

The Navigator

RBC WEALTH MANAGEMENT SERVICES

Flow-Through Shares and Limited Partnership Units

A Tempting Proposition...But do your homework before making a purchase

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There may be a year where your income is high and you are hoping that there may be a magical solution to reduce your tax “problem”. For instance, you could have a high tax liability in a particular year due to any of the following circumstances:

- › High salary or large bonus
- › Employee stock option income
- › Large realized capital gains (net of capital losses)
- › Large retiring allowance that cannot all be rolled over on a tax-deferred basis to an RRSP
- › Excess pension amounts that cannot be rolled over on a tax-deferred basis into a Locked-in RRSP (or LIRA) and are payable in cash

All of the above circumstances will trigger a legal requirement to report this income on your income tax return. **There is no getting around this reporting requirement.** In fact, in most cases the Canada Revenue Agency (CRA) will receive

supporting information from your employer or financial institution that you have received this income. An example would be the reporting of dispositions to the CRA that result from the sale of securities such as equities or mutual funds.

Given that this income must be reported on your tax return, in order to reduce the taxes payable associated with this income, you must “hunt” for other tax deductions or tax credits that you can legally claim in order to reduce your taxes payable.

Some high-income earners invariably entertain the thought of purchasing a flow-through investment before year-end in order to create tax deductions to

significantly reduce their taxes payable. If you are considering purchasing these investments, you should realize that not all are created equal and as a result an impulsive purchase might be costly. It is very important to consider the quality of the investment, and not just the potential write-off. As the saying goes, “A good tax shelter that is a bad investment is really a bad tax shelter.”

What is a Flow-Through Investment?

A flow-through is a type of tax-advantaged investment designed to encourage investing in resource companies engaging in exploration and development



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in the mining, oil and gas, and renewable energy and energy conservation sectors. If structured properly, Canadian tax laws allow certain expenses incurred by the resource company to be “renounced” or “flowed through” to you and can be deducted by you personally on your tax return up to the maximum you paid for the investment. You may apply the deductions against all sources of income, thereby reducing your net income. This is what results in tax savings for you.

There are two types of flow-through investments: flow-through common shares issued directly by a resource company and flow-through LP units issued by entities that purchase a diversified portfolio of flow-through shares (these are the most common type of flow-through investments).

This article is intended to provide an overview of the investment highlights and risks of investing in flow-through shares and limited partnerships (LPs). For a complete summary of the details and risks of specific issues, you should consult each issuer’s original prospectus and/or related offering documents.

What is a Flow-Through Share?

Flow-through common shares are issued directly by a resource company 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. Individuals, trusts, corporations, and partnerships can invest in flow-through shares, but only the original investors can deduct renounced expenses. These renounced expenses may be claimed in the year or carried forward. Original investors are entitled to deductions renounced by the resource company typically for a number of years after investment.

It’s important to note that the adjusted cost base (ACB) of a flow-through share is deemed to be zero. This means that when you eventually sell your shares, the sale proceeds will be taxed as a capital gain. You are usually able to sell your flow-through shares on the open market as soon as you have purchased your shares and the deal is closed; however, you should consult the prospectus and/or related offering documents of the investment for any holding restrictions.

What is a Flow-Through Limited Partnership?

Flow-through limited partnership (LP) units may be issued by an entity that purchases a diversified portfolio of flow-through shares. Flow-through LPs offer tax benefits to investors similar to flow-through shares, but with some different features. Unlike flow-through shares

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where only the original investor can deduct renounced expenses, the owner of the LP unit on the last day of the LP's fiscal year-end (usually December 31) will be entitled to deduct the renounced expenses. Typically, the LP flows through about 90-95% of your invested amount in deductions in the first year; the remaining 5-10% is flowed through in the following year(s).

The following is a step-by-step overview of the typical flow-through LP structure:

Step 1: You purchase units of a flow-through limited partnership.

Step 2: The limited partnership's portfolio manager invests in flow-through shares of resource companies.

Step 3: Resource companies use the capital to incur eligible expenses. The expenses are flowed-through to the limited partnership, which in turn flows through the eligible expenses to you. The expenses are reported to you on a T5013A tax slip (and a Québec RL-15, if applicable) which should be mailed by March 31st of the year following the allocation of expenses.

Step 4: In general, approximately 18 – 24 months from the close of the limited partnership offering, the limited partnership is dissolved and your limited partnership units are exchanged for shares of a mutual fund corporation on a tax-deferred basis. You may choose to either hold or sell the mutual fund shares.

Similar to flow-through shares, the expenses renounced to you by the flow-through LP may be claimed in the year or carried forward. However, instead of having a deemed ACB of zero, the ACB of your flow-through LP unit is reduced by the amount of flow-through deductions you claim on your tax return. This usually results in the ACB of your flow-through LP to be zero when you eventually sell your flow-through/ mutual fund shares. As a result, the sale proceeds will be taxed as a capital gain.

For tax purposes there is no maximum amount of flow-through investment that is allowed to be purchased. If you make a large investment and you have negative taxable income as a result of the deductions you claim, then a non-capital loss arises. A non-capital loss (i.e. excess deductions) may be carried back three years or carried forward 20 years, and can be claimed against all sources of income. Before undertaking this strategy it is very important to consider a set of rules called Alternative Minimum Tax (AMT) rules when making a large flow-through share or limited partnership purchase. AMT is the government's way of ensuring that high-income earners who

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take specific deductions to significantly reduce their taxes payable actually end up paying at least the minimum federal tax rate of 15% on all of their taxable income (calculated before these specific deductions are taken). The provincial AMT rates vary depending on your province of residence.

Flow-through LPs are not qualified investments for RRSPs, RRIFFs, RESPs, TFSAs, RDSPs and DPSPs. While flow-through shares are qualified investments for RRSPs, RRIFFs, RESPs, TFSAs and RDSPs, you will not realize the

associated tax benefits. Therefore it generally does not make sense to purchase flow-through shares in these vehicles. If you are a resident of Québec, please consult your tax advisor as tax treatment of flow-through shares and LPs may differ from treatment in other Canadian provinces.

Individuals Purchasing Flow-Through LP Units

Let's look at an example to illustrate the tax implications for an individual investing in flow-through LP units. Scenario A illustrates an investor purchasing

units for \$100,000 and selling the resulting mutual fund shares for \$100,000 after 24 months. Scenario B illustrates the same initial investment of \$100,000; however, the mutual fund shares are sold for \$70,000 after 24 months.

	Scenario A	Scenario B
	Sell flow-through / mutual fund after 24 months for \$100,000	Sell flow-through / mutual fund after 24 months for \$70,000
Initial flow-through investment (a)	\$100,000	\$100,000
Deductions claimed	\$(100,000)	\$(100,000)
Tax savings @ 48%* (b)	\$48,000	\$48,000
Proceeds of disposition after 24 months (c)	\$100,000	\$70,000
Adjusted cost base**	\$0	\$0
Capital gain	\$100,000	\$70,000
Taxable capital gain	\$50,000	\$35,000
Tax on taxable capital gain @ 48% (d)	\$24,000	\$16,800
Net after-tax profit = (c) - (a) + (b) - (d)	\$24,000	\$1,200
Total after-tax return on investment over 24 month holding period	24.0%	1.2%
Compound annual after-tax return (e)	11.4%	0.6%
Pre-tax interest equivalent return = [(e) / (1 - 48%)]	21.9%	1.3%

* The above illustration uses an assumed top marginal tax rate of 48%

** Assumes no income or capital gain allocations from LP during holding period

Tax Implications during LP Ownership

If you choose to purchase flow-through investments through an LP, you should be aware that during the flow-through LP's life of approximately two years, the LP will normally incur and allocate some capital gains and potentially other taxable income to you. This is because for tax purposes, an LP itself is not a taxpayer; instead its income (loss) is allocated for tax purposes to its partners for inclusion in their tax returns, even though cash has not been distributed from the LP to the partners. The gain in the LP results primarily from dispositions of flow-through shares due to corporate acquisitions or restructurings of the issuers, but may also be due to portfolio management decisions made by the portfolio manager. Any income (losses) or capital gains (losses) will be reported to you each year on a T5013A tax slip (and Québec RL-15, if applicable).

To prevent double taxation on the future disposal of your LP units, the ACB of your LP units is adjusted when amounts are allocated to you. The amounts reported on the T5013A that are losses (whether the losses can be used as a deduction or results in a tax credit) must be subtracted from your ACB at the beginning of the following year.

Similarly, the amounts reported on the T5013A that are income must be added to your ACB at the beginning of the following year. If you receive a cash distribution from the LP, this amount will reduce your ACB.

“Super” Flow-Through Shares

In October 2000, the federal government introduced a temporary 15% investment tax credit as part of a program to promote exploration and help moderate the impact of the downturn on mining communities. The federal government has extended the program to investors subscribing to qualifying flow-through share agreements on or before **March 31, 2013**. Please note there is no guarantee that the federal government will continue to offer this credit on a go-forward basis. The credit, called the Mineral Exploration Tax Credit, may be claimed on the amount of certain renounced “grassroot” mineral exploration expenses. The credit, which is only available to individuals and not trusts, partnerships, or corporations, is deductible from federal income taxes payable and is in addition to the existing flow-through deductions. Flow-through investments qualifying for this additional credit are commonly referred to as “super” flow-through shares to distinguish them from regular flow-through shares.

The federal investment tax credit that you claim is first used to reduce your current year tax. Any excess credit may be carried back for up to three years to reduce your federal income taxes payable in those years, or may be carried forward for 20 years, if it was earned in a year after 2005. You may also be able to claim a refund of your unused investment tax credit but it can only be done in the year it is earned. This refund will reduce the amount of credit available to you for other years. The refundable part of your investment tax credit is calculated on Form T2038(IND), Investment Tax Credit (Individuals). The investment tax credit you claim in the year may result in an income inclusion in the following year in the absence of a new investment in flow-through shares / LP units.

If you reside in a province that provides a provincial investment tax credit, this tax credit may be claimed in combination with the federal credit. However, the provincial credit received or entitled to be received in a taxation year will reduce your federal tax credit.

Ownership of Flow-Through Investments by Corporations

A corporation can also purchase flow-through investments directly in order to reduce taxes. The tax benefit to the corporation of the deductions flowed through depends on the type of income


the renounced expenses are being deducted against (i.e. investment income, active business income under the small business limit, or active income taxed at the general corporate rate). A corporation is not subject to AMT, however corporate minimum tax should be considered if applicable in the corporation's province and it is making a large flow-through investment purchase.

A corporation can benefit from owning flow-through investments in particular if it has capital loss carry-forwards that can be used to offset the resulting capital gain arising on the disposition of the investment. If you own a corporation, you may wish to consider a strategy where you purchase a flow-through investment and transfer the investment to your wholly-owned corporation. After you have received the initial tax benefits and have personally deducted the expenses flowed through to you, you can transfer the investment to your corporation and make an election under subsection 85(1) of the Income Tax Act to transfer at the ACB. The corporation then sells the investment (after the holding period, if applicable). The corporation will then realize a capital gain, which can be sheltered by the corporation's capital loss carry-forwards.


Donating Flow-Through Investments

In 2006, the federal government announced the elimination of capital gains tax triggered upon the disposition of publicly traded securities that are donated to a charitable organization or a public foundation. In 2007, this rule was extended to donations of publicly traded securities to private foundations. The tax benefit of donating securities was enhanced when a flow-through common share or a share of a mutual fund corporation that was originally a flow-through LP unit was donated to a charity. Upon disposition of the flow-through common share or the share of a mutual fund corporation, you would trigger a capital gain equal to its fair market value (FMV). If you donated the flow-through common share or the share of a mutual fund corporation to a charity, you would benefit from the elimination of the taxable capital gain and the charitable donation tax credit. To summarize, if you donated the flow-through common shares or the shares of a mutual fund corporation instead of selling them and donating the cash proceeds, you would benefit from the following treatment:

- › Current full deduction of exploration and development expenses flowed through to you;
- › Applicable federal mineral exploration tax credit and applicable provincial flow-through share tax credits;



A corporation can also purchase flow-through investments directly in order to reduce taxes.



- › Taxable portion of capital gains on disposition eliminated on donation of the flow-through securities; and
- › Donation tax credit based on the FMV of the donated flow-through securities.

In 2011, the federal government introduced new rules to limit what they saw as excessive tax benefits that resulted from the elimination of the taxable capital gains on the donation of flow-through securities by effectively taxing the portion of any capital gain up to the original cost of the shares. As a result of these new rules, a deemed capital gain may be triggered when flow-through securities are donated. The deemed capital gain is equal to the lesser of the actual capital gain triggered on the donation and your “exemption threshold”. In very simplified terms, your exemption threshold is equal to the original cost of all flow-through shares of the same class less any cumulative capital gains realized on the disposition of flow-through shares in the same class. What this all means is that the exemption from capital gains tax will be available only to the extent that the actual capital gain on the donation of flow-through securities is in excess of your original cost amount.

In 2011, the federal government introduced new rules to limit what they saw as excessive tax benefits that resulted from the elimination of the taxable capital gains on the donation of flow-through securities by effectively taxing the portion of any capital gain up to the original cost of the shares.

These new rules apply to donations of a “flow-through share class of property” made on or after March 22, 2011. The definition of “flow-through share class of property” generally includes shares of a particular class of the capital stock of a corporation if any share of that class are at any time a flow-through share or any right to acquire such a share. The definition may also include shares of a mutual fund corporation that were received in exchange for units of a partnership if at any time more than 50% of the FMV of the partnership’s assets is attributable to property included in a flow-through share class of property.

However, the new rules do not apply to flow-through common shares acquired before March 22, 2011 or mutual fund corporation shares that are received in exchange for flow-through limited partnership units acquired before August 16, 2011 (no contributions to the partnership can be made on or after August 16, 2011). Generally, only the original cost of flow-through shares acquired on or after March 22, 2011 and flow-through limited partnership units acquired on or after August 16, 2011 get added to your exemption threshold. For example, if you only owned flow-through common shares purchased prior to March 22, 2011, your exemption threshold will remain at zero and you can donate the shares and benefit from the old rules (i.e. you will still be able to exclude your entire capital gain realized at the time of donation). Likewise, if you acquired flow-through limited partnership units before August 16, 2011, once they are exchanged for shares of a mutual fund corporation, you

can donate them and still benefit from the old rules.

Here is an example to illustrate the impact of the new rules. Say you purchased 500 flow-through shares of XYZ Co. for an original cost of \$50,000 and later donated all 500 shares of XYZ Co. when they are worth \$45,000. Under the old rules, or if all the 500 shares were acquired before March 22, 2011, then the taxable capital gain would be zero.

Under the new rules, (assuming the 500 shares were purchased on or after March 22, 2011 or the shares were received in exchange for flow-through

limited partnership units acquired on or after August 16, 2011), the exemption threshold is calculated as the original cost of \$50,000 (ignoring the deemed zero cost for flow-through shares and in the case of mutual fund corporation shares, assuming no income or capital gain allocations were made from the Limited Partnership during the holding period). The deemed capital gain is calculated as the lesser of:

- a) the actual capital gain on the donation (\$45,000); and
- b) the exemption threshold (\$50,000).

In this example, a deemed capital gain of \$45,000 is triggered and is subject to capital gains tax on the in-kind donation.

The following table illustrates how the new rules have eliminated the cost savings of donating the flow-through share class of property instead of selling it and donating the cash proceeds. Continuing with the example above, the FMV of the shares decreased by \$5,000 to \$45,000.

	Sell flow-through class of property and donate cash	Donate flow-through class of property directly (old rules)	Donate flow-through class of property directly (new rules)**
Initial flow-through investment (a)	\$50,000	\$50,000	\$50,000
Deductions claimed	\$(50,000)	\$(50,000)	\$(50,000)
Tax savings @ 48%* (b)	\$24,000	\$24,000	\$24,000
FMV of donation	\$45,000	\$45,000	\$45,000
Adjusted cost base	\$0	\$0	\$0
Capital gain/ deemed capital gain	\$45,000	\$45,000	\$45,000
Taxable capital gain	\$22,500	\$0	\$22,500
Tax on taxable capital gain @ 48% (c)	\$10,800	\$0	\$10,800
Tax savings from donation tax credit (d)	\$21,600	\$21,600	\$21,600
Total cost of donation = (a) – (b) + (c) – (d)	\$15,200	\$4,400	\$15,200

* The above illustration uses an assumed top marginal tax rate of 48%

** The above assumes that all 500 shares/units were acquired after March 22, 2011/August 16, 2011 and as such, the exemption threshold is \$50,000.

Although the new rules limit the ability to claim an exemption from capital gains tax on the donation of a publicly listed flow-through class of property to the amount of capital gains realized in excess of the original cost, this only eliminates one part of the tax benefit that currently exists. If you acquire flow-through shares or flow-through LP units and subsequently donate them (or substituted property – mutual fund shares) to a registered charity, you can continue to benefit from resource deductions allocated to you and a charitable donation tax credit based on the FMV of the securities but you will be taxable on any capital gain up to the original cost of the security.

We have simplified our discussion above and the example provided to make it easy to understand. If you currently own flow-through shares which you acquired before and on or after March 22, 2011, or if you dispose of some flow-through shares and donate some of the same class, your situation would be more complicated. Also, if you own shares of the same class but some were flow-through shares for you and others were not, again your situation would be more complex. In these situations it is even more important to consult with your qualified tax advisor to determine the tax impact.

Possible Drawbacks of Flow-Through Investments

■ Investment risk

What will the proceeds from sale be when the flow-through shares / mutual fund shares are sold 18-24 months from now? There is a risk that the underlying shares will not perform well and you may realize a loss on the sale. It's important that the tax savings will make up for any potential investment losses.

■ Tax risk

To be eligible for renunciation, expenses incurred by the resource company must meet certain criteria. You should be aware there is a tax risk that CRA will deny the renunciation of expenses that do not meet these qualifications.

■ Time horizon and liquidity

As there is generally no secondary market for units of flow-through LPs, in most cases you will need to wait until the partnership is dissolved and your units are converted to shares of a mutual fund corporation before you can liquidate your position. The units may not be converted into mutual fund shares for 18-24 months or longer after the close of the LP offering, and there may be a short holding period once converted to shares of a mutual fund corporation.

You should be aware there is a tax risk that CRA will deny the renunciation of expenses that do not meet these qualifications.

■ **Alternative Minimum Tax**

It's important to consider AMT before making a large flow-through share or limited partnership purchase. AMT is the government's way of ensuring that high-income earners who take specific deductions to significantly reduce their tax payable actually end up paying at least the minimum federal tax rate of 15% on all of their taxable income (calculated before these specific deductions are taken). The provincial AMT rate varies depending on your province of residence. The calculations for AMT are usually complicated and a professional tax advisor should be consulted. Please contact your advisor for assistance in estimating federal AMT.

■ **Additional tax reporting**

You should seek the assistance of a professional tax advisor to determine the optimal use of your share of the federal/provincial deductions/credits and for tax reporting assistance.

Considerations Prior to Purchasing the Investment

In determining whether or not a flow-through investment is right for you, you should discuss the following questions with your professional advisor:

- › What are the specific features and inherent risks associated with this investment?
- › What is the issuer's track record?
- › Is there a prospectus or offering memorandum?
- › Is future financing required? (i.e. additional future instalment payment or liability for debts incurred by the partnership)
- › When will the tax deductions be available?
- › Will the tax deductions trigger AMT?
- › How liquid is my initial investment?
- › How does the investment affect my overall asset allocation strategy and my risk tolerance?
- › How long do I plan to hold the investment and what are the tax implications on disposition?
- › Has the issuer received an Advanced Income Tax Ruling from the CRA regarding certain aspects of the investment? If so, ask to see a copy.

Although the temptation may be high to invest in a flow-through investment solely for the immediate tax benefits, you should ensure that there is a profit potential after taking the tax benefits into account. In addition, the opportunity cost of investing in a particular tax shelter should outweigh other investment alternatives at that time.

Alternatives to Flow-Through Investments to reduce your taxes payable

■ RRSP Contribution

Maximizing your RRSP contribution will assist in reducing your taxes payable, however, the tax savings from this RRSP deduction are generally small (due to RRSP contribution limits) relative to the total taxes payable.

■ Labour Sponsored Investment Funds

The purchase of a labour-sponsored investment fund will generate a tax credit to reduce your taxes payable. This investment is similar to a mutual fund; however, the attraction of a labour-sponsored investment fund as opposed to a regular mutual fund is that a federal tax credit of 15% can be realized on the first \$5,000 purchase. Additional provincial tax credits can also be generated depending on the individual's province of residence. Note that the labour-sponsored investment fund must be held for at least eight years to avoid repaying the tax credits. Similar to the RRSP tax savings, labour-sponsored fund tax credits are generally minimal in relation to a high-income earner's overall tax liability.

■ Charitable Donations

Making charitable donations of securities (other than flow-through investments) before year-end can create tax savings of approximately 25% on the first \$200 donated and up to approximately 50% on the remainder of the donations in the year. Although this strategy does reduce taxes, there may be limitations on how much cash and/or securities you may be willing to or can afford to donate.

Although the temptation may be high to invest in a flow-through investment solely for the immediate tax benefits, you should ensure that there is a profit potential after taking the tax benefits into account.

› Please contact us for more information.

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