Sentry Select
Flow-Through Limited Partnerships

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TAX PLANNING

A guide for investors and investment professionals

INTRODUCTION

Flow-through shares are one of the few remaining tax-assisted investments available to Canadian investors.

Recent government actions have reduced or eliminated the attractiveness of alternatives such as mutual fund limited partnerships, donations of art to charities and film partnerships as tax-planning tools. Along with Registered Retirement Savings Plans and labour-sponsored investments, flow-through investments remain, in part because they help the government achieve a specific policy objective, which is financing the exploration for and development of Canada's natural resources.

Flow-through shares do not exist to circumvent tax rules or take advantage of "loopholes". They were explicitly created by government policy and they are effected through specific provisions within the Income Tax Act.

The primary benefit of flow-through investing is to convert income otherwise fully taxable in the current year into capital gains taxable at some time in the future.

The three tax advantages are:

1) Tax savings — Taxes on capital gains are lower than on regular income (e.g., income from employment, business or property) and dividends.
2) Tax deferral — It is usually advantageous to pay taxes in the future rather than today.
3) Tax efficiency — A way to benefit from capital loss carry-forwards.

This booklet is designed to provide investors and investment professionals with basic information about NCE Flow-Through Limited Partnerships. It provides a brief discussion of how they work and seven different examples of how flow-through investments can be used in tax planning.

ABOUT FLOW-THROUGH SHARES

Flow-through shares have helped expand Canada's resource sector since their introduction to the Canadian tax system in 1954. At that time, the Canadian government introduced provisions to allow for the transfer of tax deductions between companies, in an effort to assist in financing exploration projects in Canada. Resource companies could transfer certain exploration expenses to investors, who were then able to deduct these expenses against their own resource income.

In the early 1980s, the government was asked to find additional tax incentives to encourage exploration and development in the resource sector. In the April 1983 federal budget, the government allowed certain investors to deduct exploration expenses (and related depletion allowances) against any income. As a result, flow-through investments became more popular and exploration activity increased dramatically.

The government now allows Canadian resource companies, including those in oil and gas, mining, base metals and renewable energy to fully deduct specific exploration expenses, known as Canadian Exploration Expense (CEE). Many of these companies issue flow-through shares to raise capital, and in turn renounce the CEE to these shareholders. The renounced CEE is generally fully deductible against any source of income.

Flow-through shares are usually issued by junior resource companies. Investing in individual smaller resource companies is speculative. These companies are often small, with minimal liquidity and returns dependent on commodity prices. These companies have the potential to post very strong short-term performance numbers. Investments of this nature also have the potential to be more volatile than the overall market, which could lead to greater-than-average losses. Adding smaller resource companies to a portfolio can increase returns, and it can also reduce overall portfolio volatility. Resource stock prices often move independently of the overall market, and smaller companies' stock prices may move independently of larger companies.

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ABOUT FLOW-THROUGH LIMITED PARTNERSHIPS

Investors can invest in flow-through shares indirectly through limited partnerships.

Flow-through limited partnerships are used to bring two important benefits to flow-through investing: professional management and diversification.

The risk of investing in smaller resource companies may be lowered when a team of experienced managers selects a diversified portfolio of companies. A diversified portfolio of flow-through shares can be owned in a limited partnership.

The tax benefit is unchanged. Investors who purchase flow-through shares indirectly through limited partnerships usually find the amounts invested fully or almost fully deductible against other taxable income in the year the investment is made. The deduction can be found on line 224 of your T-1 Canadian Income Tax return.

The chart (right) offers a basic diagram of how flow-through limited partnerships work. Investors purchase units of a flow-through limited partnership. This partnership is managed by a general partner on behalf of the investors, the limited partners. The partnership's net proceeds are used to purchase the flow-through shares of several resource companies. The resource companies renounce their CEE to the limited partnership, which allocates the CEE out to its investors. The investors deduct the CEE and the partnership's losses from organization and operating costs. Investors generally receive a substantial portion of their original investment back in the form of tax savings. Tax savings alone could amount to nearly half of the original investment, depending on each investor's marginal tax rate. A limited partner's exposure to the liabilities of a limited partnership is generally limited to their investment.

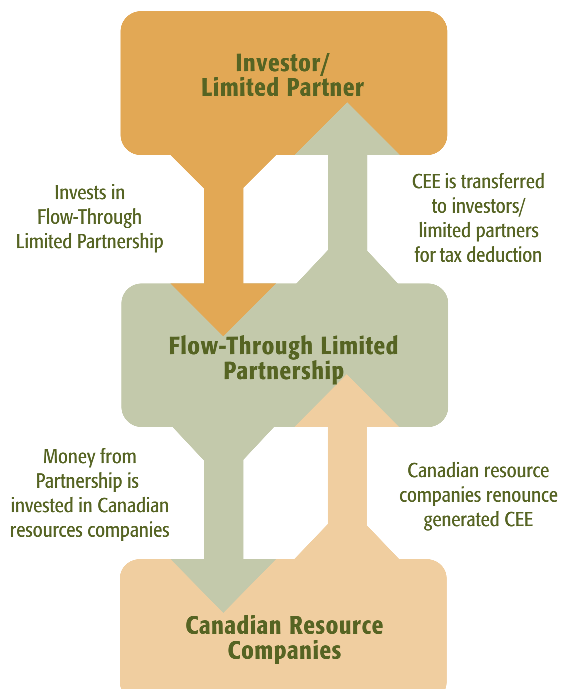
Most flow-through limited partnerships have a life span of less than two years (just enough time to allocate most of the tax deductions to the investors). Once the tax deductions have been claimed, investors continue to be partners in a diversified portfolio of smaller Canadian resource companies. The up-front tax deductions will usually mean investors have a low or nil adjusted cost base in the flow-through limited partnership. At maturity, NCE Flow-Through Limited Partnership investors exchange their partnership interests for shares in an open-end mutual fund that invests in energy and natural resource companies. This exchange is done without any immediate tax consequences, thereby deferring any tax liability.

The investor may eventually decide to redeem the mutual fund shares. The investor would generally realize a capital gain at that time equal to the proceeds received on redemption less the adjusted cost base of the shares (which is usually nil).

Investing through a flow-through limited partnership is an important tool in tax planning. It can be used to reduce income taxes, utilize capital losses incurred on other portfolio holdings and in other ways. On the pages that follow, we present a number of examples on how flow-through investments may be used in tax planning.

In each example, the following assumptions are made for simplicity:

1) The flow-through investment is 100% deductible in the year that it is made. In practice, the actual amount typically ranges from 90% to 100%, with the balance deductible in the following years. The amounts deductible in future years typically relate to organization costs.
2) The value of the flow-through investment at maturity is the same as its original purchase price. In practice, the value of the flow-through shares of each company may rise or fall during the period of investment, changing the value of the flow-through limited partnership units.



ABOUT FLOW-THROUGH LIMITED PARTNERSHIPS (CONT'D)

3) The investor is an Ontario resident and is single. Tax rates differ by province. See Appendix 1 for a listing of the top marginal tax rates by province for 2006.
4) Tax proposals announced on October 31, 2003 would, if enacted, restrict the deductibility of certain expenses or losses in certain circumstances. The Department of Finance has indicated the proposals are not intended to represent a major change in policy but are to reaffirm many current practices that support the deductibility of interest. Accordingly, the anticipated effect of the proposals are noted where they are expected to be applicable. See Appendix 2 for more details.
5) Several provinces allow their residents to claim additional tax credits on flow-through investments when calculating their provincial taxes. These credits arise from companies engaged in the exploration of metal and mineral resources, and are in addition to the existing deduction of eligible exploration expenditures from the federal portion of an investor's taxes. The effect of these incentives varies depending on which province the investor resides. For simplicity, it is assumed that any provincial credits are nil in the following examples.

EXAMPLE 1

Use flow-through limited partnerships to reduce taxable income

Taxpayer earns $200,000 per year. He is considering investing $50,000 in a flow-through limited partnership each year for the next nine years. This would be done by two initial investments of $50,000, then re-investing the proceeds from the redemption of the mutual fund shares.

Here is a summary of the effect of this flow-through limited partnership investment on his taxes.

If he earns $200,000, he will pay approximately $75,180 in taxes, based on 2006 tax rates.

If he invests $50,000 in a flow-through limited partnership, his income tax will be reduced to approximately $51,975 resulting in an immediate savings of approximately $23,200. When he redeems the investment after it has been converted into a mutual fund, there will be a taxable capital gain of $25,000 and tax payable of about $11,600, leaving him ahead by about $11,600.

The table below indicates the tax savings achieved over 11 years on an investment of $50,000 each year for nine years. In each of the first two years, the investor will realize savings of $23,200. In years three through nine, Taxpayer redeems the mutual fund shares and re-invests $50,000 in a flow-through limited partnership. The tax savings help fund the subsequent investments. In the third year, and all subsequent years, the $23,200 tax savings is reduced by the amount of tax payable on capital gains arising from the redemption of the mutual fund shares. Finally in years 10 and 11, the remaining mutual fund shares are redeemed and capital gains realized.

Year	F-T Purchase	Income Tax Savings	Capital Gains Tax Paid	Net Savings	Cumulative Savings
2006	$ 50,000	$ 23,200	$ –	$ 23,200	$ 23,200
2007	50,000	23,200	–	23,200	46,400
2008	50,000	23,200	11,600	11,600	58,000
2009	50,000	23,200	11,600	11,600	69,600
2010	50,000	23,200	11,600	11,600	81,200
2011	50,000	23,200	11,600	11,600	92,800
2012	50,000	23,200	11,600	11,600	104,400
2013	50,000	23,200	11,600	11,600	116,000
2014	50,000	23,200	11,600	11,600	127,600
2015	–	–	11,600	(11,600)	116,600
2016	–	–	11,600	(11,600)	104,400

After 11 years, the taxpayer has achieved cumulative tax savings of $104,400 or $11,600 for each year $50,000 was invested.

EXAMPLE 2

Use flow-through limited partnerships to reduce taxable income and take advantage of capital loss carry-forwards

Capital losses generally occur when an investor sells capital property for an amount below the amount invested. Capital loss carry-forwards arise when capital losses exceed capital gains for a year. Capital losses can be used to offset future capital gains or capital gains from the previous three years.

The tax savings from investing $50,000 in a flow-through limited partnership each year for nine years would be the same as in Example 1, but a difference would occur in 2008 when the investor starts redeeming his mutual fund shares. In Example 1, Taxpayer was required to pay $11,600 of tax on capital gains realized when the mutual fund shares were redeemed. In this example, he can use his capital loss carry-forwards to offset the capital gains realized on redemption.

Year	F-T Purchase	Income Tax Saving	Capital Gains Tax Payable	Less: Capital Loss Carry-Forward Tax Savings	Net Capital Gains Tax Paid	Net Savings	Cumulative Savings
2006	$ 50,000	$ 23,200	$ –	$ –	$ –	$ 23,200	$ 23,200
2007	50,000	23,200	–	–	–	23,200	46,400
2008	50,000	23,200	11,600	(11,600)	–	23,200	69,600
2009	50,000	23,200	11,600	(11,600)	–	23,200	92,800
2010	50,000	23,200	11,600	(11,600)	–	23,200	116,000
2011	50,000	23,200	11,600	(11,600)	–	23,200	139,200
2012	50,000	23,200	11,600	(11,600)	–	23,200	162,400
2013	50,000	23,200	11,600	(11,600)	–	23,200	185,600
2014	50,000	23,200	11,600	(11,600)	–	23,200	208,800
2015	–	–	11,600	(11,600)	–	–	–
2016	–	–	11,600	(11,600)	–	–	–

The cumulative tax savings after nine years would be $208,800 or $23,200 per year.

EXAMPLE 3

Use flow-through limited partnerships to improve the tax-efficiency of charitable donations

A $100,000 donation to a charity will generate a tax credit of approximately $46,400 in the year of the donation, assuming Taxpayer has sufficient income to use the donation credit.

A $100,000 investment in a flow-through limited partnership will generate a deduction of approximately $46,400 in the year of investment. Two years later, after the flow-through limited partnership has been converted into a mutual fund, Taxpayer can donate the mutual fund shares to a registered charity, for the same tax credit of $46,400 as in the straight cash donation. This donation will also trigger a tax on the capital gain. However, the capital gain on donations to charity of mutual fund shares is only 25% taxable. This special tax rate is an incentive to individuals to make donations to public charities. The net tax savings from the donation are $34,800.

Using a flow-through limited partnership, Taxpayer achieves additional cash savings of $34,800 (see below) versus a cash donation of the $100,000 to a charity.

The donation of mutual fund shares could also be postponed until a later year, should Taxpayer's circumstances change.

Donation of cash to charity	
Tax credit (in year of donation)	$ 46,400
Flow-through investment, donate proceeds	
Tax savings (in first year)	$ 46,400
Tax credit from donation of mutual fund (in third year or later)	46,400
Less: Capital gains taxes paid (in third year or later)	(11,600)
Total	$ 81,200
Additional tax benefit	$ 34,800

EXAMPLE 4

Use of flow-through limited partnerships in RRSPs

Contributing mutual fund shares into an RRSP is another alternative. The contribution would result in a further deferral of taxes payable, but the investor would forgo the up-front deductions available on reinvesting the proceeds in another flow-through limited partnership.

The contribution of the mutual fund shares into an RRSP will trigger a capital gain, which is 50% taxable. The RRSP contribution is also deductible.

Assuming the same amounts as Example 1, the tax on the capital gain will remain $11,600 and the RRSP contribution of $50,000 will reduce taxes by $23,200. The net tax savings will be a further $11,600.

EXAMPLE 5

Borrowing to aquire flow-through limited partnerships

Taxpayer is interested in purchasing $10,000 of a flow-through limited partnership. In this example, Taxpayer borrows $10,000 to make the purchase. Taxpayer incurs a 5% annual interest cost on the loan, acquires the flow-through limited partnership at the beginning of 2006 and redeems the mutual fund shares at the beginning of 2008.

Year	F-T Purchased	Income Tax Savings	Capital Gains Tax Paid	Net Savings	Savings apply to Loan
2006	$ 10,000	$ 4,640	$ –	$ 4,640	$ 4,640
2007	–	–	–	–	–
2008	–	–	2,320	(2,320)	(2,320)

	Loan (beginning of year)	Annual Interest	Tax Deduction on Interest	Loan outstanding (end of year)
2006	$ 10,000	$ 500	$ –	$ 10,000
2007	10,000	500	–	10,000
2008	10,000	–	–	–

In this example, it has been assumed that proposals announced October 31, 2003 related to the deduction of interest payments have become law. See Appendix 2.

In the example, Taxpayer has been able to repay the loan with proceeds from the sale of the mutual funds shares. The net after-tax cost of the loan is $1,000. The after-tax cash savings are $1,320. If the proposals are not enacted to deny such expenses, interest expense would create a tax reduction of $232 in both 2006 and 2007, the net after-tax cost of the loan would be $536, and the after-tax cash savings would be $1,784.

EXAMPLE 6

Use of flow-through limited partnerships by high-income seniors to reduce income and avoid Old Age Security and other clawbacks

Old Age Security (OAS) benefits begin to be reduced (or "clawed back") when taxable income reaches $62,144. If a taxpayer's income reaches $100,914, the OAS benefit is fully repaid. Other tax credits (e.g. GST, Ontario Health Premium, medical expenses) are also a function of a taxpayer's taxable income.

As a result, an additional benefit of investing in flow-through limited partnerships for high-income seniors is the potential reduction of the OAS clawback and possible increases to GST and medical expenses tax credits.

An investor with taxable income of $100,000 before any claw back of the OAS payment, who makes a $40,000 investment in a flow-through limited partnership will receive a number of benefits:

1) Additional current year tax reductions of approximately $19,400
2) Full restoration of Old Age Security of approximately $5,815
3) A tax liability of approximately $8,700 in the year the mutual fund shares are sold, unless the investor has capital loss carry-forwards
4) Possible additional GST credits
5) Possible additional medical tax credits

As this example shows, flow-through limited partnerships needn't be restricted to high-income earners. Flow-through investments can also provide a substantial benefit to seniors who earn above $62,144, which is the threshold for 2006 at which OAS starts to be clawed back. Seniors should determine the suitability of an investment of this nature in the context of their overall portfolio of investments and their individual financial circumstances before investing.

EXAMPLE 7
Ownership of flow-through limited partnerships by corporations

Corporations can also own flow-through limited partnerships. In particular, if the corporation has capital loss carry-forwards they can be used to offset the resulting capital gain on the redemption or the disposition.

Here is a step-by-step example of how Taxpayer can use a $100,000 flow-through limited partnership investment to benefit himself and his wholly owned company, TP Enterprises. The example assumes that Taxpayer has sufficient taxable income to fully use the tax benefits.

Step 1 Taxpayer invests $100,000 in a flow-through limited partnership and receives a tax saving of $46,400 in the first year.

Step 2 After these initial tax benefits have been received by Taxpayer, he transfers the flow-through limited partnership or the mutual fund shares into TP Enterprises and elects under subsection 85(1) of the Income Tax Act to transfer the investment at his adjusted cost base. The investment should have an adjusted cost base of approximately zero. There should be no income tax triggered on the transfer.

Step 3 The corporation TP Enterprises then sells or redeems the investment. This can be done while it is still a flow-through investment, or after it has "matured" into a mutual fund. There will be a $100,000 capital gain, $50,000 of which is taxable, although the gain is sheltered by the corporation's capital losses. One-half of any prior capital losses and the $50,000 non-taxable portion of the capital gain would be included in TP Enterprises' Capital Dividend Account. The positive balance, if any, of the Capital Dividend Account could be paid as a tax-free dividend to Taxpayer.

In summary, the original $100,000 investment will provide:

1) A tax saving of $46,400 to Taxpayer;
2) A $50,000 capital gain to TP Enterprises that can be sheltered by its capital losses;
3) In some circumstances, a tax-free dividend to Taxpayer from the Capital Dividend Account of TP Enterprises.

APPENDIX 1 — COMPARISON OF MARGINAL TAX RATES

Here are the top marginal tax rates in each of Canada's provinces and territories for 2006:

Newfoundland	48.64%
Nova Scotia	48.25%
Quebec	48.22%
Prince Edward Island	47.37%
New Brunswick	46.84%
Ontario	46.41%
Manitoba	46.40%
Saskatchewan	44.00%
British Columbia	43.70%
Alberta	39.00%
Yukon	42.40%
Northwest Territories	43.05%
Nunavut	40.50%

APPENDIX 2 — OTHER TAX CONSIDERATIONS

Renounced expenditures deducted by the individual taxpayer may affect the ability of the taxpayer to claim the $500,000 capital gains exemption in respect of sales of qualified small business shares and certain farm assets, as the taxpayer's cumulative net investment loss requires an inclusion of 50% of the deductions taken by the taxpayer in respect of flow-through share renouncements.

Alternative minimum tax may apply in a given taxation year, depending on the value of renounced expenditures deducted by the investor.

The investment of a corporation in a flow-through limited partnership or shares of a mutual fund could change a corporation's status as a "qualified small business corporation."

It is generally tax inefficient to realize capital gains in a corporation as opposed to directly by an individual. Thus, holding mutual fund shares in a corporation is generally not recommended unless it has tax losses to shelter the gains.

Certain CEE relating to mining expenditures also qualifies for a 15% investment tax credit if the investor is an individual. It has been assumed in the examples that none of the renounced CEE is eligible for this additional tax incentive primarily because most renounced CEE relates to oil and gas expenditures.

It has been assumed that the Tax Proposals announced on October 31, 2003 have been enacted to deny the deduction for certain expenses in respect of flow-through share investments commencing after 2004. The Tax Proposals would have the effect of permitting deductions and losses from a business or property only if it was reasonable to expect the taxpayer would realize a cumulative profit from the business or property during the time the taxpayer carried on or held (or could reasonably be expected to carry on or hold) the business or property. Profit for this purpose will not include a capital gain.

SENTRY SELECT CAPITAL CORP.
Tel: 416-861-8729
1-888-246-6656
Fax: 416-364-1197
E-mail: info@sentryselect.com
www.sentryselect.com

HEAD OFFICE
The Exchange Tower
130 King Street West
Suite 2850, P.O. Box 104
Toronto, Ontario
M5X 1A4
Tel: 416-861-8729
1-888-246-6656
Fax: 416-364-5615

FTTP-GD(E)-01/06