

Flow-Through Shares

Flow-through shares are similar to common shares with added tax benefits for investors.

Canadian resource companies can raise capital by issuing flow-through shares to investors and agree to use the proceeds to finance exploration and development activities. Tax deductions associated with these activities are renounced by the flow-through issuer and are allocated to investors who can then claim these deductions for tax purposes. These deductions include Canadian Exploration Expenses (CEE), Canadian Development Expenses (CDE) and Canadian Renewal and Conservation Expenses (CRCE).

Flow-through shares are mutually beneficial for both investors and resource companies. Flow-through shares are an important source of capital for early-stage resource companies that expect to generate significant returns on the capital raised and may not have an immediate use for tax deductions from exploration and development activities. For investors, flow-through shares are an excellent tax-planning tool and provide an opportunity for capital appreciation.

Flow-Through Limited Partnerships

A flow-through limited partnership (“LP”) invests in a portfolio of flow-through shares. Investors are limited partners and the general partner is responsible for managing the affairs of the LP. Investors purchase units of an LP, which then invests the proceeds in flow-through shares of favoured resource companies. The LP allocates tax deductions to limited partners on a pro rata basis each year, which the limited partners can apply to their taxable income. Flow-through limited partnerships offer several benefits over investing directly in flow-through shares. These benefits include portfolio diversification, professional management, access to flow-through investments and simplified administration.



Advantages of Flow-Through Limited Partnerships

- **Potential for capital appreciation:** LPs primarily invest in growth-oriented oil & gas and mining exploration, production and development companies.
- **Reduce current taxable income:** LPs 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 disposition.
- **Take advantage of capital losses:** Realized capital losses and/or net capital loss carry forwards can be used to offset capital gains realized on disposition.
- **Diversification:** LPs may offer exposure to several public and private issuers of flow-through shares.
- **Professional investment management:** LPs are actively managed by professional money 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:** LPs can be used to defer taxes to periods when an investor will be taxable at a lower tax rate.
- **Recipients of large lump sums:** A recipient of a large lump sum payment 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 LP units.
- **Investors who plan to make donations:** Investors can maximize tax savings by donating LP units to qualified charitable organizations.
- **Investors saving for retirement:** Investors can use LPs to augment their retirement savings while obtaining tax benefits similar to those provided by RSPs.
- **High-income seniors:** High-income seniors can use LPs 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 LPs.

Investors should understand and accept the risks associated with investing in early-stage resource companies.

Example 1: Reducing Taxable Income

Assumptions: An investor has \$1,000 of taxable income and has a 46% marginal tax rate. The investor can invest in a flow-through limited partnership that is 100% tax deductible in the year of investment and the redemption proceeds are estimated to be the same as the original investment amount.

By investing in an LP, the investor saves the taxes payable on income and instead pays taxes on capital gains on disposition, only half of which are taxable.

Capital losses and/or net capital loss carry forwards from preceding years (and the three following years) can be used to offset the capital gain realized on disposition resulting in additional tax savings by reducing or eliminating the capital gains.

Even with no capital appreciation, the investor realizes a return on “at-risk capital”^{*} from the tax savings.

^{*} At-risk capital is the initial investment less tax savings from deductions.

	Scenario 1: Do Nothing	Scenario 2: Invest in a Flow-Through LP	Scenario 3: Invest in a Flow-Through LP & Use Capital Losses to Offset Capital Gains
Income	\$1,000	\$1,000	\$1,000
Flow-Through LP Investment	0	(1,000)	(1,000)
Income Tax Payable	(460)	0	0
LP Redemption Proceeds	0	1,000	1,000
Capital Gains Tax	0	(230)	0
Total Proceeds After Tax	\$540	\$770	\$1,000
Tax Deductions (100%)	\$0	\$1,000	\$1,000
Income Tax Savings from Deductions	\$0	\$460	\$460
Adjusted Cost Base	\$0	\$0	\$0
Capital Gain Realized on Disposition	\$0	\$1,000	\$1,000
Capital Losses	\$0	\$0	(\$1,000)
Taxable Capital Gains	\$0	\$1,000	\$0
At-Risk Capital	\$0	\$540	\$540
Return on At-Risk Capital	0%	43%	85%

Example 2: Tax Deferral

Assumptions: An investor has \$1,000 of taxable income and is currently taxable at a 46% marginal rate but will be taxable at 30% in subsequent years. The investor can invest in a flow-through limited partnership that is 100% tax deductible in the year of investment and the redemption proceeds are estimated to be the same as the original investment amount.

The investment is fully deductible in the year of purchase and capital gains taxes are incurred in a subsequent year upon disposition.

The tax deferral is even more beneficial if an investor’s marginal tax rate will be lower in the year of disposition.

CEE deductions can also be deferred to future years if an investor expects to be in a higher tax bracket.

	Scenario 1: Do Nothing & Pay Tax at Current Tax Rate of 46%	Scenario 2: Invest in a Flow-Through LP & Pay Tax at Future Tax Rate of 30% on Disposition
Income	\$1,000	\$1,000
Flow-Through LP Investment	0	(1,000)
Income Tax Payable	(460)	0
LP Redemption Proceeds	0	1,000
Capital Gains Tax	0	(150)
Total Proceeds After Tax	\$540	\$850
Tax Deductions (100%)	\$0	\$1,000
Income Tax Savings from Deductions	\$0	\$460
Adjusted Cost Base	\$0	\$0
Capital Gain Realized on Disposition	\$0	\$1,000
Taxable Capital Gains	\$0	\$1,000
At-Risk Capital	\$0	\$540
Return on At-Risk Capital	0%	57%

Example 3:
Tax-Efficient Charitable Donations

Assumptions: An investor has \$10,000 of taxable income and has a 46% marginal tax rate. The investor can invest in a flow-through limited partnership that is 100% tax deductible in the year of investment and the redemption proceeds are estimated to be the same as the original investment amount.

An investor purchases \$10,000 of units of an LP and receives a 100% tax deduction, saving \$4,600 in current income taxes. The deduction reduces the investor's adjusted cost base to nil. As a result, the investor will pay capital gains tax upon disposition.

However, if the investor donates the LP units to a registered charity, the capital gain will be exempt from tax. In addition, the investor will receive a donation tax credit for the amount of the donation (assumed to be equal to the original investment amount) resulting in additional tax savings.

Amount Invested in Flow-Through LP	\$10,000
100% Deduction	\$10,000
Tax Savings from Deduction	(\$4,600)
Net Cash Outlay Before Donation	\$5,400
Donation Tax Credit	\$10,000
Tax Savings from Donation Credit	(\$4,600)
Capital Gains Tax	\$0
Net Cash Outlay	\$800

In Quebec, investors in a flow-through limited partnership can only deduct investment expenses incurred up to the amount of the investment income earned in any year. Deductible interest and losses as well as deductions allocated from investments in flow-through limited partnerships cannot be deducted against any source of income, only investment income.

Investors are cautioned to obtain professional advice, and to have an accountant prepare a pro forma tax return to avoid the risk of incurring Alternative Minimum Tax (AMT). The amount invested in flow-through limited partnership units should not exceed the maximum amount the investor may deduct without incurring AMT.

Because the market value of a flow-through limited partnership could decline, these strategies should be considered in relation to the investor's overall risk tolerance.

The information contained in this guide is general in nature and is not intended to be professional tax advice. Investments should not be made for tax considerations alone. Each investor's situation is unique and advice should be received from a financial advisor. The examples in this guide are based on a number of assumptions and are illustrative of the application of the relevant income tax provisions to a hypothetical investor.

For more information on flow-through investing or other innovative products, please contact:

**Connor, Clark & Lunn
 Capital Markets Inc.**

181 University Avenue
 Suite 300
 Toronto, ON M5H 3M7

www.cclcapitalmarkets.com

**Darren Cabral
 Vice-President**

Tel: 416-214-6182
 Toll free: 1-888-276-2258
 Fax: 416-363-2089

Email: dcabral@cclgroup.com

