

HOW FLOW-THROUGH SHARE LIMITED PARTNERSHIPS WORK

Following is a brief summary of the operation of a flow-through share limited partnership, and the income tax consequences to the limited partner of the ultimate transfer of the partnership's assets to a mutual fund corporation and the dissolution of the partnership.

For purposes of this illustration, assume that a limited partner invests \$10,000 in a limited partnership, and that the partnership uses the funds to purchase flow-through shares of resource companies. The resource companies would "renounce" \$10,000 of exploration expenses to the partnership. In essence, the partnership is considered to have incurred these expenses. These expenses are allocated to the limited partner who then claims a deduction for \$10,000 of resource expenditures on his or her personal tax return. After these transactions have occurred, the shares of the resource companies owned by the partnership have a nil cost base, and the limited partner's cost base of his partnership interest is also nil. The partnership might decide to sell certain of its shareholdings in due course and, if it does, a capital gain will be realized in an amount equal to the proceeds. Should these proceeds be reinvested in another flow-through share the partnership will be able to allocate out to its limited partners a capital gain, of which only 50% is taxable, and resource expenses, which are fully deductible.

Most flow-through limited partnerships anticipate that they will transfer their flow-through share investments, which we will assume still to be worth \$10,000, to a mutual fund corporation in exchange for \$10,000 worth of shares of that corporation, and will pass these out to their partners. The purpose of this transaction is to give liquidity to the partners. Since the flow-through shares have a nil cost base to the partnership, this transaction would normally give rise to a \$10,000 capital gain to the partnership which would have to be allocated to the partners. To avoid this result, the partnership and the mutual fund corporation will file an election, for tax purposes, that the transaction takes place at the partnership's nil cost base, notwithstanding that full value has been paid.

Thereafter the mutual fund corporation shares will be passed out to the partners and the partnership wound up. The end result is that the partners end up with \$10,000 worth of shares of the mutual fund corporation which have a nil cost base, and the mutual fund corporation ends up with \$10,000 of flow-through shares which have a nil cost base.

When the partner sells or redeems his or her mutual fund corporation shares for \$10,000 (to continue the example), a capital gain of \$10,000 will result and tax will be payable. Likewise, the mutual fund corporation will have a \$10,000 capital gain when it sells the flow-through shares. However, a mutual fund corporation may recover its capital gains tax upon the payment of capital gains dividends to its shareholders or through share redemptions. Accordingly, "double taxation" of the \$10,000 gain, once in the partner's hands and again in the mutual fund corporation, is essentially avoided.