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Canadian Mining, Oil & Gas Flow-Through Limited Partnerships

Mining and oil & gas flow-through limited partnerships (the "Partnership") provide an opportunity for Canadian investors to participate in the resource sector while enjoying significant tax benefits.

The Partnership starts by investing exclusively in a portfolio of flow-through shares of Canadian resource companies. Flow-through shares are common shares of Canadian resource companies issued to finance the exploration and development of resource properties. To encourage investment in exploration and development programs by these companies, the federal government allows exploration and development expenses incurred to be "flowed-through" to investors and deducted for tax purposes. Canadian Exploration Expenses (CEE) are 100% tax deductible in the year the funds are spent. In essence, an investor in flow-through shares can expect to deduct the full amount of his or her investment against income. However, at the time of disposition the full proceeds of the sale of the assets acquired in this fashion, generally become taxable capital gains.

Investment Strategy

The Partnership's initial strategy entails investing primarily in a portfolio of flow-through shares of resource companies that offer the potential for future growth in the mining, oil and gas, or alternative energy sector and that will allow the Limited Partners certain tax deductions from income for income tax purposes.

Limited Partnerships are usually "blind pool" offerings because when purchasing the Partnership units investors usually do not know which companies will be included in the portfolio. A premium to current stock market price is often paid by the Partnership when purchasing flow-through shares in Canadian resource companies in order to obtain their associated tax benefits. The premium is to compensate the resource company for "selling" to investors what would otherwise be their tax shield. In essence, what these companies are really doing is selling their tax pools to investors today to raise additional financing for their exploration and development programs. Investors need to realize that even though they are often paying a premium to current stock market prices to purchase the flow-through shares in Canadian resource companies, they are receiving both a common share and the tax shield value associated with deducting the full amount of their investment against income. The amount of any premium paid is also tax deductible.

The Partnership usually retains a professional investment advisor in order to manage the portfolio. The investment advisor is responsible for developing, implementing, and refining the Partnership's investment strategy.

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Investment Considerations

Some investment factors and associated risks that should be considered when purchasing a flow-through share limited partnership are discussed in more detail below:

Liquidity

No formal market exists in which Partnership units may be sold. Therefore, in order to provide liquidity, after a predetermined period (usually approximately two years) some Partnerships allow Limited Partners to vote on rolling over the assets of the Partnership into an open ended mutual fund on a tax-deferred basis. The number of mutual fund units received will depend on the relative values of the mutual fund units and the partnership units at the time. After the rollover, investors may elect to redeem their mutual fund units at any time but pay tax on gains realized on disposition.

Income Tax

Since CIBC Wood Gundy is not a tax advisor, we recommend that clients seek independent advice on tax-related matters when dealing with Limited Partnerships.

Only Canadian residents can own mining, oil & gas flow through Limited Partnerships. As well, these Partnerships are not qualified investments for trusts governed by rules regarding RRSPs, RRIFs, deferred profit sharing and RESPs.

- **How They Work**

As noted earlier, to encourage investment in exploration programs, the federal government allows Canadian exploration and development companies to renounce expenses, known as Canadian Exploration Expenses (CEE) and Canadian Development Expenses (CDE), for tax purposes. Limited partners may claim 100% of CEE pool balance in year, but only 30% of CDE pool balance on a declining balance basis. Exploration is more risky than development... hence the better write-off.

Losses realized by the Partnership will be allocated to the Limited Partners. Since the cost base of Limited Partnership units is reduced by the amount of loss deductions claimed by their owner, and since these Limited Partnerships generally provide deductions equal to the amount invested, the cost base on Limited Partnership units will likely be close to nil. Therefore, the subsequent disposition of the partnership units will likely trigger a capital gain.

The principal tax benefit of flow-through limited partnerships is tax deferral. The simplified example below is hypothetical only and is intended to illustrate the tax features of flow-through limited partnerships. The example assumes a 90% deduction in the first year and the remaining 10% in subsequent years at a 46% marginal tax rate and a 50% capital inclusion rate.

- **Example:**

An Investor is in the highest marginal tax bracket and makes an initial investment of $10,000.

Table 1: Tax Deductions Based on a $10,000 Investment

	Year of Investment	Subsequent Years	Total
Assumed marginal tax rate	46%	46%	
Investment	$10,000	-	$10,000
Income tax savings from deductions	(4,140)	(460)	(4,600)
Capital Gains tax	-	2,300	2,300
Total income tax (savings)/expense	$(4,140)	$1,840	$(2,300)

Source: CIBC Wood Gundy

Actual deductions can vary significantly for an investor.

Breakeven proceeds of disposition (1)	$7,013
Downside protection (2)	30%
After-Tax Money-at-risk (3)	$5,400

(1) Breakeven proceeds of disposition of flow-through shares is calculated as money at risk divided by one minus the assumed marginal tax rate on capital gains in the year the flow-through shares are disposed of.
(2) Downside protection is calculated as investment cost ($10,000) minus breakeven proceeds of disposition of flow-through shares divided by investment cost.
(3) Money at risk is calculated as total investment by the Limited Partners less all income tax savings from deductions. The calculation is prior to the sale by the Partnership of any flow-through shares.

If the Partnership rolls over its assets into a mutual fund no taxable capital gains will be realized by the Partnership provided that all the appropriate elections are properly completed and filed in a timely manner. However, if the Partnership is dissolved (i.e., it does not roll over its assets to a mutual fund), each Limited Partner will acquire a pro-rata portion of the net assets of the Partnership. This will be either cash or in some cases, cash and shares of the individual resource companies in the Partnership portfolio. A Dissolution in the Partnership will likely trigger capital gains for the Limited Partners in an amount equal to the cash that is distributed. If certain requirements in the Tax Act are satisfied, the distribution of the underlying portfolio may occur on a tax-deferred basis until the shares are ultimately sold. This may or may not be the case and can vary for each offering.

In addition to CEE there is also a 15% nonrefundable investment tax credit to individuals (but not corporations or trusts) that invest in flow-through shares of mineral exploration companies. The credit could be claimed in respect of specified Canadian mineral exploration expenses incurred after March 2011 and before 2013 and renounced to the Limited Partners pursuant to flow through share agreements signed on or before March 31, 2012. As suggested earlier clients should consult with licensed professionals qualified to advise on specific tax aspects of Limited Partnership.

For Quebec provincial tax purposes only, 100% of CEE incurred in Quebec is deductible from income from any source, but only 50% of CEE incurred outside of Quebec. The other 50% of CEE incurred outside Quebec would be deductible only if investment income for Quebec tax purposes for the year exceeds investment expenses for Quebec tax purposes (including that 50% of CEE) for the year in question. Investment expenses not deductible in a year for Quebec provincial tax purposes may be carried back three years or carried forward indefinitely to apply against investment income in those years.

Sensitivity of After-Tax Returns

The table below (see table 2) highlights the impact of tax deductions from the Partnership's units on after-tax returns.

In the circumstances of capital appreciation in the underlying portfolio, the tax savings will give the effect of providing positive leverage on the performance. In essence, net of the tax effect at an assumed 46% tax rate, a $1 investment has an after-tax cost of $0.54. If the underlying portfolio appreciates by 20% (i.e., grows to $1.20), the investor will realize an after-tax return of 71%. If, on the other hand, the underlying portfolio depreciates by 30% (i.e., declines to $0.70) investors will realize an after-tax return of 0%. The tax savings are estimated to give downside protection to the extent of a 30% decline in net asset value. This means that a $1 investment will need to fall below $0.70 before the investor starts to incur an after-tax loss.

- **Example:**

Using the same assumptions in the previous example, here we illustrate two different scenarios. The initial investment by an Investor was $10,000. The first scenario assumes the Investor sold below his initial investment at $7,013. The second assumes the Investor sold above his initial investment at $12,000.

Table 2: Sensitivity of After-Tax Return to Net Asset Value

	Sale at $7,013	Sale at $12,000
Initial Investment	$10,000	$10,000
After-tax Cost (Money at Risk)	5,400	5,400
Proceeds on Disposition	7,013	12,000
After-tax Proceeds on Disposition	5,400	9,240
After-tax Return	Break-Even	71%

Source: CIBC Wood Gundy

As the above example illustrates, if the value of the portfolio declines, the initial tax savings will provide protection on the downside.

Risks

Flow-through limited partnerships are speculative investments. Investors should consider the following risk factors before making an investment decision:

- Investors must rely on the sole discretion and judgement of the General Partner which may not have any operating or investment history and is expected to have only nominal assets.
- There is no assurance of a positive return on this investment and only investors who can afford the potential of loss should consider such an investment.
- The flow-through shares are typically issued to the partnership at prices greater than the market price for the common shares.
- There is no assurance that the General Partner (on behalf of the Partnership) will be able to identify a sufficient number of Resource Companies willing to issue flow-through shares to permit the Partnership to commit all proceeds available for investment to purchase flow-through shares. Therefore the possibility exists that capital may be returned to the Limited Partners and the Limited Partners may be unable to claim anticipated deductions from income for income tax purposes.
- The Limited Partnership will invest only in companies engaged in the exploration, development, and production of natural resources. This focus may result in the value of the portfolio being more volatile than portfolios with a more diversified investment focus.
- There is no assurance that the income tax laws in various jurisdictions of Canada will not be changed in a manner that will fundamentally alter the tax consequences to the Limited Partners.
- The limited liability of investors may be lost under certain circumstances as the General Partner may not be able to satisfy its obligations. In the event the investor's limited liability is lost, additional funds may need to be paid by investors to cover the Partnership's liabilities.

Investors should refer to the information contained in the prospectus before making an investment decision.

What to look for…

Before you invest in a flow-through limited partnerships make sure that you have reviewed the following:

- **Management Performance**

Invest only with an experienced management team with a proven track record. If possible, review management's performance in other flow-through limited partnerships that they manage.

- **Investment Suitability**

Ensure that the investment strategy and guidelines regarding the types of companies that the partnership will invest in including diversification, market capitalization, liquidity, and exchange listings are suitable. Also of importance is the planned mix of investments between oil & gas and mining companies.

- **Liquidity**

Ensure that liquidity provisions exist in the Limited Partnership agreement.

- **Outlook**

Ensure that the flow-through limited partnership invests in a sector with a favorable outlook.

- **Tax Benefits**

While the tax benefits of investing in flow-through limited partnerships are attractive, they should not be the primary investment criteria.

- **Deal Size**

Overall deal size can impact on a manager's ability to diversify, attract issuers, negotiate premiums, find sufficient issuers in whom to invest and impact on the Partnership economics for fixed costs associated with the Offering and an on-going basis.

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