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Flow-throughs for taxes

Maximizing tax efficiency

Many investors forget about taxes once May comes along. However, prudent tax planning should be done through the course of the year to gain dividends over the long term. A significant tax-planning tool for Canadian investors to consider is the use of flow-through shares, one of our last legitimate tax-assisted investment vehicles.

Designed to expand Canada's natural resources, flow-through shares help finance Canadian exploration projects. Through provisions in the Income Tax act, early-stage resource companies, including those in oil and gas, base metals, mining, and select renewable energy companies, can fully deduct certain exploration expenses.

These special tax deductions can then be transferred to investors through the use of flow-through shares, allowing investors to deduct the exploration expenses against their own income, typically up to 100% of the amount invested. Flow-through shares can serve many purposes.

One is to take taxable income from a current year and convert it to capital gains taxation in the future. Due to the upfront tax deduction, the adjusted cost base of the flow-through shares is low or nil. Later, when investors decide to sell their flow-through shares, any gains they've made are capital gains and taxed more favorably than income.

Flow-through shares may provide benefits to retired seniors whose income is above the Old Age Security clawback threshold. The tax deductibility can potentially reduce OAS clawbacks and increase GST and medical expenses tax credits. However, because of risk, seniors should carefully weigh the suitability of these investments relative to their particular personal circumstances.

Flow-through shares can generate tax efficiency. When investors sell their flow-through shares, they can use their capital loss carry-forwards to offset the gains realized on the sale of shares. Investors with a lot of capital loss carry-forwards have the flexibility of offsetting capital gains backward three years or forward indefinitely.

Flow-through shares can maximize philanthropic endeavors. When investors donate flow-through shares to qualified charities, they receive the same tax credit as if they had made a straight cash donation. They also benefit from the tax deduction they receive when making the initial investment in the flow-through shares. The total tax savings between the flow-through deductions and the charitable donation can be significant.

Consider an initial $50,000 flow-through investment for an investor with a marginal tax rate of 45%. Assuming the entire initial investment was deducted over the life of the flow-through, the total tax savings from deductions would be $22,500. If the market value at maturity is

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$50,000 and the same 45% rate is applied, the tax savings from the resulting charitable donation would be $22,500. That amounts to a total tax savings of $45,000. Even better, the after-tax cost of the gift to the charity is only $5,000.

Still, flow-through shares are not for everyone. The most suitable investors are those subject to the highest marginal tax rate and, since the investments involve small-cap resource companies, these investors should also have a high degree of risk tolerance. Exploration is risky and an exploration company could fail to find what it seeks, with a subsequent drop in stock value exceeding any tax savings.

Liquidity can also be a problem if investors need to sell in a hurry, and flow-through shares can be more volatile than the overall market. The potential exists for above average losses that might outweigh tax savings, so investors should carefully evaluate these investments vis-a-vis their goals before investing.

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