

Drache LLP

TAX, ESTATES & CHARITY LAW

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Wealth Creation & Preservation Inc.
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Attention: Mr. Peter Nicholson
President

Re: Donation of Flow-Through Shares to Canadian Charities

You have asked us to review the tax consequences of donating flow through shares to certain Canadian charities in light of recent changes made to the *Income Tax Act* (the “Act”) in respect of donations of securities listed on prescribed exchanges to public Canadian charities (as opposed to private foundations). Our understanding is that you are considering marketing the sale of flow through shares as a good investment, and when donated to charities, a good way to significantly reduce the total cost of a donation otherwise made.

The actual specifics of the plan involve the sale of units in a limited partnership, which will own flow through shares from a diversified portfolio of mining corporations, all of which are publicly listed on either the TSE or TSX exchanges. After a period of time, (determined by the success of the portfolio but no later than Nov 28, 2008), the underlying shares will be distributed to the owners of the partnership units. It is then at the discretion of the owners to donate the flow through shares to either a charitable organization or a public foundation as those terms are defined in the Act (hereinafter a “Public Charity”). Alternatively, the owners could sell the shares triggering a likely capital gain.

Assuming the flow through shares are listed shares on a prescribed stock exchange, our opinion is that the donation of flow through shares to a Public Charity will be treated as any other donation of publicly listed securities; that is the donor would be entitled to a tax credit for the fair market value of the donation and there will be no taxable capital gain on the disposition. Moreover, given that the adjusted cost base of flow through shares under the Act is deemed to be nil, the donation of shares will mitigate the capital gain that would otherwise occur upon the normal disposition of these shares.

Flow-Through Shares

A flow through share is defined in the Income Tax Act (hereinafter the “Act”) as a share in a principal – business corporation where the corporation agrees to renounce Canadian Exploration Expenses (“CEE”) and Canadian Development Expenses (“CDE”) in favour of the shareholder. A principal business corporation is essentially a mining or mineral processing corporation¹. As we do not have any detailed information regarding the exact portfolio of shares we will assume that for the purposes of this letter it is unnecessary to explain the detailed tax treatment surrounding flow through shares. However, it is critical to note that subsection 66.1(3) of the Act generally allows for a shareholder to deduct 100% of CEE while 66.2(2) allows for a deduction of only 30% of renounced CDE. So, in order to maximize the value of the share it is important to be sure of the type of expenses incurred by the company. Our understanding from you is that all the expenses renounced by the companies involved qualifies as CEE.

As alluded to above, by definition, the adjusted cost base (“ACB”) of a flow through share is deemed to be nil (subsection 66.3(3) of the Act). Thus, when a taxpayer disposes of a flow through share, the entire value is considered to be a capital gain. However, where the share is listed on a prescribed exchange and is donated to a Public Charity, there will be no taxable capital gain on the disposition of the share, thus eliminating the usual drawback of flow through shares. We can also confirm that the donor will receive a donation tax credit equal to the value of the share in the year of the donation.

Gifting Arrangements

On December 5, 2003 the government proposed draft legislation (which is currently in first reading in Parliament) which applied to certain donations made after that date. The operation of proposed subsection 248(35) will, if applicable, limit the donation tax credit available for donated property to the cost of the property for tax purposes. Accordingly, given that subsection 66.3(3) reduces the adjusted cost base to nil, the donation tax credit would be zero. However, our opinion is that these provisions are not applicable. Specifically, although it is our opinion that you are marketing a gifting arrangement which is a tax shelter under the rules contained in proposed subsection 248(37), the rules do not apply where the property donated is listed in subsection 38(a.1). This provision includes shares of corporations listed on a prescribed stock exchange, a share of a mutual fund corporation or a unit of a mutual fund trust. Thus, as the flow through shares are to be listed on either the TSE or TSX, there should be no reduction of the donation tax credit under the tax shelter rules.

Section 248(31) requires a charity to reduce the amount receipted on an official donation tax credit by the value of the advantage returned to the donor. You have raised the concern that the CRA might take the position that either the tax benefit arising as a result of the renounced CEE expenses or the donation tax credit itself might constitute an advantage which would reduce the value of the receipt.

¹ Principal – Business Corporation is defined in subsection 66(15) of the Act.

The proposed law defines “advantage” broadly but is contingent on that benefit being:

- (i) consideration for the gift or monetary contribution,
- (ii) in gratitude for the gift or monetary contribution, or
- (iii) that is in any other way related to the gift or monetary contribution.

Our understanding is that the CRA will shortly be releasing an opinion which will make it clear that the value of the receipt will not be reduced by the value of a tax deduction taken as a result of the renounced CEE in the situation described. In the event, we agree with this position. It is unnecessary to elaborate as it seems clear that this deduction could not be considered as connected with the donation.

The Donation Tax Credit is also unlikely to be considered an advantage bestowed on the donor. This issue was explicitly considered by the technical notes released by the Department of Finance when the proposed legislation was released. At the time the Department of Finance did not consider the donation tax credit to be an advantage for the purposes of the proposed legislation. We have no reason to believe that this has changed.

Impact on the Charity

While you have not asked us to comment directly on the impact the donation of a flow through share would have on the charity, it is incumbent on us to raise the issue. In the plan you have developed, the charity is not presented with the valuation issues which normally plague gifts in kind. In the situation you propose, the charity will receive a gift of publicly traded securities, thus the value of the shares are simply the value of the shares on the day they were donated.

Capital Dividend Account

There may be an additional benefit for holders of flow through shares, where such a shareholder also has a private corporation. Based upon proposed subsection 38(a.1), the donation of publicly traded securities to a Public Charity allows the donor to receive a full charitable donation tax credit without recognizing any taxable capital gain. A private corporation increases its capital dividend account by the non-taxable portion of any capital gains. The amount in the capital dividend account can be paid out to the shareholders on a tax free basis. In this situation, because there is no taxable capital gain on the donation of publicly listed securities to a Public Charity, the non-taxable portion of the capital gain will be the full value of the shares.

Accordingly, it may be that some shareholder/taxpayers will find that using their corporation to acquire (either directly or via transfer from the shareholder) and then donate the flow-through shares will maximize the value of the original investment. Another, more likely, scenario is that some taxpayers may choose to acquire the shares personally and thus obtain the benefit of the flow through tax deduction personally. They could then transfer the shares to their private corporation on a tax-free basis pursuant to the provisions of Section 85 of the Act. The corporation would then donate the flow through shares to a Public Charity and increase its capital dividend account by the full value of the shares at the time of the donation. The

corporation could then use the capital dividend account to distribute dividends to the shareholder on a tax free basis.

GAAR

You have asked us to comment on the applicability of the General Anti-Avoidance Rule (“GAAR”) to the transactions described in this letter, in particular the transfer of the shares to a private corporation. GAAR is applicable where a taxpayer, through a transaction, or a series of transactions, contravenes the intention of any one provision of the Act. In this case, the plan you have proposed is rewarding for donors because it makes use of two separate incentive programmes in the Act (namely those promoting investment in the mining sector and donations to charities). The purchase and donation of these shares should not contravene any part of the Act, particularly as you are acting in accordance with the purpose for which these incentive programmes were designed. It is also our opinion that the same is true with respect to the transfer of the flow through shares to a private corporation.

We hope the above answers your questions. If you have any further questions we would be happy to field them.

Yours truly,

Adam Aptowitz