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Pros and cons of flow-through shares

Examining your tax planning

As the year draws to a close, investors focus on their tax planning. While many have been working on tax-loss selling strategies, others have been examining flow-through opportunities to help defer and save taxes. Since a number of companies have been coming out with new flow-through share financings, we should review their structure.

Used correctly, flow-through shares can be an excellent tax-planning tool. Early-stage Canadian resource companies can fully deduct certain exploration expenses, which "flow through" to investors who use these special deductions against their own income. In most cases, this can be up to 100% of the amount invested.

Investors can take taxable income from a current year and convert it to capital gains taxable in the future. Due to the preferential tax treatment of capital gains, the adjusted cost base of the flow-through shares is low or nil. Investors have the flexibility of offsetting capital gains backward three years or forward indefinitely.

Flow-through shares can reduce the cost of philanthropy. Donated to qualified charities, they provide investors with the same tax credit as if they had made a straight cash donation. Investors also benefit from the tax deduction they receive when buying the flow-through shares, and the combined tax savings can be significant.

Let's look at an investor with a marginal tax rate of 45% who makes an initial flow-through investment of $50,000, and assume 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 were still $50,000, with the 45% rate applied the tax savings from the charitable donation would be $22,500. That's a total tax savings of $45,000, making the real cost of the $50,000 charitable gift only $5,000.

Flow-through share purchases should be assessed to ensure that potential tax advantages are not just apparent. These shares are usually issued at a price higher than the market price of the underlying common shares. The size of this premium, combined with various fees, will have an impact on the real value of the favourable tax treatment. And, liquidity can be a problem if investors need to sell in a hurry.

Flow-through shares are complex investments most suitable for investors subject to the highest marginal tax rate. Investors should have a high degree of risk tolerance and should be comfortable with small-cap junior resource companies.

Investors may wish to diversify their risk with flow-through limited partnerships, which provide a basket of flow-through shares actively monitored by professional managers.

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