General Corporate — Commentary — Articles — English — Vern Krishna —, 2013-09-167 -- 2013 Year-End Tax Planning For Investors

2013-10-21

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Delivery Details

Date: January 8, 2019 at 3:15 p.m.
Delivered By: VERN KRISHNA
Client File: GAAR

Corporate Tax Centre – In this article, Vern Krishna discusses tax planning, charitable donations, capital losses and exemptions, and insights into investments.

2013 Year-End Tax Planning For Investors

Date: October 21, 2013

2013 Year-End Tax Planning for Investors—By Vern Krishna

The income tax is a tax on transactions and not on income. Tax planning is about timing transactions and identifying sources of income. Timing and choice of type of investment are important decisions for investors.

A fundamental rule of tax law is that one pays tax only when one *disposes*, or is deemed to have disposed, of investments. Tax planning involves controlling taxable events. Now is the time for investors to address some decisions before the year-end.

The past six years have been volatile for stock markets. The Dow Jones Industrial Index hit a high in April 2007. We then witnessed the rocky rides down in response to the American subprime mortgage fiasco. The Dow Jones Industrial Index skidded from its high of 14087 to 8451 in October 2008 and then climbed back up to 15400 on October 18, 2013. Patient investors have been rewarded, but are likely sitting on both accrued capital gains and losses.

Charitable Donations

Individuals who have benefitted from the surge in stock prices may consider donating appreciated stock to registered charities and reduce their tax bill at the same time. Donations will eliminate the accrued capital gain on the securities and also allow the taxpayer to claim a tax credit of about 50 percent. This is a far better option than donating cash. For example, assume that in 2008 an individual purchased shares for $20,000, which have since appreciated to $120,000. The accrued taxable capital gain of $50,000 would normally attract tax of about $25,000. By donating the shares in kind, the taxpayer would save the capital gains tax and also get a charitable credit of about $60,000, for total savings of $85,000.

Clean Out Capital Losses

Tax sheltering means protecting income gains from taxation by offsetting losses or deductions. Now is the time for portfolio pruning. Individuals should clean out their stock portfolio by December 23 to trigger sufficient capital losses so that they can offset them against any capital gains realized in the year or to carry back to offset gains in previous years. Similarly, investors should close out their option contracts with accrued capital losses in 2013 in order to shelter their capital gains. You will need to indicate that you wish to apply capital losses against prior year capital gains on your 2013 tax return. The CRA will do the rest for you.

If you are sufficiently optimistic and believe that your losers—such as, BP, will rise again to become stars in the future, you can “bed and breakfast” them: Sell the shares and then repurchase them after 30 days. This is entirely legitimate tax mitigation and not subject to any anti-avoidance rule.

Use Your Allowable Business Investment Losses

Investors who lost money in private corporations should evaluate whether they can write off their losses as allowable business investment losses (ABILs)—a special type of capital loss. A business investment loss is a capital loss that arises when one disposes of shares or debt of a "small business corporation" to an unrelated person.

The deductible portion is only 50 percent of the loss. The advantage of ABILs, however, is that, unlike ordinary capital losses, which one may deduct only against capital gains, they are deductible against any source of income—for example, business or rental income. Certain restrictions may apply if the individual previously claimed the capital gains exemption.

A business investment loss arises when one sells or transfers the shares or debt of a corporation that qualified as a small business corporation *at any time* within the preceding twelve months. Hence, shareholders in financially troubled corporations or individuals who have lent money to such a corporation can use these losses if they dispose of their interests before the year-end.

Claim the Capital Gains Exemption

The $750,000 capital gains exemption ($800,000 after 2014) is one of the richest exemptions in the Income Tax Act. The exemption is available in respect of shares of a qualified small business corporation (QSBC)—that is, a Canadian-controlled private corporation that carries on an active business primarily in Canada. The exemption is available when the taxpayer disposes of his shares of such a corporation if the individual held the shares for at least 24 months.

An individual can trigger the gain by selling the QSBC shares at their fair market value to his spouse, to a third party or to a corporation that one controls. The rules in respect of QSBCs are quite technical and you would do well to consult a professional advisor before finalizing your plans.

Defer Mutual Fund Purchases

Defer purchasing mutual funds in taxable accounts. Mutual funds generally clean up their portfolios in December to window dress their yearend performance reports and promote sales in the New Year. For tax purposes, a mutual fund is a conduit that flows through its realized dividends, interest and capital gains to unit holders each year. Unit holders must include their share in income and pay tax thereon, regardless whether the fund actually pays out or reinvests the income in additional units. Thus, an individual who purchases mutual fund units in December will end up paying tax on undistributed income that the fund allocates to him or her in 2013.

Investing in a mutual fund just before it pays a large distribution is like joining a party as it is winding down—you are saddled with the clean up. You should wait until January 2014 before making additional or new fund commitments in taxable accounts. Call the fund company and ask about its income distribution policies and dates. You may even get a clear answer.

Review Portfolio Mix

Evaluate the risk-reward ratio of your investments. The income tax system does not treat all income equally. There are four different forms of investment income: capital gains, eligible dividends, ineligible dividends and interest. Different rates of tax apply to each source of income. Ultimately, only after-tax returns really matter.

At the top end, an Ontario individual will pay tax of approximately 25 percent on capital gains, 34 percent on eligible Canadian public company dividends, 36 percent on other Canadian dividends, and 50 percent on interest, rents, royalties and foreign dividends. For example, an individual who earns $100 from each of these four types of investments would keep $75 (capital gains), $66 (eligible dividends), $64 (other dividends) and $50 (interest income).

On an after-tax basis, a dividend is usually more valuable than interest income. Interest income is taxable on an accrued, as-earned, basis annually. Hence, it is generally better to earn interest income in an RRSP and capital gains and dividends outside tax-sheltered plans.

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