TerraFunds
Tax-Smart Investments

Flow-Through Limited Partnerships

Tax Planning Guide

An investor's guide to flow-through investments

About Terra

Terra Fund Management Ltd. offers a family of flow-through limited partnerships and mutual funds which invest primarily in publicly traded companies but may also invest in a select group of private firms with proven management. These funds have been developed to meet the needs of individual and corporate investors seeking high quality growth and tax-advantaged investment products.

Terra currently offers five funds sold by offering memorandum: two **Terra Flow-Through Limited Partnerships**, **Terra Small Cap Growth Mutual Fund**, **TerraTundra Dividend Growth Mutual Fund** and **TerraTundra Money Market Fund**. Terra's mutual funds are corporate class funds which also provide the flexibility to switch between each mutual fund on a tax-deferred basis.

The purpose of this brochure is to provide investors with an overview of how flow-through shares work and the benefits of investing in them through a Terra managed flow-through share limited partnership. Should you have any further questions regarding Terra, please contact your investment advisor or Terra directly at **info@terrafunds.ca** or **1-888-449-4645**.

Introduction

Flow-through shares are one of the few remaining tax-assisted investments available to Canadian investors and are a resource exploration incentive program sponsored by the Canadian federal government. Recent government changes have reduced or eliminated the attractiveness of other tax-planning alternatives such as mutual fund limited partnerships and film partnerships. 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.

Flow-through shares provide three tax advantages which include the following:

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

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

Who should consider investment in flow-through shares?

Investors in the top marginal tax bracket who understand the risks of investing in junior resource companies may consider investment in flow-through shares. Flow-through limited partnerships may be suitable to the following investors:

- Individuals or corporations resident in Canada interested in reducing their current taxable income
- Individual and corporate investors with unused capital losses
- Charitable donors
- Individuals interested in reducing Old Age Security clawbacks
- Recipients of substantial lump sums of taxable income
- Individuals or corporations resident in Canada with sufficiently large past income tax liabilities

General overview of the benefits of flow-through investing

- Shelter income taxed at highest marginal rate
- Defer taxes until redemption
- Convert income taxed at a higher tax rate into a capital gain with a tax deferral until sale
- Tax savings provide downside protection against investment losses
- 100% deductible against income from any Canadian source
- Available capital losses can be used to offset capital gains to provide even better after-tax returns

Specific benefits of a Terra Flow-Through LP

- Expert portfolio management.
- Proven track record.
- Access to a select portfolio of approximately 30 public and 6 private flow-through share issuers
- Enhanced diversification through investment in both the energy & mining sectors
- Early redemption on or about June 30 of the year following the initial investment
- Up to 115% in tax deductions and, if applicable, additional investment tax credits
- Yearly tax packages, quarterly investment updates and access to our website for detailed information

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About flow-through shares

Flow-through shares were first introduced to the Canadian tax system in 1954 to assist in the financing of exploration projects in Canada. At that time, the Canadian government introduced provisions to allow for the transfer of tax deductions between companies.

To further encourage exploration and development in the resource sector the April 1983 federal budget allowed certain individual 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 substantially.

The government currently permits Canadian resource companies, including those in oil and gas, mining, base metals and renewable energy to fully deduct qualified exploration expenses, known as Canadian Exploration Expense (CEE). Flow-through common shares are issued from the treasury of a company engaged in resource exploration in Canada. Many of these companies issue flow-through shares to raise capital, and in turn renounce the CEE to investors purchasing their flow-through shares. The renounced CEE is generally fully deductible and flowed through to the investor who can use these deductions against any source of Canadian income.

Flow-through shares are usually issued by junior resource companies who can be either private or publicly traded firms. To ensure liquidity, Terra primarily purchases flow-through shares in publicly traded companies, but may invest up to 20% of the assets in private firms. Private firms may be purchased at more favourable prices than comparable public firms and also offer the potential for higher returns and lower volatility. Investing in individual smaller resource companies is speculative and returns are dependent on commodity prices and management execution. Investments in junior resource companies have the potential to be more volatile than the overall market, which could lead to greater-than-average losses or higher than average returns depending on the overall market sentiment for these companies and the ability of management to increase the value of the company. To reduce the risk of loss, investors receive a substantial portion of their original investment back in the form of tax savings.

Super Flow-Through Shares

In October, 2000, the Canadian federal government introduced a temporary 15% non-refundable tax credit for qualified mineral resource companies, which has been extended on a yearly basis in the Federal Budgets to date. The tax credit is in addition to the existing 100% deduction of eligible exploration expenditures and is deductible from the federal portion of one's taxes. To distinguish this additional tax credit from a "regular" flow-through share (typically issued by oil & gas resource companies), these shares are commonly referred to as "super" flow-through shares. The "super" flow-through share program has been very successful in helping junior companies raise much needed funding for mineral exploration. The Prospectors & Developers Association of Canada (PDAC) estimates the program has helped raise over $2.5 billion for mineral exploration since inception.

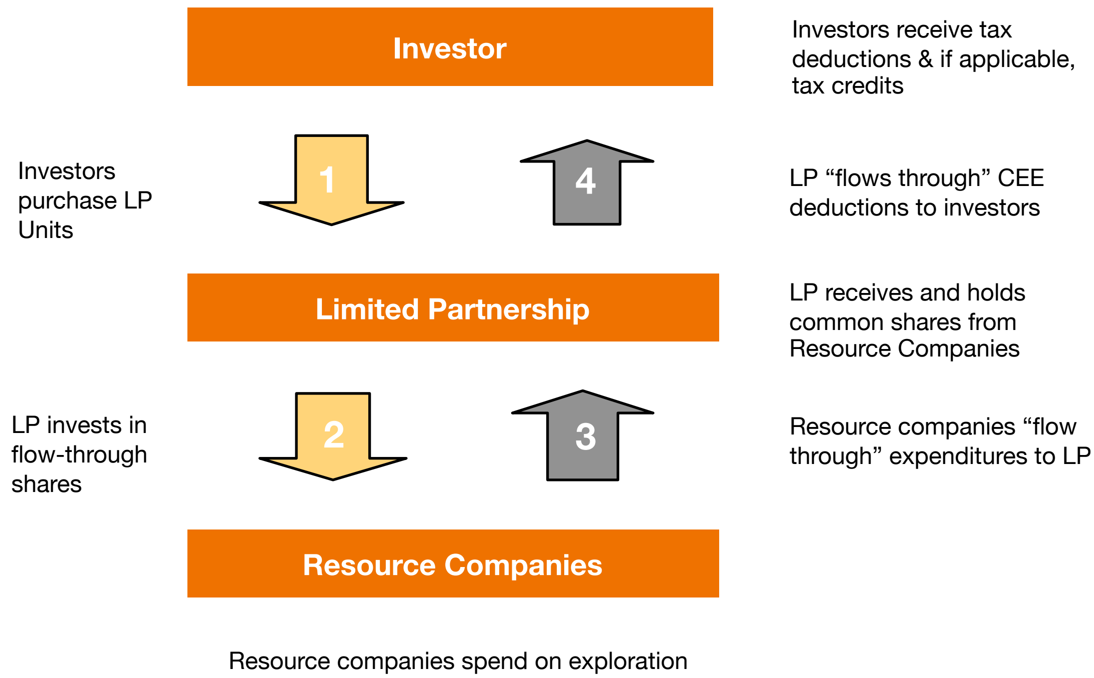
About flow-through limited partnerships

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

Individual and corporate investors may invest in flow-through limited partnerships. Flow-through share partnerships provide an effective method for investing in the resource sector because investors are not burdened with finding and deciding which resource companies are qualified investments. The advantage with a limited partnership structure is that investors "pool" their money and rely on the professional manager retained by the partnership to review and select those resource companies with strong management and good upside potential. The partnership also handles all the administrative duties, including the issuance of a tax receipts which detail the tax deductions and, if applicable, tax credits available to investors for reducing their taxes.

The risk of investing in smaller resource companies may be lowered when an experienced portfolio manager selects a diversified portfolio of companies. The benefits of diversification are further enhanced if the partnership invests in both the energy and mining sectors. Investors who purchase flow-through shares indirectly through a limited partnership usually find the amounts invested fully or almost fully deductible against taxable income in the first year the investment is made.

The chart below offers a diagram of how flow-through limited partnerships work.



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

Step 2: The partnership’s net proceeds are used to purchase a basket of flow-through shares of resource companies on behalf of the investors who are limited partners.

Step 3: The resource companies issue common shares from treasury in return for the investment received from the partnership. These investment proceeds are spent by the resource companies on exploration activities. The resource companies in turn renounce their CEE (i.e. exploration expenses) to the limited partnership, which in turn allocates the CEE on a pro rata basis to each investor in the partnership.

Step 4: Investors in the partnership receive a T5013A Tax Form (Relevé 15 Form for Quebec investors) which shows their share of the CEE deductions, partnership’s losses from organization and operating costs and, if applicable, any investment tax credits available for reducing their personal income tax.

Investors generally receive a substantial portion of their original investment back in the form of tax savings. Tax savings alone may amount to approximately 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 two years which provides enough time to allocate most of the tax deductions to the investors. Terra FTLPs have the additional advantage of a shorter hold period.

At maturity, Terra Flow-Through Limited Partnership investors automatically exchange their partnership interests for shares in Terra’s open-end Small Cap Resource mutual fund that invests in a diversified portfolio of energy and natural resource companies. This exchange is done without any immediate tax consequences for shares held by the partnership, thereby deferring any tax liability. Because the partnership provides investors with tax deductions equal to their initial investment, flow-through shares are deemed to have an “adjusted cost base” (ACB) of zero for tax purposes. Should an investor decide to redeem all or a portion of their mutual fund shares they would realize a capital gain at that time equal to the proceeds received on redemption less the adjusted cost base of the shares.

Investing through a flow-through limited partnership is an important tool in tax planning for reducing income taxes, utilizing capital losses incurred on other portfolio holdings and reducing the OAS clawback. The following pages 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, resulting in a change in the value of the flow-through limited partnership units.
3. The investor is an Ontario resident and is taxed at the highest marginal tax rate of 46.41%. Tax rates differ by province. See Appendix 1 for a listing of the top marginal tax rates by province.
4. The Canadian government also provides for a 15% federal investment tax credit on qualified mining investments. Several provinces also allow their residents to claim additional tax credits on qualified flow-through investments when calculating their provincial taxes. For simplicity, it is assumed that any federal and provincial credits are nil in the following examples.

Example 1: Reduce taxable income

A. Taxpayer contributes $25,000 for 1 year

In this example a Taxpayer earns $150,000 in the current year and is considering investing $25,000 in a flow-through limited partnership to lower his or her taxable income. This would be done by making one initial investment of $25,000 and then redeeming the mutual fund shares in year 3. The table below provides a summary of the effect of this flow-through limited partnership investment on his or her taxes.

Table 1: $25,000 for 1 year

Year	F-T Purchase	Income Tax Savings	Capital Gains Tax Paid	Net Savings	Cumulative Savings
1	$25,000	$11,603	$0	$11,603	$11,603
2	$0	$0	$0	$0	$11,603
3	$0	$0	($5,801)	($5,801)	$5,801

After 3 years, the taxpayer has achieved cumulative tax savings of $5,801 for a $25,000 investment.

B. Taxpayer contributes $50,000 per year for 5 years

In this example a Taxpayer earns $200,000 per year and is considering investing $50,000 in a flow-through limited partnership each year for the next five years. This would be done by two initial investments of $50,000, then re-investing over the next three years the proceeds from the redemption of the mutual fund shares. The table below provides a summary of the effect of this flow-through limited partnership investment on his or her taxes.

If the Taxpayer earns $200,000, he or she will pay approximately $75,180 in taxes, based on recent tax rates. If $50,000 is invested in a flow-through limited partnership, his or her income tax will be reduced to approximately $51,975 resulting in an immediate savings of approximately $23,200. When the investment is redeemed each year for the next five years after it has been converted into a mutual fund. With each mutual fund redemption, there will be a taxable capital gain of $25,000 and tax payable of approximately $11,600, leaving a net gain of approximately $11,600. The table below indicates the tax savings achieved over seven years on an investment of $50,000 each year for five years. In each of the first two years, the investor will realize savings of $23,200.

The tax savings help fund the subsequent investments in years three through five. In the third year, and all subsequent years, the $23,200 tax savings is also reduced by the amount of tax payable on capital gains arising from the redemption of the mutual fund shares. Finally in years six and seven, no more investments are made and the remaining mutual fund shares are redeemed and capital gains realized.

Table 2: $50,000 per year for 5 years

Year	F-T Purchase	Income Tax Savings	Capital Gains Tax Paid	Net Savings	Cumulative Savings
1	$50,000	$23,200	$0	$23,200	$23,200
2	50,000	23,200	0	23,200	46,400
3	50,000	23,200	11,600	11,600	58,000
4	50,000	23,200	11,600	11,600	69,600
5	$50,000	23,200	11,600	11,600	81,200
6	0	0	11,600	(11,600)	69,600
7	$0	$0	$11,600	($11,600)	$58,000

After 7 years, the taxpayer has achieved cumulative tax savings of $58,000 or approximately $11,600 for each year $50,000 was invested.

Example 2: Utilize 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 five years would be the same as in Example 1, but a difference would occur in year 3 when the investor starts redeeming his mutual fund shares. In Example B on page 7, the Taxpayer was required to pay $11,600 of tax on capital gains realized when the mutual fund shares were redeemed. In this example, the Taxpayer can use his or her capital loss carry-forwards to offset the capital gains realized on redemption, thereby eliminating any capital gains tax.

Year	F-T Purchase	Income Tax Savings	Capital Gains Tax Paid	Less: Capital Loss Carry-Forward Tax Savings	Net Capital Gains Tax Paid	Net Savings	Cumulative Savings
1	$50,000	$23,200	–	–	–	$23,200	$23,200
2	50,000	23,200	–	–	–	23,200	46,400
3	50,000	23,200	11,600	(11,600)	–	23,200	69,600
4	50,000	23,200	11,600	(11,600)	–	23,200	92,800
5	$50,000	$23,200	11,600	(11,600)	–	$23,200	$116,000
6	–	–	11,600	(11,600)	–	–	–
7	–	–	$11,600	($11,600)	–	–	–

The cumulative tax savings after seven years would be $116,000 or $16,571 per year.

Example 3: Donating your Flow-Through investment

For an Ontario resident a $10,000 donation to a charity will generate a tax credit of approximately $4,641 in the year of the donation, assuming the Taxpayer has sufficient income to use the donation credit (see note below).

A $10,000 investment in a flow-through limited partnership will initially generate a tax deduction which provides tax savings of approximately $4,641 in the year of investment. Approximately 9 months later, after the Terra flow-through limited partnership has been converted into a mutual fund, the Taxpayer can donate the mutual fund shares to a registered charity, for an additional donation tax credit worth $4,641, assuming a $10,000 donation value.

The Government of Canada recently introduced legislation in the March 22, 2011 Budget which increased the inclusion rate (amount of taxable capital gains on charitable donations) to fifty percent, for flow-through securities donated to registered charities.

In summary this means for an Ontario investors that an initial $10,000 investment in a flow-through limited partnership which is subsequently donated provides: (1) tax savings worth $4,641 upon investment and; (2) an additional tax credit of approximately $4,641 upon donation to a registered charity less capitals tax owing on the donation.

Tax savings from donating shares to a registered charity

Activity	BC	Alberta	Ontario
Original investment in a Terra Flow-Through LP	$10,000	$10,000	$10,000
Tax savings on initial investment (($10,000 x highest marginal tax rate for province) [2]	($4,370)	($3,900)	($4,641)
Tax on exchange of LP Units for mutual fund shares	$0	$0	$0
Individual gifts the shares to a registered charity ($10,000 donation value x marginal tax rate) [2]	($4,370)	($5,000)	($4,641)
Capital gains tax on donation	$2,185	$1,950	$2,321
After tax cost of donating $10,000	**$3,445**	**$3,050**	**$3,039**

Notes:

1. The annual general donation claim limit is 75% of an investor's net income, although donations in excess of the annual limit may be carried forward and claimed in any of the following five years.
2. In British Columbia the donation tax credit is equal to 43.7% of the donated securities. For Alberta residents the donation tax credit is equal to 50% of the donated securities. In Ontario the donation tax credit is equal to 46.41% of the donated securities. For Quebec residents the donation tax credit is equal to 48.2% of the donated securities.

Example 4: Contributing mutual fund shares into an RRSP

An RRSP 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.

By contributing the mutual fund shares into an RRSP account, shareholders receive an additional tax benefit. This contribution "in kind" to an RRSP account will trigger capital gains, of which 50% is taxable. However, the RRSP contribution is 100% tax-deductible.

Assuming the same amounts as Example B on page 7, 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 acquire flow-through limited partnership units

A Taxpayer borrows $10,000 to invest in a flow-through limited partnership. The Taxpayer incurs a 5% annual interest cost on this loan, acquires the flow-through limited partnership at the beginning of the year and redeems the mutual fund shares in two years.

Year	F-T Purchased	Income Tax Savings	Net Interest Expense	Capital Gains Tax Paid	Net Savings	Savings apply to Loan
1	$10,000	$4,641	$268	–	$4,373	$4,373
2	–	–	$268	–	($268)	$4,105
3	–	–	–	$2,320	($2,320)	$1,785

Year	Loan (beginning of year)	Annual Interest	Tax Deduction on Interest	Loan outstanding (end of year)
1	$10,000	$500	–	$10,000
2	$10,000	$500	–	$10,000
3	$10,000	–	–	–

In this example, the Taxpayer has been able to repay the loan with proceeds from the sale of the mutual funds shares. The interest expense of the loan is $1,000 (i.e. annual interest rate of $500 for 2 years). The interest expense would create a tax reduction of $232 in both year 1 and year 2, meaning the net after-tax cost of the loan would be $536, and the after-tax cash savings would be $1,785.

Example 6: Reduce income and avoid Old Age Security (OAS) and other clawbacks

For 2013, Old Age Security benefits are reduced (or “clawed back”) when taxable income exceeds $70,954. If a taxpayer’s income reaches $114,640, 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.

Your repayment calculation is based on the difference between your income and the threshold amount for the year. The first step is to figure out how much higher your income is than the threshold. Your repayment amount is 15 percent of that amount. An investor with taxable income of $114,640 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 $19,600
2. Full restoration of Old Age Security of approximately $6,290
3. A tax liability of approximately $8,600 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 $70,954 in 2013 which is the threshold at which OAS starts to be clawed back. Investors should consult with a qualified tax expert and their investment advisor to ensure that this strategy is suitable for their particular circumstances.

Example 7: Corporate use of flow-through LPs

Corporations and holding companies can make investments in flow-through limited partnerships. A flow-through investment is particularly attractive if the corporation has capital loss carry-forwards that can be used to offset the resulting capital gain on its redemption or disposition.

A step-by-step example below illustrates how an Individual Taxpayer can use a $100,000 flow-through limited partnership investment both personally and through their wholly owned company, ABC Enterprises. This example assumes the Individual Taxpayer has taxable income taxed at a 45% marginal rate.

Step 1: Individual Taxpayer invests $100,000 in a flow-through limited partnership and receives a tax saving of approximately $45,000 in the first year. Additional tax deductions in year 2 may also apply for a Terra Flow-Through Limited Partnership.

Step 2: After receiving these tax savings the Individual Taxpayer, can transfer the flow-through limited partnership units or mutual fund shares into ABC Enterprises by making an election under subsection 85(1) of the Income Tax Act to transfer the investment at its adjusted cost base. If the investment has an adjusted cost base of zero no income tax is triggered on the transfer.

Step 3: ABC Enterprises sells the flow-through investment after it has converted to mutual fund shares. Assuming the fair market value of the investment is the same as the original investment, the result is a $100,000 capital gain, $50,000 of which is taxable. If the corporation has capital loss carry-forwards, the capital gain is sheltered and no capital gains tax is owing. One-half of any prior capital losses and the $50,000 non-taxable portion of the capital gain would be included in ABC Enterprises' Capital Dividend Account. A positive balance, if any, in the Capital Dividend Account may then be paid as a tax-free dividend to the Individual Taxpayer provided they are a shareholder of ABC Enterprises.

A summary of what the original $100,000 provides is listed and highlighted in the table below:

1. A tax saving of $45,000 to Taxpayer in Year 1. Additional deductions may also apply in Year 2;
2. A $100,000 increase in the cash balance for ABC Enterprises and $50,000 capital gain to ABC Enterprises that can be sheltered by its capital losses;
3. And if applicable, a tax-free dividend to Individual Taxpayer from the Capital Dividend Account of ABC Enterprises worth $45,000.

Individual FTLP Purchase / Corporate Sale	Personal	Corporate	Total
Investment cost	($100,000)	–	($100,000)
Tax savings	**$45,000**	–	**$45,000**
Tax on transfer to private company	–	–	–
Proceeds from sale of shares	–	$100,000	$100,000
Tax on capital gains	–	$0	$0
Cumulative cash position	($55,000)	$100,000	$45,000

A corporation or holding company may also purchase a flow-through limited partnership to reduce taxes on the same basis as an individual. However the tax rate for the corporation or holding company may be much lower than the tax rate for an individual thereby making the tax savings less attractive. Corporations, unlike individuals cannot claim the Investment Tax Credit portion on qualified mining investments, if any.

A corporation, however, is not subject to alternative minimum tax, although a corporate minimum tax may apply in certain circumstances. A flow-through limited partnership investment not only allows a corporate holder to reduce its taxes overall, but the capital gains triggered on the redemption of mutual fund shares will create capital dividend account additions that can then be distributed to shareholders tax-free. In this circumstance, using flow-through's may allow shareholders to receive higher levels of after-tax cash from their corporations. Investors are urged to contact their tax specialist to determine if an investment should be made through a corporation or holding company.

Appendix 1 – Marginal tax rates by province and territory

Here are the top marginal tax rates in each of Canada's provinces and territories, which are subject to change:

Province	Marginal Tax Rate
Alberta	39.00%
British Columbia	43.70%
Manitoba	46.40%
New Brunswick	43.30%
Newfoundland	42.30%
Northwest Territories	43.05%
Nova Scotia	50.00%

Province	Marginal Tax Rate
Nunavut	40.50%
Ontario	49.53%
Prince Edward Island	47.37%
Quebec	49.97%
Saskatchewan	44.00%
Yukon	42.40%

Appendix 2 – Other tax considerations

Renounced expenditures deducted by the individual taxpayer may affect the ability of the taxpayer to claim the $750,000 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 federal investment tax credit incentive.

The CEE relinquished on flow-through shares are added to an investor's Cumulative CEE Account. Because this deduction is discretionary, the investor can claim any portion of the maximum deduction allowed in a year and carry forward any unused deductions for up to 10 years. Investors can take advantage of this benefit should they anticipate being in a higher marginal tax rate in a future year. Similarly, an investor who would otherwise be subject to AMT can carry forward and use deductions in subsequent years.

Terra Fund Management Ltd.
207-517 Wellington Street West
Toronto, Ontario, M5V 1G1
Toll-Free: 1.888.449.4645
Fax: 416.203.1544
Email: info@terrafunds.ca
www.terrafunds.ca