

Flow-Through Shares and LPs

January 15, 2008

FLOW-THROUGH SHARES AND LIMITED PARTNERSHIPS

Brian Hutchison MBA, CFA - Associate Director, Portfolio Advisory Group

OVERVIEW

Flow-through shares and flow-through limited partnerships (LPs) offer investors both a tax benefit and the potential for capital appreciation in the resource sector, typically in oil & gas and mineral exploration. To encourage investment in resource exploration and development, the Canadian government allows corporations with eligible tax deductions to “flow-through” (pass along) these expenses to investors. Firms that issue flow-through shares are typically small-cap firms that do not expect to use their tax deductions because they are not yet profitable. Flow-through shares are common shares with a tax benefit. There are two types of flow-through investments that we will discuss in this introductory piece, flow-through common shares and flow-through limited partnerships.

HOW ARE FLOW THROUGH SHARES ORIGINATED?

Flow-through shares issued by a corporation are originated from treasury in a similar fashion to common shares. However, flow-through shares are typically offered at a significant premium to the price of the company’s common shares at the time of issuance, often in the order of 25-30%. Purchasers of flow-through product are compensated for their premium paid with a significant tax benefit that common shareholders do not possess. For example, if company ABC’s common shares trade on the exchange at \$10.00 per share, ABC may issue flow-through shares at \$12.50-\$13.00 per share. By paying a premium, investors are compensating the company for renouncing their tax benefits to them. Investors in flow-through shares receive a tax deduction which is 100% tax deductible against any source of income in the year that the eligible exploration costs are incurred. These deductions are available to the investor in the year that the shares are purchased. The investor’s adjusted cost base (ACB) will be zero for the flow-through shares. Once an investor has purchased the shares from the corporation and deal has closed, they are able to sell their shares in the market. However, since flow-through shares are actually common shares, an investor would only realize \$10.00 per share pre-tax, assuming the common share price has not moved from \$10.00 per share, for the shares that cost them \$12.50-\$13.00, if they sold them in the market immediately. In the case of a private placement, there is usually a resale restriction of the lesser of the time it takes to file a prospectus or 120 days.

Example of Investing in Flow-Through Shares

Flow-through Share Price	(\$12.50)
Tax Deduction (100%)	\$12.50
Adjusted Cost Base	-
Common Share Price	\$10.00
Gross Proceeds from Sale of Common Shares	\$10.00
Capital Gains Tax Payable on Sale of Common Shares	(\$2.32)
Net Proceeds from Sale of Common Shares	\$7.68
Cash Paid for Flow-through Shares	(\$12.50)
Tax Benefit from Flow-through Shares (46.41%* of \$12.50)	\$5.80
Net Proceeds from Sales of Common Shares	\$7.68
Net After Tax Return	\$0.98
% After Tax Return	7.85%

* 46.41% is the highest marginal tax rate in Ontario for 2008

WHAT ARE FLOW-THROUGH LIMITED PARTNERSHIPS?

Flow-through product can be purchased in the form of either flow-through common shares (as in the above example of ABC Corp.), or as flow-through limited partnerships. Flow-through limited partnerships are entities that purchase a diversified portfolio of flow-through shares. Flow-through limited partnerships offer flow-through tax benefits to investors like flow-through shares, but are similar in structure to mutual funds. Limited partnerships will employ a General Partner to decide which investments will be included, develop the investment objectives, investment strategy and guidelines. The General Partner might work with a Partnership Advisor to help them with the evaluation of investment opportunities. A limited partnership differs from a mutual fund in that it invests in flow-through shares, not common shares. By purchasing limited partnership units, investors are buying into a “blind pool” offering, meaning investors do not know which flow-through shares the limited partnership will invest in. However, a limited partnership may mention anticipated investments in its prospectus.

Unlike flow-through shares which can be held indefinitely, flow-through limited partnerships have a finite life, typically between 14-24 months or over two calendar year-ends on a tax deferred basis. Investors must feel comfortable to hold their investment for the mentioned period of time and possibly beyond,

depending on the issuer, as there is no secondary market for the units. At the end of the life of the limited partnership, the units are rolled on a tax-deferred basis into an open ended mutual fund to provide liquidity for unitholders, subject to the receipt of regulatory and other approvals. There may also be a mandatory period of time over which the investor is required to hold the mutual fund before it can be switched into another fund or liquidated. As liquidation of the mutual fund is considered to be a taxable event, an investor would have to pay taxes on disposition.

	Flow-Through Shares	Flow-Through Limited Partnerships
Advantages:	<ul style="list-style-type: none"> ▪ Can be sold once deal closes ▪ Commodity risk exposure is for a shorter time horizon 	<ul style="list-style-type: none"> ▪ Portfolio Diversification (numerous flow through issues in the LP) ▪ Professional Money Managers deciding which flow-through issues to include in the LP ▪ Longer time frame to make investment decision
Disadvantages:	<ul style="list-style-type: none"> ▪ Single security risk ▪ Client may have limited time frame to make investment decision ▪ Investor (not professional money manager) makes decision to invest in specific flow-through issue 	<ul style="list-style-type: none"> ▪ Longer time to liquidity typically 14-24 mos.). No secondary market for LP units. ▪ Exposure to commodity risk for longer period of time due to LP. ▪ Potential loss of limited liability in certain circumstances

WHY AND WHO WOULD CONSIDER INVESTING IN FLOW-THROUGH SHARES & LPs?

Investors invest in flow-through shares and limited partnerships units to receive the tax benefit associated with these investments and to participate in the potential capital appreciation in the value of the shares or units. Investors in the top marginal tax-bracket will benefit more from flow-through investing as they would derive the largest tax benefit. Due to the premium paid for the flow-through shares, an investment in this asset class may not be as attractive for investors in a lower tax bracket. Please consult your tax advisor to determine whether this might be advantageous for you. Investors who are considering a charitable donation may want to consider investing in flow-through shares or flow-through limited partnerships. Please refer to “Donations to Charity” for a more extensive discussion of in-kind charitable donations.

Please note that flow-through limited partnerships are not eligible for RRSPs, RRIF, RESPs, and Deferred Profit Sharing Plans. While flow-through shares are eligible for RRSPs, RRIFs, and RESPs, an investor would not realize the associated tax benefit. Also, only Canadian residents or Canadian businesses, excluding financial institutions will get the tax benefit from flow-through shares or limited partnerships. If you are a resident of Quebec, please consult your tax

Flow-Through Shares & LPs

advisor as tax treatment of flow-through shares and LPs may differ from treatment in other Canadian provinces.

RISKS OF FLOW-THROUGH SHARES & FLOW-THROUGH LIMITED PARTNERSHIPS

When investing directly in flow-through common shares the investor should be aware of several things. Flow-through shares are often offered on a “bought deal” basis. As such, an investor’s timeline for making their investment decision is much shorter versus an investment in flow-through limited partnerships. Scotia Capital may or may not have analyst coverage of the flow-through issuer, and Scotia Capital does not cover LPs. Investors should feel comfortable holding the individual security irrespective of the tax benefits associated with the flow-through shares. If an investor owns a single flow-through share issue they have single security risk.

While not exhaustive, here are some of the risks of investing in limited partnerships. As there is no secondary market for units of flow-through limited partnerships, investors will need to wait until it rolls into a mutual fund to liquidate their position. Most limited partnerships have terms between 14-24 months before they roll into a mutual fund, and there may be a short hold period once in the mutual fund. While unusual, there can be no assurances that the rollover of the limited partnership to a mutual fund will take place, in which case the limited partnership may be sold, and the partnership dissolved on a taxable basis.

Proceeds of units issued by limited partnerships are invested into publicly-traded and private corporations, as such there can be no guarantee that investors will not incur a loss on their investment after the tax-derived benefit. Because limited partnerships will be investing in the natural resource space in primarily junior stocks, the volatility level of the overall investment will likely be higher than a larger cap investment.

Investors in flow-through limited partnerships have limited liability, in that the most that they can lose is the amount of their initial investment. However, in certain circumstances it is possible that an investor could lose their limited liability.

THINGS TO CONSIDER WHEN INVESTING IN A LIMITED PARTNERSHIP

Here are some things an investor should consider prior to investing in limited partnerships. While past performance is no guarantee of future performance investors may want to consider management’s track record of past performance, just as one might check a mutual fund’s previous performance before investing. Investors should consider how long their funds will be locked up in the limited partnership. Typically most limited partnerships exist for 14-24 months before they are rolled over into a mutual fund. Once the units of the limited partnership are exchanged into mutual fund units there may be a mandatory hold period before an investor can divest or switch out of their units. Investors should consider the investment merits of investing in a particular sector, irrespective of the tax credits generated. Just as one would consider the outlook for a sector before investing in a company, one should do the same for limited partnerships.

OPTIONS TO CONSIDER UPON ROLLOVER OF A LIMITED PARTNERSHIP

Upon rollover of the limited partnership into a mutual fund an investor has several options including making an RRSP contribution, switching between mutual funds (possibly on a tax free basis), investing into a new limited partnership, or donating the mutual fund units “in kind” to a registered charity.

DONATIONS TO CHARITY

With a change in legislation, donations of publicly-listed securities made “in-kind” after May 1, 2006 will have a capital gains inclusion rate of zero. Thus an investor will not have to pay capital gains taxes on a donation of publicly traded shares as was previously the case. By donating flow-through shares or mutual fund units after LP rollover to

After-tax Costs of Flow-Through Common Share Gifts and Cash Gifts			
Flow-Through Common Shares “in kind” Gift		Cash Gift to Charity	
Initial Investment into FTS (100 shares @ \$12.50)	\$1250	Cash Gift to Charity	\$1000
Less: Tax benefit of FTS (46.41% of \$1250)	(\$580)		
Less: Tax benefit of “in kind” gift (46.41% of \$1000)	(\$464)	Less: Tax benefit of cash gift	(\$464)
After-tax cost of the gift	\$206	After-tax cost of the gift	\$536
Assumptions: Ontario marginal tax rate of 46.41%. Flow-Through Shares (FTS) are purchased at (\$12.50 per unit) a 25% premium to common shares @\$10.00. Common shares subsequently sold at \$10.00.			

charity investors can significantly reduce their cost of making a donation. Consider the transaction in the chart.

For more information on the suitability of flow-through shares or flow-through limited partnerships please consult with your ScotiaMcLeod Investment Executive.

The information contained in this article including the appendix is strictly for information purposes only and should in no way be regarded as tax advice. We strongly suggest that you consult with your own tax advisor to determine the optimal use of your share of the federal/provincial deductions/credits, as well as the impact if any, on your liability for alternative minimum tax.

APPENDIX

CANADIAN EXPLORATION EXPENSES (CEE) AND CANADIAN RENEWABLE AND CONSERVATION EXPENSE (CRCE)

To encourage investment in exploration and development the Canadian government allows eligible expenses incurred in Canada, known as Canadian Exploration Expenses (CEE) to be “flowed-through” (passed along) to investors from corporations. Canadian exploration expense (CEE) includes qualifying expenses to determine the existence, location, extent or quality of a non-renewable resource. CEE can be fully written off as soon as the money is spent (with some limitations) or carried forward to future years. It also allows certain qualifying expenditures to be deemed as Canadian Renewable and Conservation Expense (CRCE), used for development of renewable resources such as solar and wind, which can be renounced (given up) as Canadian Exploration Expenses to investors.

INVESTMENT TAX CREDIT FOR EXPLORATION (ITCE)

In order to help junior mining companies with exploration in Canada, the 2007 federal budget extended eligibility for the Investment Tax Credit for Exploration (ITCE) to flow-through-share agreements entered into on or before March 31, 2008. The ITCE gives investors a 15% non-refundable federal exploration tax credit for flow-through shares. The tax credit can be carried back three years or carried forward ten years. Note that because the ITCE is a tax credit rather than a deduction against income like the CEE, the tax credit will be the same irrespective of an investor’s tax bracket. Please note there is no guarantee that the Federal Government will continue to offer this tax credit on a go forward basis.

CANADIAN DEVELOPMENT EXPENSE (CDE)

Canadian Development Expense includes qualifying drilling expenses to bring known reserves into production. CDE can be written off at a maximum rate of 30 percent of the balance in the pool each year. The balance left in the pool is carried forward to future years. CDE can be flowed through to shareholders. Under certain conditions small companies can reclassify the first \$1 million of CDE as CEE to get a faster write-off.

FOR QUEBEC TAXPAYERS

The Province of Quebec levies its own income tax pursuant to the *Income Tax Act* (ITA), and provides a more robust tax incentive to taxpayers that wish to invest in flow-through shares. In fact the Province of Quebec offers the largest potential of incentives for flow-through shares in Canada. An individual can claim a deduction of 125% of certain CEE and a deduction of 150% in respect of Quebec surface mining exploration and oil and gas exploration expenses.

Quebec taxpayers are entitled to use 100% of eligible CEE incurred in Quebec, against income from any source. However, if CEE are incurred outside of Quebec the investor is entitled to write off only 50% of eligible CEE against any source of income, while the remaining amount (50%) will be considered an investment expense. Should an investor’s expenses (including the 50%) be greater than their investment income in the taxation year, the investor is required to report the difference as income, thereby offsetting the expense. However, investors are then able to carry the difference, which they included as income, back three years to offset previously reported investment income or carry it forward up to ten years.

We suggest you consult with your tax advisor to determine the optimal use of your share of the federal/provincial deductions /credits, as well as the impact if any on your liability for alternative minimum tax. In order to encourage exploration in their respective jurisdiction some provinces and territories may offer a tax credit as well, thus helping to reduce an investor’s after-tax cost of their investment.