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Flow-Through Investing Made Simple

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FLOW-THROUGH INVESTING

Flow-through (FT) shares are tax-advantaged investments in the Canadian resource sector. Canadian resource companies can raise capital by issuing FT shares to investors, provided they agree to use the proceeds to finance exploration and development activities. Tax deductions associated with these activities are renounced by the FT 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).

FT shares are mutually beneficial for investors and resource companies. They are an important source of capital for early-stage resource companies who 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, FT shares are an excellent tax-planning tool and provide an opportunity for capital appreciation.

Flow-Through Limited Partnerships

A flow-through limited partnership (FTLP) invests in a portfolio of FT shares. Investors are limited partners and the general partner is responsible for managing the affairs of the FTLP. Investors purchase units of an FTLP, which then invests the proceeds in FT 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. FTLPs offer several benefits over investing directly in FT shares. These benefits include portfolio diversification, professional management, access to FT investments and simplified administration.

Figure 1: Flow-Through Limited Partnerships



Source: Canaccord Genuity

Advantages of FTLPs

- **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 FT shares.
- **Professional investment management:** LPs are actively managed by professional money managers.

Who Can Benefit From FTLPs?

- **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 FTLPs 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 FTLP units.
- **Investors saving for retirement:** Investors can use LPs to augment their retirement savings while obtaining tax benefits similar to those provided by Retirement Savings Plans.
- **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.

Example: Reducing Taxable Income

Assumptions: An investor has \$1,000 of taxable income and has a 46.41% marginal tax rate. The investor can invest in a FTLP 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.

**46.41% was the highest marginal tax rate in Ontario for 2011*

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

Figure 2: Reducing Taxable Income

	Scenario 1: Do Nothing	Scenario 2: Invest in FTLP	Scenario 3: Invest in FTLP & Use Losses to Offset Gains
Income	\$1,000	\$1,000	\$1,000
Flow-through LP Investments	\$0	(\$1,000)	(\$1,000)
Income Tax Payable	(\$464)	\$0	\$0
LP Redemption Proceeds	\$0	\$1,000	\$1,000
Capital Gains Tax	\$0	(\$232)	\$0
Total Proceeds After Tax	\$536	\$768	\$1,000
Tax Deductions (100%)	\$0	\$1,000	\$1,000
Income Tax Savings From Deductions	\$0	\$464	\$464
Adjusted Cost Base (ACB)	\$0	\$0	\$0
Capital Gain Realized on Disposition	\$0	\$1,000	\$1,000
Capital Losses	\$0	\$0	(\$1,000)
Taxable Gains	\$0	\$1,000	\$0
At-Risk Capital	\$0	\$536	\$536
Return on At-Risk Capital	0%	43%	87%

Source: Canaccord Genuity

Example: Tax Deferral

Assumptions: An investor has \$1,000 of taxable income and is currently taxable at a 46.41% marginal rate, but will be taxable at 30% in subsequent years. The investor can invest in a FTLP 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.

Figure 3: Tax Deferral

	Scenario 1: Do Nothing & Pay Tax at Current Tax Rate of 46.41%	Scenario 2: Invest in FTLP & Pay Tax at Future Tax Rate of 30% of Disposition
Income	\$1,000	\$1,000
Flow-through LP Investments	\$0	(\$1,000)
Income Tax Payable	\$(464)	\$0
LP Redemption Proceeds	\$0	\$1,000
Capital Gains Tax	\$0	\$150
Total Proceeds After Tax	\$536	\$850
Tax Deductions (100%)	\$0	\$1,000
Income Tax Savings From Deductions	\$0	\$464
Adjusted Cost Base (ACB)	\$0	\$0
Capital Gain Realized on Disposition	\$0	\$1,000
Taxable Gains	\$0	\$1,000
At-Risk Capital	\$0	\$536
Return on At-Risk Capital	0%	59%

Source: Canaccord Genuity

Risks and Other Considerations

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. 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 is 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. 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 10 years.

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.

Flow-through investments should be considered in relation to the investor’s overall risk tolerance. Investors should understand and accept the risks associated with investing in early-stage resource companies:

Investing in the resource exploration and development sector involves a high degree of risk. Many of the companies capable of renouncing Canadian Exploration Expense will not have a history of earnings. Moreover, the majority of these businesses will have small market capitalization and low market liquidity. Therefore, this sector is extremely sensitive to the business cycle and stock market volatility.

The benefits of flow-through shares are based on federal and provincial income tax legislation that could be amended or changed. There is no assurance as to whether the rules on flow-through shares will stay favourable in the future. The CRA may also disagree whether some of the expenditures renounced by the resource companies qualify as Eligible Expenditures. Any reassessment caused by such a situation could reduce the subscribers return on the units.

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.

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