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Examining a common tax planning investment

Making your portfolio more tax efficient

As Canadian investors contemplate tax season, they think about efficiency. Do I pay too much in taxes? How can I minimize them? One answer comes in the form of flow-through shares, which provide a legitimate tax-assisted investment vehicle to save or defer taxes.

Flow-through shares are a financing mechanism that has been around for nearly three decades, originally designed to expand Canada's natural resources sector. Certain early-stage Canadian resource companies, which typically have overhead but little income, can fully deduct eligible exploration expenses that "flow through" to investors.

Resource companies and investors can both benefit. Investors are able to apply these special deductions against their own income and, in the year they are purchased, the deduction can be up to 100% of the amount invested. Resource companies in the mining, oil and gas, and renewable energy and energy conservation sectors acquire capital, raised through the flow-through share offerings, to finance exploration and development.

According to Canada's Department of Finance, in the period from 2007 to 2012 the oil and gas, mining, and clean energy sectors raised approximately $1.4 billion of public equity annually via flow-through shares. Tax benefits, including the Mineral Exploration Tax Credit, averaged $440 million per year.

Investors can take current year taxable income 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. When the flow-through shares are eventually sold, investors can offset capital gains against available capital losses backwards three years or forward indefinitely.

Because flow-through shares involve investment in junior resource companies, volatility and liquidity are considerations. Proper diversification is difficult to achieve when buying the shares outright; so some investors choose flow-through limited partnerships (FTLP). FTLPs pool their funds with other investors and invest in multiple flow-through share issues actively monitored by professional managers.

It's generally considered best to purchase FTLPs early in the year because the FTLPs that come out early are more likely to allocate the full value of their investors' funds. And, since they're out early, they have greater choice in the resource issuers they select for investment.

FTLPs that open for purchase later may find there are insufficient flow-through issues to invest all of the investors' funds, and investors won't get the full tax deduction of their initial investments. This

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defeats a key reason for using flow-through in the first place.

Flow-through is not for everyone. These shares are complex investments most suitable for sophisticated investors subject to the highest marginal tax rate. Investors should have a high degree of risk tolerance; they should carefully assess both risks and benefits; and they should seek professional tax advice. Investment decisions should never be based solely on tax advantages; they must always reflect investment merits and compatibility with portfolio goals.

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