News update

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Flow through limited partnerships

At the start of a new year, it's usual to start thinking about making an RRSP contribution or to the Tax Free Savings Account (TFSA). It may not be usual to think about investing into a flow-through limited partnership (LP) at the beginning of the year. But, we should. That's because the beginning of the year is the most ideal time to invest into flow-through shares. I'll talk more on this later.

But first, what are flow-through shares? They are special common shares issued by Canadian mining and oil and gas companies to finance exploration. Apart from their attractive tax benefits, flow-through shares are identical to non-flow-through shares of the same company. Although any resource company can issue flow-through shares, typically only junior ones do so. After issuing shares and receiving the capital, these companies transfer, or "flow-through," certain Canadian Exploration Expenses (CEEs) to investors. CEEs are generally fully tax deductible against all income sources. With mining-focused limited partnerships (LPs), there may also be certain provincial and federal tax credits that increase the tax benefits even more.

How dependable are the tax benefits? Although nothing is ever permanently guaranteed when it comes to Canada Revenue Agency tax provisions, the tax benefits of flow-through shares are written specifically within the Income Tax Act, making flow-through shares as legitimate a tax saving vehicles as we can get. It also helps that flow-through shares have existed in one form or another since 1954. There have been cases in history where investors did not receive 100 per cent of their CEE deductions, but these are rare.

Investors are able to invest in individual flow-through shares of single companies or invest through a flow-through LP, which is essentially an actively managed flow- through fund portfolio. Flow-through LPs allows money managers to build portfolios of flow-through shares while the investor receives all the tax benefits. So, the benefits of investing with a flow-through LP should be obvious: diversification of risk and access to a professional money manager with the skill and experience in identifying the best opportunities.

So, using an example, let's say you invested $5,000 into a flow-through LP, which is then expected to transfer up to $5,000 of CEE to you in the year of purchase.

According to the Income Tax Act, you are allowed to claim this CEE as a deduction on line 224 of the T1 return against all sources of income. So, in effect, it acts just like an RRSP deduction. Meanwhile, you hold an investment that, hopefully over time, will grow well over the $5,000 cost. But wait, there's more to it. The CEE deduction gives you an immediate tax savings, which in itself is an economic benefit. For example, someone in the 40 per cent marginal tax bracket would save $2,000 in taxes that year ($5,000 x 40 per cent), which reduces the net cost of the investment (also called net capital at risk) to $3,000 ($5,000 less $2,000).

At the end of the day, investors can potentially receive a significant amount of their original investment back in the form of tax savings. Clearly, the higher the marginal tax bracket, the greater the immediate economic benefit, which is why flow-through shares can be a valuable tool for high income earners to manage their income taxes each year.

Why start investing at the start of the year?

The reason why the beginning of the year is the most ideal time to invest in flow-through shares has mainly to do with the premiums that flow-through LP managers must pay for the shares. You see, a flow-through common share is issued at a premium compared to the normal common share of the same company. Using a simple example, the normal common share of XYZ Company might be trading at $1, but XYZ Company might issue a flow-through share at $1.20. The extra premium for the flow-through share is essentially compensation to the company for giving up the CEE tax benefits.

Premiums vary from company to company and across different sectors, but usually a 10 to 20 per cent premium is quite common.

The general rule of thumb is that premiums tend to be lower at the beginning of the year. As a flow-through LP investor, you want your money manager paying lower premiums to buy the flow-through shares, so the opportunity to actually make a capital gain and a positive return over time increases. Once an LP is issued, the manager uses the net proceeds to purchase the flow-through shares of a number of resource companies. All money raised has to be put to work by December 31 of the year in which it was raised for tax purposes. So, with a full year, the manager can be more selective in choosing the best opportunities and ensure that the money raised is deployed by the end of the year to achieve full tax benefits.

Flow-through shares are issued by companies only several times during the year, if at all. They are not publicly traded throughout the year on a stock exchange, so, unlike regular common shares, one cannot just simply buy them anytime. So, each flow-through LP generally comes to market only once or twice each year. Investors will usually find a better selection of LPs at the beginning of the year compared to the end. Many LP issuers only launch one issue per year, and it's almost always in the first three months.

What happens at the end of the LP holding period?

The LP holding period is typically 18 to 20 months. During this time, there is usually no liquidity. At the end of the 20 months, the LP is dissolved and the assets of the LP are normally rolled over into a regular mutual fund (mostly on a tax- deferred basis) where liquidity is available. It is important to note here that, as a result of the initial tax deductions, the adjusted cost base (ACB) of the LP is zero or very close to zero. So, on a rollover, the mutual fund position will also carry the same ACB. Once the mutual fund is sold, a capital gain equal to the proceeds less the ACB (which is usually close to zero) is incurred.

The immediate tax deductions available for the investor are the most obvious tax benefits associated with a flow-through LP investment. However, there a few other subtle tax benefits. The eventual capital gain income results in lower taxation compared to regular income, as capital gains are taxed at only a 50 per cent inclusion rate. Also, capital gains can be offset by capital losses. Finally, the ability to defer taxation and choose when to sell the mutual fund and trigger taxes can be an important tax planning tool. In fact, most fund companies now offer a family of corporate class funds to switch into, thereby providing another level of tax deferral.

Risks

As with most equity based investing, there are risks to consider with flow-through LPs. The most obvious is that you can lose money. There is no guarantee that the rollover value will exceed your original investment cost. After all, the LPs do invest in junior resource companies, some of which may not make it through one resource cycle. However, like regular mutual funds, the chances of losing everything in a diversified flow-through portfolio are slim. Some years, like 2008, can be very bad for flow-through LPs, but fortunately these have been rare. What limits the loss potential is the fact that an investor receives immediate tax benefits. Using the prior example of the individual with a 40 per cent marginal tax bracket, her LP would have to decline roughly 40 per cent in value (pretax) before s/he can say it was a failure.

Of course, choosing the right flow-through manager with a long, successful track record will increase the odds significantly of making a positive return over time. The choice of rollover mutual funds is also an important consideration; the more choices, the better the options to stay invested and recoup any losses that the LP may have incurred.

Liquidity can also be a risk factor. At the investor level, as mentioned, there is usually no liquidity during the 18 to 20 month lock-up period. At the portfolio level, the companies that are held in the LP may be highly illiquid themselves, meaning the manager may have difficulty rebalancing positions in a timely manner. Poor portfolio liquidity is hardly beneficial to investors. Loss of tax benefits can also be a risk factor, should the CRA make any changes to the income tax act.

Bottom line

With any tax-driven investment, the investment quality should always be the primary consideration. Flow-through LPs provide the opportunity to invest in junior resource companies within commodity sectors with strong medium term fundamentals, such as copper, precious metals and oil. A flow-through LP offers professionally managed pools spreading risk across a number of companies and sectors.

But, flow-through LPs also provide a tangible tax benefit. The flow-through LP sector is one of the few areas of the Canadian investment landscape that still offers individuals a real tax break.

Flow-through limited partnerships provide important information in their Prospectus/Offering Memorandum. Please obtain a copy and read it carefully and be sure to note the associated risks and tax consequences before investing.

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