Getting the MOST out of FLOW-THROUGH INVESTING

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Special to Mining Markets

Flow-through shares have been extremely popular investment vehicles for countless Canadian investors over the past 25 years. They have provided over $10 billion in exploration finance to Canadian resource companies and have become a critical component of the development of Canada's Far North. Both federal and provincial governments recognize the significant benefits of flow-through and strongly support the concept.

For many investors, investing in flow-through is an annual ritual for the purpose of reducing income tax payable. The concept is simple: A resource company that requires capital to undertake exploration for resources in Canada passes on their Canadian Exploration Expense (CEE) to investors through the issuance of flow-through shares. The tax deductions related to the exploration or development of their resources "flow-through" to the investors. The investing public can participate through a flow-through share offering or a limited partnership offering.

Investors will typically be able to claim 100% of the value of the investment they make against their taxes for that year. From a tax-deduction perspective, the investor receives a similar tax benefit as making an RRSP contribution (a reduction of line 236 on their tax return). However, flow-through must be purchased and held outside a registered plan. Investors may choose to invest in either individual flow-through shares or professionally managed

TABLE 1: BENEFITS OF FLOW-THROUGH

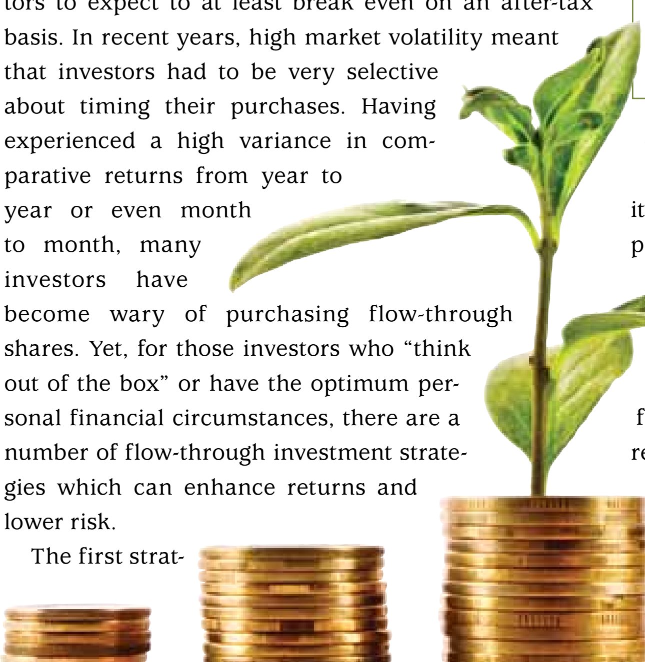
An Ontario investor earns $150,000 annually (marginal tax rate = 46.41%, effective tax rate = 33.16%) and invests $20,000 into a flow-through limited partnership in Year 1. After 2 years the value of the investment remains unchanged and it is then sold.

	INVEST IN LP	DO NOTHING
EARNED INCOME	$20,000	$20,000
INVESTMENT IN LP	$20,000	–
INCOME TAX PAYABLE	–	$9,282
YEAR 2 SALE PROCEEDS	$20,000	–
CAPITAL GAINS TAX PAYABLE	$3,316	–
AFTER-TAX PROCEEDS	**$16,684**	**$10,718**

units of a flow-through limited partnership. Most limited partnerships require that investors hold their units for 18 to 24 months, while individual flow-through shares usually have a four-month escrow period. In addition, it is important to note that when the flow-through is sold, a zero cost base is applied in calculating the capital gain. Table 1 shows the benefits of flow-through for an Ontario investor in the top marginal bracket (see Table 1).

Flow-through investing is most appropriate for high-income investors. Through the initial tax deduction and the impact of capital gains tax when the investment is sold, investors gain almost 30% downside protection on the value of their investment. When the assets are eventually sold, the 50% inclusion rate on capital gains will mean a tax hit of 23%, assuming the investor remains in the same tax bracket and the value of the flow-through does not change.

In the past, when market volatility was much lower, the 30% downside protection was sufficient for investors to expect to at least break even on an after-tax basis. In recent years, high market volatility meant that investors had to be very selective about timing their purchases. Having experienced a high variance in comparative returns from year to year or even month to month, many investors have become wary of purchasing flow-through shares. Yet, for those investors who “think out of the box” or have the optimum personal financial circumstances, there are a number of flow-through investment strategies which can enhance returns and lower risk.



The first strategy involves triggering sufficient capital losses on securities that have declined in value within a portfolio and then investing the proceeds of the sale into flow-though shares or into a flow-through limited partnership. The losses may be carried forward up to three years and used when the flow-through is sold. Since the adjusted cost base of flow-through is normally zero, the capital losses carried forward must be sufficient to offset the entire proceeds of the sale of the flow-through. In that case, the amount of tax owing upon the sale of the flow-through is nil. This strategy is attractive for investors who realize losses on other speculative natural resource securities in their portfolio. If those losing securities are sold, triggering the loss, and the proceeds are immediately used to purchase flow-through, then portfolio risk may not increase significantly as the money is essentially moving sideways. Table 2 illustrates how an Ontario investor in the top marginal tax bracket would be able to shelter 100% of $20,000 in income (see Table 2).

TABLE 2: UTILIZING CAPITAL LOSSES

An Ontario investor at the top marginal tax rate (46.41%) sells losing investments realizing capital losses during year 1 totalling $20,000. Also in year 1, the investor purchases $20,000 of flow-through LP using the proceeds of his tax loss selling. Finally, the investor sells the flow-through LP for the same value upon maturity in year 3 and then applies the year 1 tax losses carried forward. Effectively, the net result for the investor is 100% sheltering of $20,000 in income.

	INVEST IN LP	DO NOTHING
YEAR 1 EARNED INCOME	$20,000	$20,000
YEAR 1 INVEST IN LP	$20,000	–
YEAR 1 INCOME TAX PAYABLE	–	$9,282
YEAR 3 SALE PROCEEDS	$20,000	–
CAPITAL GAINS TRIGGERED	$20,000	–
YEAR 1 LOSS CARRY FORWARD	($20,000)	–
CAPITAL GAINS TAX PAYABLE	–	–
AFTER-TAX PROCEEDS	**$20,000**	**$10,718**

A second strategy involves using a flow-through limited partnership together with an RRSP to reduce tax payable on a capital gain. Again, investors who benefit the most from this strategy would be those who are in the top tax bracket and that may have a large capital gain from the sale of securities or other investments such as real estate. Also, the investor must have sufficient contribution room within their RRSP to optimize their return. Table 3 is a simplified illustration showing how an investor who realizes a capital gain of $200,000 may use flow-through together with their RRSP to nearly eliminate capital gains tax payable (see Table 3):

TABLE 3: REDUCING CAPITAL GAINS TAX

In year 1, an Ontario investor at the top marginal tax rate (46.41%) sells an investment triggering a $200,000 capital gain and then invests only $100,000 of the proceeds into a flow-through LP. For each of the 2 years following maturity, assuming the LP value remains the same, the maximum amount of LP shares are contributed to the investor's RRSP then the remaining units are sold in the final year. For the investor in this example, the capital gains tax is nearly eliminated.

	INVEST IN LP	DO NOTHING
YR 1 CAPITAL GAIN (50% TAXABLE)	$20,000	$20,000
YR 1 INVESTMENT IN LP	($100,000)	–
YR 1 TAX PAYABLE	–	($46,410)
YR 3 RSP CONTRIBUTION LP UNITS	$23,820	–
YR 3 NET TAX SAVINGS	$5,527	–
YR 4 RSP CONTRIBUTION LP UNITS	$24,270	–
YR 4 NET TAX SAVINGS	$5,631	–
YR 5 REMAINING LP UNITS SOLD	$51,910	–
YR 5 TAX PAYABLE	$12,046	–
TOTAL TAX PAID	**($888)**	**($46,410)**

The third strategy utilizes the shorter hold period of four months, associated with individual flow-through shares, to obtain multiple tax deductions in the same year from the same initial investment. The strategy involves selling the maturing flow-through shares and then immediately reinvesting the proceeds into another flow-through share issue. When the investor begins this process by investing in March, the first deduction occurs. Then four months later, in July, the shares may be sold and the proceeds reinvested. This will trigger a capital gain from selling the first shares and another deduction as a result of the second purchase. After another four months, in November, the second investment may be sold and the proceeds reinvested in a 3rd flow-though issue. This will trigger another capital gain from selling the second shares and another deduction from the third purchase. Table 4 illustrates this high-frequency rollover strategy designed to compound a single investment into three deductions for a particular tax year. The result is that $20,000 in pre-tax income is compounded into $33,923 in the pocket of the investor (see Table 4).

The same-year triple compounding rollover strategy can produce remarkable returns if it can be implemented. However, finding the appropriate flow-through shares at precisely the correct time is a low probability for most investors. Yet, for those who wish to alter the strategy, and invest twice rather than three times in the same year, the probabilities increase significantly. For investors who begin the strategy early in the year, it is quite possible to find a second suitable flow-through issue, after the four-month hold period, prior to the end of the calendar year. The final result is two deductions from only one out-of-pocket investment.

The tax savings on flow-though can be very significant. Yet investors should be selective on which flow-through products they buy. Whether an investor chooses individual flow-through shares or limited partnership units, it is always prudent to consult a professional financial advisor who is experienced with these types of investments. When selecting a limited partnership, seek out managers who have a history of getting good returns. Look for a long track record of mostly positive returns. Consider if the portfolio will be invested entirely in mining, or energy or a mix. Speak with an advisor to see which approach is best for you.

Before buying a flow-through limited partnership, investors should examine its fee structure. Most pay a sales commission to advisors (usually about 3-6% of the original investment), plus upfront or ongoing management fees and/or performance bonuses. Other partnerships charge a small annual management fee (1%) or none at all, and then charge a management incentive bonus between 10% and 50% of the profits in excess of a certain return on the portfolio. Based on provincial securities laws, some investors may not qualify to buy flow-through shares or certain limited partnerships. A financial advisor can clarify if an investor meets the criteria.

Still, flow-through shares are not for everyone. The resource sector is cyclical by nature, and exploration is risky. Investors need the fortitude to tolerate the volatility. However, those investors who apply well-planned strategies may experience attractive investment returns. MM

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TABLE 4: SAME-YEAR TRIPLE COMPOUNDING ROLLOVER STRATEGY

In March, an Ontario investor at the top marginal tax rate (46.41%) invests $20,000 into flow-through shares. In July, the shares can be sold and the proceeds reinvested in other flow-through shares. In November, the second flow-through shares can be sold and the proceeds invested in a third flow-through issue. Assuming the value of the flow-through shares remains the same, the investor will realize 3 deductions totalling $60,000 within the same tax year from only one initial investment of $20,000. The investor will save $18,564 in taxes during the year and still have $20,000 remaining in flow-through shares. These shares can be sold the following year netting an additional $15,359 after the final capital gains tax is paid. The investor is able to convert $20,000 of pre-tax income into $33,923 in his pocket.

MONTH	OUT OF POCKET PURCHASE	REINVESTMENT OF MATURING SHARES	TAX DEDUCTION	TAX SAVINGS	CAPITAL GAINS TAX	NET TAX SAVINGS
MARCH	$20,000	–	$20,000	$9,282	–	$9,282
JULY	–	$20,000	$20,000	$9,282	$4,641	$4,641
NOVEMBER	–	$20,000	$20,000	$9,282	$4,641	$4,641
TOTAL	**$20,000**		**$60,000**	**$27,846**	**$9,282**	**$18,564**