Flow-Through Investments Can Result in Tax Savings

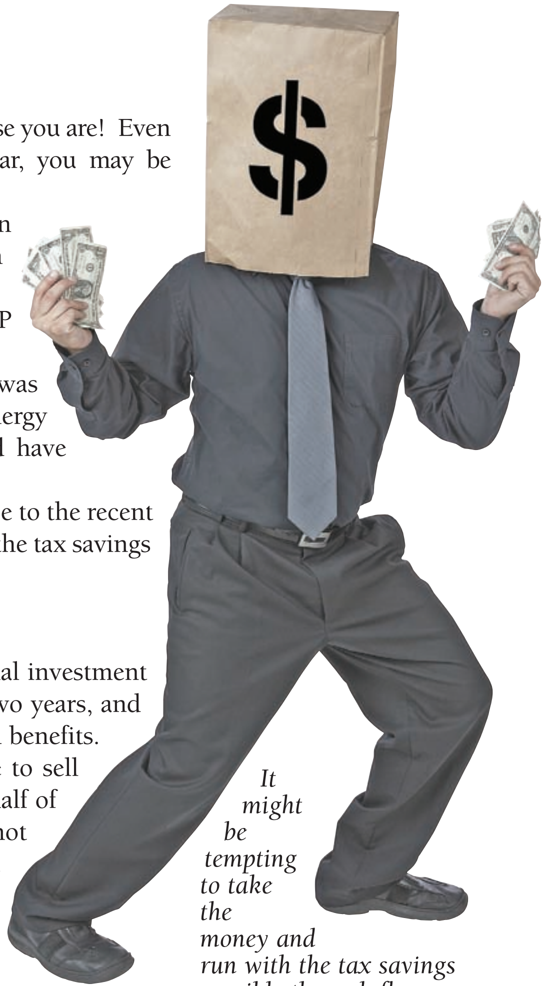
Strategies that make financial sense

Are you looking to save the amount of income tax you pay? Of course you are! Even though you might maximize your RRSP contributions each year, you may be interested in other ways to reduce the government's take.

As a working Canadian, you are limited to the amount you can contribute to your RRSP each year. Maximizing your RRSP contribution can be a great way to build your nest egg and cut down on your taxes payable. But what if you want to achieve greater tax savings than the RRSP rules allow?

A special tax savings strategy, called flow-through investing, was introduced in the early 1980s to encourage investment in Canadian energy and mining companies. The tax savings that these companies would have received are instead "flowed through" to you as an investor.

Flow-through investments are more popular today than ever before due to the recent boom in our energy and mining sectors. Also, investors are learning that the tax savings from flow-throughs can be impressive.



It might be tempting to take the money and run with the tax savings possible through flow-through investments.

HERE'S HOW THEY WORK

The government allows you to deduct up to 100 per cent of your original investment from your current year's income. You must own the flow-through for two years, and it should be invested outside your RRSP, to allow for future tax-preferred benefits.

On the two-year anniversary, you have some choices. If you decide to sell your investment, you will declare it as a capital gain. Remember, only half of a capital gain is taxable, the other is tax-free. If you decide that you do not want to sell your investment, you may do a tax-free rollover into a specified mutual fund in order to defer tax to a later date. Or, you might even decide to use your proceeds to buy another flow-through, so that you may receive the tax benefits all over again. This is known as flow-through recycling.

Let's look at an example. Dr. Tom and Dr. Jerry, who are in the 45% tax bracket, each just earned an additional $10,000. Dr. Tom didn't do any tax planning and as a result, has an after-tax income of $5,500 from that $10,000.

On the other hand, Dr. Jerry invested $10,000 in a flow-through investment so that he may receive a $4,500 tax refund. In two years, assuming Dr. Jerry's flow-through has maintained its value of $10,000, he would pay tax on only half of the investment. Therefore, his total taxes payable would be $2,250 (45% of $5,000), while his overall after-tax benefit would be $2,250 ($4,500 refund less $2,250 tax payable).

Dr. Jerry's after-tax benefit includes the $10,000 proceeds from his initial investment plus the $2,250, whereas Dr. Tom's after-tax income is $5,500. In other words, compared to Dr. Tom, Dr. Jerry is better off by $6,750.

In order to eliminate the capital gains tax altogether, Dr. Jerry would consider flow-through recycling, thereby dramatically increasing his tax savings.

It is important to keep in mind that there are risks associated with flow-through investing, as the market value can fluctuate. A decision to invest should be made primarily on the merits of the underlying investment, while the tax advantages should be treated as an additional benefit.

There are several strategies whereby flow-through investments can make good financial sense. Working Canadians through to retirees living on pension would be well advised to evaluate the power of flow-through investments with their financial advisor. •

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