



# How a Typical Flow-Through Limited Partnership Works

Canadians enjoy a higher standard of living than people in most countries, but that comes with a price tag - higher taxes! And because of the high tax rate, Canadians look to ways of reducing the tax they have to pay. If an investor's RRSP contributions are maximized each year, there is another tax saving strategy known as flow-through investing. This special tax-savings strategy was introduced in the early 1980's to encourage investment in Canadian energy and mining companies and was coined flow-through investing because the tax savings the companies could receive are instead "flowed-through" to investors. Following are commonly asked questions about flow-through investing.

## What is a Flow-Through share?

Flow-through shares are common shares of a resource company which provide flow-through tax deductions to investors. Resource companies issue flow-through shares to attract capital for exploration and development. Resource companies "flow through" eligible Canadian Exploration Expenses (CEE) and Canadian Development Expenses (CDE) to their flow-through share investors. Shareholders can deduct these flow-through expenses against their taxable income.

## Why does the Government of Canada provide investors with a flow-through tax deduction?

The Government of Canada recognizes the economic benefits of the exploration for, and development of, Canada's natural resources and encourages investment with a flow-through tax deduction for investors. Originally, flow-through shares were only deductible against resource income, however, in 1983 the federal government changed legislation which allowed qualifying flow-through expenses to be deductible against other income. In recent years, the federal government and some provinces have introduced additional tax incentives for investors purchasing certain flow-through shares issued by Canadian mining companies to provide additional incentive for investment in Canada's mining industry.

## What are the tax benefits?

From a tax deduction perspective, the investor receives the same tax benefit as making an RRSP contribution, but the difference is that a flow-through investment is purchased and held outside a registered plan.

## How does a typical flow-through limited partnership work?

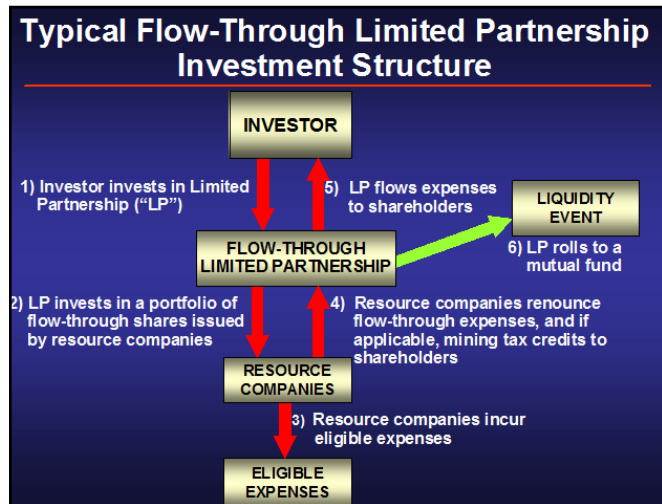
- 1) Investors invest in a flow-through limited partnership.
- 2) The limited partnership's portfolio manager invests in flow-through shares of resource companies.
- 3) Resource companies use the flow-through capital to incur eligible CEE and CDE expenses.
- 4) Resource companies "flow through" expenses to flow-through limited partnership, i.e. the shareholder.

- 5) The limited partnership flows through the eligible expenses to its shareholders, a tax deductible expense against their taxable income.
- 6) Eighteen to twenty-four months from the close of the limited partnership offering, the flow-through portfolio assets are liquidated, typically by way of a tax-deferred rollover of the limited partnership's assets to a mutual fund. Shareholders choose to either hold or sell the mutual fund units.

## How can individual investors purchase a flow-through investment?

Flow-through investments can be purchased in one of two ways:

- 1) Purchase flow-through shares directly from a resource company.  
Disadvantages: limited access to direct flow-through investments and the higher risk associated with a lack of portfolio diversification; or
- 2) Purchase a flow-through limited partnership (through an investment advisor).  
Advantages: portfolio diversification and a portfolio manager who makes the flow-through portfolio investment decisions which reduces risk and increases potential for capital gains.



## What should be considered in reviewing a flow-through limited partnership?

There are many aspects of a limited partnership which investors need to consider. They include: a) the portfolio management team's experience and track record; b) the sector focus of the limited partnership (i.e. mining, oil & gas and alternative energy); c) the amount of capital raised relative to the quantity and quality of the flow-through share investment opportunities; d) management of flow-through share premiums; and e) the limited partnership's liquidity strategy. These matters can be reviewed in a limited partnership's offering documents or, investors can ask their investment advisor about the flow-through limited partnership offering.

## What are some of the risks with flow-through investments?

As with any investment, there are certain risks associated with flow-through investments. Risks can include, but are not limited to: 1) the cyclical nature of the resource industry; 2) commodity price fluctuations; 3) the resource company's share price volatility; and 4) the resource company's operational risks. The flow-through tax deduction and the portfolio diversification of a flow-through limited partnership are designed to provide investors with downside risk protection. Investors should review the risk factors for a flow-through share offering or limited partnership investment opportunity by reviewing the offering documents or discussing the risk factors with their investment advisor.

## How does a flow-through limited partnership provide liquidity for investors?

Liquidity for a flow-through limited partnership typically comes in the form of a "tax-deferred" rollover to units of a mutual fund and usually occurs eighteen to twenty-four months from the closing date of the limited partnership offering. When an investor eventually sells his/her mutual fund units, the value of the units sold are taxable as a capital gain. Although not typical, a limited partnership could also provide liquidity by distributing to investors, on a pro-rata basis, the cash and shares of the

resource companies in the flow-through portfolio. The value of the distributed cash and shares would be taxable as a capital gain.

## Why is the entire value of the proceeds of selling a flow-through investment taxed as a capital gain?

Flow-through investments typically have an adjusted cost base (ACB) of "zero" because of the flow-through tax deduction. Therefore, for tax purposes the entire value of the proceeds realized from the sale of a flow-through investment is subject to capital gains. If an investor's flow-through shares roll to a mutual fund, the capital gains tax is deferred until such time as the investor sells their mutual fund units.

## Is it to my advantage to re-invest my tax savings in another flow-through offering?

One of the most compelling strategies with flow-through investing is "recycling" the tax savings! With this strategy, an investor sells the flow-through upon maturity (and declares a capital gain), then reinvests the proceeds in another flow-through investment where 100% of that invested amount is fully deductible. An investor now legitimately receives recurring tax savings by simply recycling the investment proceeds. This is a simple, yet extremely effective, tax planning strategy.

### Flow-Through Limited Partnership Investment & Tax Illustration

Based on a \$10,000 Investment

Flow-Through Tax Savings (\$10,000 x 45%):*	\$ 4,500
Sale of Flow-Through Investment:**	\$10,000
Capital Gain Tax:	<u>(\$ 2,250)</u>
<b>After-Tax Return:</b>	<b><u>\$12,250</u></b>

\* Assumes a marginal tax rate of 45%  
 \*\* Assumes value of investment equals amount invested

#### Advantages of Flow-Through Limited Partnerships

- **Potential for Capital Appreciation:** Flow-through limited partnerships primarily invest in growth-oriented oil & gas and mining exploration, production and development companies.
- **Reduce Current Taxable Income:** Flow-through limited partnerships may be structured such that the amount invested is 100% tax deductible against any source of income in the year the investment is made (except in Quebec). Additional deductions may also be available in subsequent years.
- **Preferential Tax Treatment of Capital Gains:** Tax deductions shelter income and reduce the adjusted cost base of the investment to nil. As a result, proceeds realized on disposition are taxed as capital gains.
- **Tax Deferral:** Taxable income in the year of investment is effectively converted to capital gains tax in the year of the disposition.
- **Take Advantage of Capital Losses:** Realized capital losses and/or net capital loss carry-forwards can be used to offset capital gains realized.
- **Diversification:** Flow-through limited partnerships may offer exposure to several public and private issuers of flow-through shares.
- **Professional Investment Management:** Flow-through limited partnerships are actively managed by professional portfolio managers.

#### Who Can Benefit From Flow-Through Limited Partnerships?

- **High-Income Earners:** High-income earners who are taxable at the highest marginal tax rate.
- **Investors Taxable at Lower Rates in the Future:** Flow-through limited partnerships can be used to defer taxes to periods when an investor will be taxed at a lower tax rate.
- **Recipients of Large Lump Sums of Taxable Income:** A recipient of a large lump sum of taxable income can use flow-through limited partnerships to shelter the payment from taxes.
- **Investors With Capital Losses:** Investors with capital losses and/or net capital loss carry-forwards can offset capital gains realized on disposition of flow-through limited partnership units.
- **Investors Who Plan to Make a Charitable Donation:** Investors can maximize tax savings by donating the flow-through limited partnership units to qualified charitable organizations.
- **Investors Saving for Retirement:** Investors can use flow-through limited partnerships to augment their retirement savings while obtaining tax benefits similar to those provided by RRSPs.
- **High-Income Seniors:** High-income seniors can use flow-through limited partnerships to reduce taxable income to maximize OAS benefits.
- **Corporations:** Corporations, including personal holding companies, can also take advantage of many of the benefits offered by flow-through limited partnerships.

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