Understanding Flow-Through Shares and Limited Partnerships

Flow-through shares and flow-through limited partnerships (LP's) 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 Flow-Through Shares are Originated

Flow-through shares issued by a corporation are originated from its 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 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 an 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 the 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 to $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.

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 similar to 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.

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	Flow-Through Shares	Flow-Through Limited Partnerships
Advantages:	▪ Can be sold once deal closes ▪ Commodity risk exposure is for a shorter time horizon	▪ 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:	▪ 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	▪ Longer time to liquidity (typically 14-24 months). No secondary market for LP units. ▪ Exposure to commodity risk for longer period of time ▪ Potential loss of limited liability in certain circumstances

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 unit holders, 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 in that event.

Why and Who Would Consider Investing in Flow-Through Shares & LPs?

Investors invest in flow-through shares and limited partnership 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. Please consult your tax advisor to determine whether this might be advantageous for you. Investors who are considering a charitable donation may also want to consider investing in flow-through shares or flow-through limited partnerships.

Note that flow-through shares and flow-though limited partnerships are **not eligible** for RRSPs, RRIFs, RESPs, and Deferred Profit Sharing Plans. 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 personal tax advisor as tax treatment of flow-through shares and LP's differs from treatment in other Canadian provinces.

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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 regular common shares. 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. 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.

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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 the LP rollover to charity investors can significantly reduce their cost of making a donation. Consider the following transaction:

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.			

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

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