By Mike Magreehan

Flow-through investing

Anyone looking to differentiate their services would be well advised to consider the power of this tax saving strategy

Canadians enjoy a higher standard of living than people in most countries, but that comes with a price tag — higher taxes. In fact, Canada is one of the most highly taxed places in the world. And accountants are often called on by clients to help reduce the amount of income tax they pay. If RRSP contributions are maximized each year, another tax-saving strategy known as flow-through investing is worth investigating.

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Flow-through investing can be suitable for many clients with lifestyles and needs ranging from working Canadians to seniors living on pensions.

A special tax-saving strategy was introduced in the early 1980s to encourage investment in Canadian energy and mining companies. This strategy was coined flow-through investing because the tax savings the companies could receive are instead "flowed through" to investors. And investors have enjoyed some very lucrative tax savings.

Flow-throughs are a unique opportunity for clients to purchase shares in Canadian resource companies in return for a 100% tax deduction on the initial investment. (The client will receive tax form T5013 specifying the applicable deductions.)

From a tax-deduction perspective, the investor receives the same tax benefit as making an RRSP contribution (i.e., a reduction of line 236 on his or her tax return); but the difference here is that a flow-through investment is purchased and held outside a registered plan. Flow-through shares inherently carry additional risk because, as mentioned, the client is investing in energy and resource companies, and flow-throughs must be held at least four months.

There is a broader investment, known as limited partnerships, and these are simply a basket of flow-through shares of individual companies. This is similar to a mutual fund strategy, whereby you own a number of companies, thereby reducing your risk exposure to any one company. A limited partnership is a great way for clients to get started with this tax-saving opportunity. The holding period on a limited partnership is 18 months to two years. (For the purposes of this article, the overall strategy is referred to as flow-through investing.)

At maturity, the flow-through investment simply rolls, tax-deferred, into a mutual fund, which can then be sold at any time. Generally, once the investment is sold, the value of the investment becomes taxable as a capital gain.

A flow-through strategy is not tax avoidance; it is a Canada Revenue Agency (CRA)-sanctioned tax-conversion and tax-deferral strategy. Clients can legit-imately convert fully taxable income into deferred capital gains. First and foremost, an investment should be made on the merits of the investment, and only then should tax efficiency form part of the decision.

There are a few scenarios on flow-through investing that should be considered. They may give an adviser a leading edge and may turn clients into great referral sources.

Working Canadian

The 2007 maximum RRSP contribution limit is $19,000. In 2008, this limit will increase to $20,000, which is hardly suitable for someone earning a six-figure income. So how can high-income earners earn additional tax savings over and above what the maximum RRSP rules allow?

Let us assume a client earns $160,000 a year, and maximizes his or her RRSP contribution annually in an effort to reduce taxable income. For 2007, the most he or she can contribute to an RRSP is $19,000. In doing so, the taxable income is only reduced to $141,000.

In Ontario, the income a client earns over $119,000 is taxed at 46.4%. So, on the $22,000 he or she earns above $119,000, he or she will pay $10,200 in income tax.

To reduce the taxable income to the $119,000 threshold (where the income tax rate jumps to 46.4% from 43%), a client could purchase $22,000 worth of a flow-through investment.

In another example, a client has an employer pension plan, but the RRSP room is effectively eliminated each year by hefty pension adjustments. This is often the case for school teachers, principals, professors, civil servants and government employees. They may also be looking for tax savings beyond what their pension deductions allow.

An effective flow-through investment strategy can produce recurring tax savings, which can generate cash flow to fund other priorities. Of course, clients can spend the tax savings as they want; however, from a financial planning perspective, a client would be better served by using the tax savings to top up a child's Education Savings Plan, or to reduce or eliminate a mortgage or other debt.

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Downside protection

Flow-through investing is most appropriate for high-income clients. Through the initial tax deduction and the impact of capital gains tax when the investment is sold, investors gain almost 30% downside protection on the value of their investment.

If an investor in the 46.4% tax bracket purchases $10,000 worth of a flow-through, the 100% initial tax deduction will garner a $4,600 tax refund — thereby lowering his or her investment risk to $5,400.

When the assets are eventually sold, the 50% inclusion rate on capital gains will mean a tax hit of 23%, assuming the investor remains in the same tax bracket and the value of the assets does not change. If the value of the assets were to fall even by as much as 30%, to $7,000 in this case, the investor will only face capital gains tax of $1,624, leaving him or her with a post-tax balance of $5,376.

As a real-life example, CMP Resource limited partnership is Canada's oldest limited partnership. If a client invested $10,000 in the 2005 CMP offering, it matured at $16,300. As of October 31, 2007, the 2006 CMP offering was worth $9,770, while the 2007 CMP offering was worth $7,970.

These figures simply include the growth on the investment and do not include the upfront tax-deduction benefits. As a flow-through investment is largely a tax strategy, including the tax deduction in these numbers, your after-tax benefits are even better.

Retired Canadian

Currently, five million Canadians are 65-plus years old — about 15% of the population. Over the next two decades, the retired segment of our population will increase as the leading edge of baby boomers turn 62 this year, which also happens to be the average retirement age.

Once retired, most Canadians enjoy some form of government pension — the Canada Pension Plan, the Old Age Security (OAS) and perhaps the Guaranteed Income Supplement (GIS).

There are several strategies whereby flow-through investments can make good financial sense for retired Canadians.

Retirees receiving GIS or OAS pensions: Both the OAS and the GIS are subject to claw back if your client's income is beyond certain thresholds, as determined by line 236 on the tax return.

For instance, if a client earns more than $63,000, he or she will see OAS pension clawed back (reduced) by 15% for every dollar earned over this threshold. The OAS pension will be fully clawed back with income higher than $101,000.

If a client has taxable income of $70,000, and assuming no other deductions, he or she should consider a $7,000 investment in a flow-through. That way the client will receive a full OAS pension, as he or she will have reduced taxable income to just less than the claw-back threshold. In fact, the client will earn a small tax refund.

Estate planning strategy for senior clients with large RRIF accounts: CRA states that RRIF assets can be transferred tax-free from one spouse to another in the event of one partner's passing. It is upon the passing of the surviving spouse that proactive estate planning proves crucial, especially from a tax perspective.

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It is not uncommon for a senior couple to have large RRIF accounts — each valued at more than $200,000. For such clients, it is wise to evaluate the income-tax implications on the estate if one or both spouses were to die. This is increasingly important in cases of poor health or when senior clients approach five years of their life expectancy (generally between ages 75 to 80).

Let us assume that a client passed away with a RRIF account valued at $200,000. If the husband named his wife beneficiary, his RRIF simply rolls into his wife's RRIF tax-free, as allowed by CRA. If her RRIF was valued at $200,000 before her husband's passing, her RRIF balance becomes $400,000 with the roll-over.

If the wife were to then pass away, a RRIF valued at $400,000 would incur a total tax bill of approximately $168,000, less any personal exemptions. Most people would agree that this is a lot of money — especially if it is being given to CRA.

In this case, one strategy that could make sense is for the wife to withdraw lump sums from the RRIF annually, over and above her income requirements. This is known as an accelerated RRIF withdrawal strategy or RRIF meltdown. For every dollar she redeems from her RRIF, if she buys an equal amount of flow-through, she will completely offset any income tax payable.

If she repeats this strategy year after year, in the end, she will have effectively removed money from her RRIF (which is subject to full taxation on death) and invested the withdrawn funds in a nonregistered account, which can benefit from graduated tax advantages.

After year two, when the first flow-through matures, she can recycle the tax benefits. After year two, all future amounts she withdraws from her RRIF can be invested in income-preferred investments, such as dividend-paying companies, preferred shares, income funds or tax-advantaged mutual funds.

Recycle tax savings

One of the most compelling strategies with flow-through investing is recycling tax savings. With this strategy, a client sells the flow-through upon maturity (and declares a capital gain), then reinvests the proceeds in another flow-through, where 100% of that invested amount is fully deductible.

A client now legitimately receives recurring tax savings by simply recycling the investment proceeds. This is a simple, yet extremely effective, tax-planning strategy.

Charitable giving — avoiding capital gains tax

In the 2007 federal budget, the government allowed an investment to be donated to charity without claiming a capital gain. This is a tremendous benefit for philanthropic clients, provided they have investments in a gain position.

This is where a flow-through makes great sense. A client can purchase a flow-through investment, hold it for two years, then on maturity, donate the flow-through to a charity.

In this case, the client receives two tax benefits: the upfront tax-deduction on the flow-through purchase and the charitable donation tax credit he or she gets on the market value of the donated investment. The charity could then liquidate the investment and use the proceeds as it requires. For example, if a client earns $85,000 a year and makes a $10,000 flow-through investment purchase, all things being equal, he or she would receive a $4,300 tax refund. In year two, the client donates the investment to charity. Assuming the market value of the flow-through investment has kept its value and is worth $10,000 at the time of donation, the client could expect a charitable donation tax credit of about $3,800. Overall, the client would have saved $8,100 in tax, versus the simple $3,800 tax credit on a cash donation.

Conclusion

Today's clients are well educated and better informed than ever, and they expect more. If accountants are looking to differentiate their services from increasing competition, they would be well advised to consider the power of flow-through investing.

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