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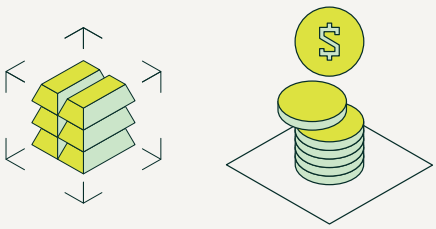
# The Tax Planning Advantages of Flow-Through Investing

## What is flow-through investing?

**1** Canadian resource companies need capital for exploration.



**2** To encourage Canadian resource exploration, the government permits qualifying companies to "flow-through" their exploration expenses to investors, for investor use as a tax offset.

**3** Investors who invest in a Flow-Through Limited Partnership (LP) may deduct the full investment from their income in the year the investment is made.

## Financial planning advantages of flow-through LPs for different investors

In 2 years or less (depending on the duration of the LP), the Limited Partnership terminates and the investment is rolled into a designated mutual fund corporation. The investor may now sell the fund, where their taxable capital gain is limited to 50% of the proceeds.

### "I HAVE CAPITAL LOSSES THAT I HAVEN'T USED YET"

Investing in a Flow-Through LP effectively converts income into capital gains, **so investors can take advantage of any unused capital losses** they are carrying when they sell their shares in the mutual fund corporation, thereby reducing their taxable income.

### "I'M MOVING TO A LOWER MARGINAL INCOME TAX BRACKET"

An investor who buys shares in a Flow-Through Limited Partnership decides to maintain their exposure to the resource sector and to defer their taxes further. As a result, they do not sell their shares of the mutual fund corporation. When the investor retires and is in a lower marginal tax bracket, they sell the fund and trigger capital gains taxes on 50% of their proceeds, at their new lower marginal tax rate.

### "I HAVE A LONGER-TERM INVESTMENT HORIZON (5+ YEARS)"

Similarly, with a longer-term investment time horizon, an investor may be well-positioned to take advantage of a deferred tax strategy by doing a "tax-free rollover" into a mutual fund corporation, which then allows their investment to compound until one of several events occurs:

- **they experience capital losses on other investments which they can now use to offset their capital gain;**
- **they enter a lower marginal tax bracket.**

# Examples of flow-through investing

## 1 Flow-Through investing offers one of the few remaining advanced tax planning strategies in Canada:

Much like RRSPs, Flow-Through investing allows the investor to deduct 100% of the investment against personal income in the year of investment. On termination of the Flow-Through LP, the investment is rolled into a designated mutual fund corporation. The investor may now sell the fund, where their taxable capital gain is limited to 50% of the proceeds.

| | YEAR 1 | | YEAR 2 | | NET 2YR CASH FLOW |
|---|---|---|---|---|---|
| Flow-Through LP Investment | ($10,000) | | | | ($10,000) |
| Tax savings[1] | $5,350 | | | | $5,350 |
| Investment redemption[2] | | | $10,000 | | $10,000 |
| Capital gains tax payable[3] | | | ($2,675) | | ($2,675) |
| After-tax cash flow | ($4,650) | + | $7,325 | = | $2,675 |
| After-tax return[4] | | | | | **57%** |

[1] Assumes highest marginal tax rate in Ontario of 53.5%. Tax rates will vary by province.
[2] Assumes no net gain or loss at the end of the term. On redemption, in exchange for favourable tax treatment, full value of investment is treated as capital gains.
[3] Assumes a 53.5% marginal tax rate x 50% Capital Gains inclusion rate x $10,000 = $2,675
[4] After-tax cost of investment is $4,650. After-tax return calculated as: $2,675/$4,650 = 57%

## 2 An excellent wealth planning tool:

In combination with the tax deferral achieved by the corporate class roll-over described above, an investor may also take advantage of any capital loss carry-forwards they have, which can be used to offset their capital gain.

| | YEAR 1 | | YEAR 2 | | NET 2YR CASH FLOW |
|---|---|---|---|---|---|
| Flow-Through LP Investment | ($10,000) | | | | ($10,000) |
| Tax savings[1] | $5,350 | | | | $5,350 |
| Investment redemption[2] | | | $10,000 | | $10,000 |
| Adjusted net capital loss of $10,000 | | | *offsets capital gain* | | |
| Capital gains tax payable[3] | | | $0 | | $0 |
| After-tax cash flow | ($4,650) | + | $10,000 | = | $5,350 |
| After-tax return[4] | | | | | **115%** |

[1] Assumes highest marginal tax rate in Ontario of 53.5%. Tax rates will vary by province.
[2] Assumes no net gain or loss at the end of the term. On redemption, in exchange for favourable tax treatment, full value of investment is treated as capital gains.
[3] Assumes investor has an adjusted net capital loss carry-forward of $10,000 which they apply to this investment.
[4] Because capital gain has been reduced to zero, capital gains taxes are likewise zero.
[5] After-tax cost of investment is $4,650. After-tax return calculated as: $2,675/$4,650 = 57%

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The income tax considerations applicable to an investor will vary depending on a number of factors, including whether units of flow-through funds are characterized as capital property, the province or territory in which he or she resides, carries on business, or has a permanent establishment, the amount that would be his or her taxable income but for the interest in the flow-through fund, and the legal characterization of the investor as an individual, corporation, trust, or partnership.

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