

Issue #30 - “Flow Through Investing”

Interesting Links from Around the Web

Money Tips : [Best things to buy in September](#) : LifeHacks
 Investing : [Canada’s Economy Expands at Fastest Rate](#) : Globe
 Other : [Why we do what we do](#) : TED Talk – Tony Robbins

“Who, That’s some catch, that Catch-22” - Yossarian, Catch-22

Along with the increases in income tax rates, cigarette tax and aviation fuel taxes, it is equally important to point out what was not addressed. As of 2014, the maximum RRSP contribution limit (18% of income below \$136,000) remains capped at \$24,270 regardless of income. As such, Ontarians seeking to lighten their income tax burden must look for alternative forms of tax-sheltered investing if they no longer have RRSP contribution room. With the elimination of credits on Labour-Sponsored Fund investing in the province, reliable options that play within the guidelines of CRA are few and far between.

One of the few remaining bastions of credits available is known as Flow-Through Limited Partnerships. Introduced in the 1980s and popularized during the commodity boom of the early 2000s, these very high-risk investments are plays on mineral and oil and gas exploration and development. At their essence, these companies raise funds to be used to explore and occasionally develop new finds within the Canadian mining and oil industries. To encourage and compensate investors for the extra-ordinary levels of risk of these funds, governments offer important tax incentives relating to investments made in this volatile sector. These tax incentives can be split into two parts: credits and tax deductions.

Essentially, the Federal Government allows Canadian resource companies in these sectors to fully deduct certain expenses known as Canadian Exploration Expenses (CEE). To entice investors, those companies typically pass along those deductions to investors who can then deduct the CEE against their own income. Given that the entire cost of a flow-through share is tax deductible, that makes for a 100% deduction in the year of purchase on the income, thus rendering an equivalent amount of income effectively non-taxable, just like RRSPs. These investments are then locked-in for 12-24 months while the exploration projects are undertaken. If the exploration proves fruitful and positive value is generated, then the investments mature as capital gains. In essence, you are hoping to pass income from one-year to another while converting it from regular income into capital gains, which are 50% taxable.

On the next page, we will present two examples of how the investment in a flow-through lp might work, one where the underlying investment breaks even and a second where it loses 50% of its value, a common occurrence in these high risk resource plays.

On July 14th of this year, Charles Sousa reintroduced the provincial budget first tabled by the Liberals on May 1st. Having been given a majority mandate by Ontarians in the June election, Kathleen Wynne and her party are moving forward with many of the changes outlined in the original budget. Of primary and direct importance to you, dear clients, is more than likely the large increases in taxes on high income earners that is effective on all income going forward. Along with introducing two new tax brackets, the new budget increases taxes paid on dividends at high income levels.

Combined Marginal Tax Rates on Income**

Bracket	Income Type	Pre-Budget	Post-Budget	% Increase
\$150,000 - \$220,000	Regular Income	46.41%	47.97%	1.56%
\$150,000 - \$220,000	Eligible Dividend	29.52%	31.67%	2.15%
\$220,000 - \$514,090	Regular Income	46.41%	49.53%	3.12%
\$220,000 - \$514,090	Eligible Dividend	29.52%	33.82%	4.30%

To be clear, tax rates on income below \$150,000 have not been changed.

It is not our place to pass comment on whether or not this will prove beneficial for the province or further alienate a portable tax base, but it is fair to say that the new budget which removes tax breaks for large corporations and introduces a new mandatory pension plan for employees payable in part by employers, is not business friendly. How this will impact Ontario’s ability to attract multi-nationals to set up operations in our fair province is certainly a fine topic of discussion.

Our role as your financial advisors is to help you make the best financial decisions for you and your family. We believe that our expertise in income tax planning and preparation makes us particularly well suited as we continue to fill the role of accountant and investment manager for you. It is in this spirit that we will dedicate this month’s issue of Integra Market Insights to shedding some light on an alternative tax savings vehicle, Flow-Through Limited Partnerships.



INTEGRA

Market Insights



Jean-François Démoré
CFP, MBA, LLQP, HB CCS

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Scenario 1 –

Partnership matures at break-even (100% of NAV) on a 2-year Maturity,
Investor in top tax bracket (Income per year of \$514k+)

	Year 1	Year 3	Total
Flow-Through Transactions	Purchase of \$10,000	Sale of \$10,000	\$0
Tax Savings	\$4953		\$4953
Capital Gains tax payable		(\$2476.50)	(\$2476.50)
After-Tax Cash Flow	(\$5047)	\$7523	\$2476.50
After-Tax Rate of Return			+49%

Scenario 2 –

Partnership matures at 50% of NAV on a 2-year Maturity,
Investor in 43.41% Tax bracket (Income per year between \$88k-\$136k)

	Year 1	Year 3	Total
Flow-Through Transactions	Purchase of \$10,000	Sale of \$5,000	(\$5000)
Tax Savings	\$4341		\$4341
Capital Gains tax payable		(\$1085.25)	(\$1085.25)
After-Tax Cash Flow	(\$5659)	\$3914.75	(\$1744.25)
After-Tax Rate of Return			-31%

As you can see, substantial tax savings are earned, but the after-tax rate of return you earn is entirely dependent on how the investments behave that year. Rather than hope for a positive rate of return, the goal of flow-through investing is to ‘not lose more than half’, and thus preserve the tax savings for the investor. Certainly, they are not for the faint of heart, but then again, neither are Ontario’s new tax rates!

* Please note, Flow-through limited partnerships are not offered by Equity Associates or our firm, rather they can be purchased through a professional referral agreement with the special services department of National Bank. If you are interested in learning more, please contact your advisor.

** Reference: [Ontario Budget Highlights](#)