Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Flow-through shares and limited partnership units

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PRIVATE INVESTMENT MANAGEMENT™

If you have high taxable income, you may be inclined to look for tax deductions or tax credits to reduce your tax liability. One possible option is to purchase flow-through investments. They may allow you to reduce your taxable income and thus reduce your tax liability. This article provides an overview of flow-through investments and discusses the tax implications of purchasing flow-through investments.

What is a flow-through investment?

A flow-through investment is a type of tax-advantaged investment vehicle. The tax advantages are meant to encourage investment in resource companies engaging in exploration and development in the mining, oil and gas, and renewable energy and energy conservation sectors. If structured properly, Canadian tax laws allow certain expenses incurred by the resource company to be "renounced" or "flowed through" to you, and you can deduct the expenses on your tax return up to the maximum of what you paid for the investment. You may apply the deductions against all sources of income, thereby reducing your net income and the associated tax liability. There is no maximum renounced expenditure claim and therefore it is possible to create a non-capital loss. You may carry the non-capital loss (i.e. excess deductions) back three years or forward 20 years, and you may use the non-capital loss to reduce all sources of income.

There are two types of flow-through investments:

- Flow-through common shares, which are issued directly by a resource company; and
- Flow-through limited partnership (LP) units, which are issued by entities that purchase a diversified portfolio of flow-through shares.

What is a flow-through share?

A resource company may issue flow-through common shares directly from treasury in a similar fashion to regular common shares. However, flow-through shares are typically offered at a significant premium to the price of the company's common shares at the time of issuance. Individuals, trusts, corporations and partnerships can invest in flow-through shares, but only the original investors can deduct renounced expenses. These renounced expenses may be claimed in the year or carried forward. Original investors are entitled to deductions renounced by the resource company typically for a number of years after investment.

It's important to note that the adjusted cost base (ACB) of a flow-through share is deemed to be zero. This means when you eventually sell your shares, the full sale proceeds are taxed as a capital gain. You are usually able to sell your flow-through shares on the open market as soon as you've purchased your shares and the trade has settled; however, you should consult the prospectus and/or related offering documents of the investment for any holding restrictions.

While flow-through shares are qualified investments for RRSPs, RRIFs, RESPs, TFSAs and RDSPs, you will not realize the associated tax benefits. Therefore, it generally does not make sense to purchase flow-through shares in these accounts.

Quebec residents and flow-through shares

If you're a resident of Quebec, please consult your tax advisor, as tax treatment of flow-through shares may differ from the treatment in other Canadian provinces and territories.

In Quebec, flow-through shares provide an additional 20% deduction for exploration expenses incurred in the province in addition to a basic deduction of 100% of their cost. The capital gain realized on the sale of shares may be exempt up to the amount of the share purchase price.

The company may also allocate out issue costs, such as brokers' commissions, legal and accounting fees, and printing costs to you. You can deduct such amounts over a period of five years.

What is a flow-through LP?

Flow-through LP units may be issued by an entity that purchases a diversified portfolio of flow-through shares. Flow-through LPs offer tax benefits to investors similar to flow-through shares, but they have some different features. Unlike flow-through shares, where only the original investor can deduct renounced expenses, the owner of the LP unit on the last day of the LP's fiscal year-end (usually December 31) is entitled to deduct the renounced expenses. Typically, the LP flows through about 90–95% of your invested amount in deductions in the first year, and the remaining 5–10% in the following year(s).

In general, approximately 18–24 months from the close of the LP offering, the LP is dissolved and your LP units are exchanged for shares of a mutual fund corporation on a tax-deferred basis. You may choose to either hold or sell the shares of the mutual fund.

If you're a resident of Quebec, please consult your tax advisor, as tax treatment of flow-through shares may differ from the treatment in other Canadian provinces and territories.

Similar to flow-through shares, you may deduct the expenses renounced by the flow-through LP in the year or carried forward. However, instead of having a deemed ACB of zero, the ACB of your flow-through LP unit is reduced by the amount of flow-through deductions you claim on your tax return. This usually results in an ACB of zero, which means when the investment is disposed of, you may realize capital gains.

Flow-through LPs are generally not qualified investments for RRSPs, RRIFs, RESPs, TFSAs and RDSPs.

Special considerations for flow-through LPs

If you choose to purchase flow-through investments through an LP, you should be aware that while you're holding the LP units, the LP may incur and allocate some capital gains and potentially other taxable income to you. This is because for tax purposes, an LP itself is not a taxpayer. Instead, the income or losses earned by the LP are allocated to its partners for inclusion on their tax returns, even if cash has not been distributed from the LP to the partners. A gain realized in an LP may be from dispositions of flow-through shares due to corporate acquisitions or restructurings of the issuers or may be due to portfolio management decisions made by the portfolio manager.

To prevent double taxation, the ACB of your LP units is adjusted by income or losses allocated to you by the partnership. Losses are subtracted from and income is added to your ACB at the beginning of the year following the allocation. If you receive a cash distribution from the LP, this amount will reduce your ACB.

"Super" flow-through shares

In October 2000, the federal government introduced a temporary 15% investment tax credit as part of a program to promote exploration and to help moderate the impact of the downturn on mining communities. The program has been extended many times and is currently available to investors subscribing to qualifying flow-through share agreements on or before 2025. The credit, called the mineral exploration tax credit (METC), may be claimed on the amount of certain renounced mineral exploration expenses. The credit, which is only available to individuals and not trusts, partnerships or corporations, is deductible from federal income taxes payable and is in addition to the existing flow-through deductions. Flow-through investments qualifying for this additional credit are commonly referred to as "super" flow-through shares to distinguish them from regular flow-through shares.

You may claim the METC to reduce your tax liability in the current year. You may carry any excess credit back for up to three years or forward for 20 years, if it was earned in a year after 2005. You may also be able to claim a refund of your unused METC, but it can only be done in the year it is earned. This refund will reduce the amount of credit available to you for other years. The METC you claim in the year may result in an income inclusion in the following year in the absence of a new investment in flow-through shares or LP units.

If you reside in a province/territory that provides an investment tax credit, this tax credit may be claimed in combination with the federal credit. However, the provincial/territorial credit received or entitled to be received in a taxation year will reduce your federal tax credit.

Alternative minimum tax (AMT)

If you're purchasing a flow-through investment in order to reduce your taxable income, it's very important to consider AMT. This tax aims to ensure that every Canadian individual pays a minimum amount of tax. The calculation of AMT is based on an adjusted taxable income, which seeks to remove the advantages of certain tax-preferential items such as deductions from flow-through investments. If the AMT calculated is greater than your regular tax liability, the AMT becomes your tax liability for the year. The difference between the AMT you have to pay in a year and your regular tax liability can be carried forward for seven years to reduce your future regular income tax liability when your taxes payable exceed your AMT. For more information about AMT, ask an RBC advisor for an article on this topic.

Be sure to speak with a qualified tax advisor to help you determine how AMT will affect you if you're considering flow-through investments.

Corporate ownership of flow-through investments

A corporation can purchase flow-through investments in order to reduce its taxes. The tax benefit to the corporation of the deductions flowed through depends on the type of income the renounced expenses are being deducted against (i.e. investment income, active business income under the small business limit or active income taxed at the general corporate rate). A corporation is not subject to AMT, however, corporate minimum tax may be applicable in the corporation's province/territory of residency if it makes a large flow-through investment purchase.

If you're purchasing a flow-through investment in order to reduce your taxable income, it's very important to consider AMT.

A corporation may benefit from owning flow-through investments in particular if it has capital loss carry-forwards that may be used to offset the resulting capital gain arising on the disposition of the investment.

If you own a corporation, you may wish to consider a strategy where you purchase a flow-through investment personally. After you have personally deducted the expenses, you may be able to then transfer the flow-through investment to your corporation, on a tax-deferred basis. When the corporation sells the investment, the corporation will realize a capital gain, which may be sheltered by the corporation's capital loss carry-forwards. Please take note of any holding period requirements if you're contemplating this strategy.

Possible drawbacks of flow-through investments

Investment risk

What will the proceeds from sale be when the flow-through shares/mutual fund shares are sold 18–24 months from now? There is a risk that the underlying investment will not perform well and you may realize a loss on the sale. You may want to review the prospectus/offering documents for more information regarding a particular investment.

Consider if the tax savings will make up for any potential investment losses. Appendix A demonstrates how investment risk could impact the expected tax savings for an individual investing in flow-through LP units.

Tax risk

To be eligible for the renunciation, expenses incurred by the resource company must meet certain criteria. You should be aware there is a tax risk that the Canada Revenue Agency (CRA) will deny the renunciation of expenses that do not meet these qualifications. You will then lose the ability to deduct these expenses. If you have already deducted them, you may be reassessed in a later tax year. A three-year extension to the normal three-year reassessment period may apply.

Time horizon and liquidity

As there is generally no secondary market for units of flow-through LPs, in most cases you will need to wait until the partnership is dissolved and your units are converted to shares of a mutual fund corporation before you can liquidate your position. The units may not be converted into mutual fund shares for 18–24 months or longer after the close of the LP offering, and there may be a short holding period once the LP units are converted to shares of a mutual fund corporation.

Additional tax reporting

Claiming the deductions and tax credits associated with flow-through investments may complicate your tax filing situation. Further, if you invest in flow-through LP units, you will need to keep track of the ACB of the investment. This may result in additional accounting fees.

Other considerations prior to purchasing the investment

When determining whether a flow-through investment is right for you, in addition to the risks discussed earlier, you may want to consider the following with a qualified investment advisor and qualified tax advisor:

- What are the specific features and inherent risks associated with a particular flow-through investment?
- What is the issuer's track record?
- Is there a prospectus or offering memorandum?
- Is future financing required (i.e. additional future instalment payment or liability for debts incurred by the partnership)?
- When will the tax deductions be available?
- How does the investment affect your overall asset allocation strategy and your risk tolerance?
- How long do you plan to hold the investment?
- Has the issuer received an Advanced Income Tax Ruling from the CRA regarding certain aspects of the investment? If so, ask to see a copy.

Alternative ways to reduce your taxes payable

The following are some alternative strategies you may want to consider if you're looking to reduce your tax liability for a particular tax year.

Charitable donations

Making charitable donations of cash or securities (other than flow-through investments) before year-end generally creates tax savings of approximately 20% on the first $200 donated and up to approximately 50% on the remainder of the donations in the year. The actual savings depends on your province/territory of residence, the amount of the donations you make and the amount of your taxable income.

Claiming the deductions and tax credits associated with flow-through investments may complicate your tax filing situation.

Although this strategy does reduce taxes, there may be limitations on how much cash and/or securities you may be willing to or can afford to donate. If you would like more information, please ask an RBC advisor for articles on the topic of charitable donations and donating securities in-kind.

Tax loss selling

If you have realized capital gains during the year, and you're holding securities with unrealized losses, consider selling those securities to realize the losses. Review your portfolio with an RBC advisor to determine if any investments are in a loss position and no longer meet your investment objectives. If the investment still has strong fundamentals and meets your investment needs, consider all costs, including transaction costs, before selling investments solely for the purpose of triggering the tax loss. For more information on tax loss selling, ask an RBC advisor for an article on capital losses and tax loss selling.

RRSP contribution

Maximizing your RRSP contribution will assist in reducing your taxes payable, however, the tax savings from this RRSP deduction are generally small (due to RRSP contribution limits) relative to the total taxes payable.

Labour-sponsored venture capital corporations (LSVCCs)

The purchase of a LSVCC will generate a tax credit to reduce your taxes payable. This investment is similar to a mutual fund; however, the attraction of an LSVCC as opposed to a regular mutual fund is that you may claim a federal tax credit of 15% on the first $5,000 purchase. Additional provincial/territorial tax credits may also be available depending on your province/territory of residence. Note that you must hold the LSVCC for at least eight years to avoid repaying the tax credits. Similar to the RRSP tax savings, LSVCC tax credits are generally minimal in relation to a high-income earner's overall tax liability. For more information on LSVCC, ask an RBC advisor for an article on this topic.

Conclusion

Investing in flow-through investments may provide you with immediate tax savings. However, there are many other factors that you should consider, such as the investment risk, the diversity of your investment portfolio and the opportunity cost. Please consult with qualified professional advisors before making these types investment decisions.

The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

Appendix A: Flow-through LP unit example

Let's look at an example to illustrate the tax implications for an individual investing in flow-through LP units, and how investment risk could impact expected tax savings.

Scenario A illustrates an investor purchasing units for $100,000 and selling the resulting mutual fund shares for $100,000 after 24 months. Scenario B illustrates the same initial investment of $100,000; however, the mutual fund shares are sold for $70,000 after 24 months.

	Scenario A Sell flow-through/mutual fund after 24 months for $100,000	Scenario B Sell flow-through/mutual fund after 24 months for $70,000
Initial flow-through investment **(a)**	$100,000	$100,000
Deductions claimed	$(100,000)	$(100,000)
Tax savings @ 48%* **(b)**	$48,000	$48,000
Proceeds of disposition after 24 months **(c)**	$100,000	$70,000
Adjusted cost base**	$0	$0
Capital gain	$100,000	$70,000
Taxable capital gain	$50,000	$35,000
Tax on taxable capital gain @ 48% **(d)**	$24,000	$16,800
Net after-tax profit = **(c)** – **(a)** + **(b)** – **(d)**	$24,000	$1,200
Total after-tax return on investment over 24-month holding period	**24.0%**	**1.2%**
Compound annual after-tax return (e)	**11.4%**	**0.6%**
Pre-tax interest equivalent return = [(e) / (1 – 48%)]	**21.9%**	**1.15%**

* The above illustration uses an assumed marginal tax rate of 48%.

** Assumes no income or capital gain allocations from LP during holding period.