictive conditions in the Tax Act preclude larger oil and gas companies from qualifying CDE into CEE.

Further information on flow through deductions can be found on many websites; however, authoritative information can be found on the Canada Revenue Agency site (**www.cra-arc.gc.ca**) and in the tax act under section 66.

The difference between CEE and CDE qualifying expenditures reflects the different risk / reward profiles associated with the two types of flow through expenses. With only six energy based CEE flow through deals to date in 2009, it is apparent that oil and gas companies are less willing to take the risks associated with exploration. Companies are instead focusing on development prospects and increasing near-term cash flow via lower risk development programs, which have been made all the more attractive by the recent drilling incentives instituted in Alberta and BC. Development projects allow companies to deploy capital, capture the new incentives and generate growth without taking the risks commonly associated with exploration.

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