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Corporate Tax Centre - Vern Krishna gives insight on managing capital gains and losses, using your allowable business investment losses, and discusses income splitting and charitable donations for year end tax planning.

2014 Year-end Tax Planning for Investors (Vern Krishna)

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Vern Krishna—2014 Year-End Tax Planning for Investors

As the 2014 tax year draws to a close, it is time for some timely arrangement of one's tax affairs. The basic general rule of tax planning is quite simple: defer tax liabilities as much as possible. The basic rule, however, must be reviewed in light of the individual's particular financial circumstances. Tax planning is about timing transactions. The last six years have been spectacular for American stock markets. The Dow Jones Industrial Index has risen from its low of 8451 in 2008 to a new high of 17,634 in November 2014, a gain of 109 percent. Patient investors have been rewarded, but are likely sitting on both accrued capital gains and losses. Now is the time to plan for 2014.

Managing Capital Gains and Losses

Tax sheltering means protecting income gains from taxation by offsetting losses or deductions. Individuals should houseclean their stock portfolio by December 24 to trigger sufficient capital losses to offset against any capital gains realized in the year, or to carry back losses to offset gains in the three previous years. Similarly, investors should close out their option contracts with accrued capital losses in order to shelter their capital gains. You can carry forward any unused capital losses and apply them in the future. They are like money in the bank.

If you are sufficiently optimistic and believe that your losers will rise again to become stars in the future, you can "bed and breakfast" them: Sell the shares, wait for 30 days and buy them back. Meanwhile, you can use your losses and end up owning the stock. This tax avoidance scheme is entirely proper.

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 advantage of ABILs is that they are deductible against any source of income—for example, business or rental income.

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 $800,000 capital gains exemption 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. There are several technical rules that apply.

Defer Mutual Fund Purchases

Defer purchasing mutual funds in taxable accounts to January 2015 or consider selling your mutual funds before year-end to minimize your allocation of taxable income for 2014. 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 for its unit holders, who must include their share in income and pay tax thereon, regardless whether the fund actually pays out or reinvests the income in additional units.

An individual who buys fund units in December can end up paying tax on undistributed income that the fund allocates to him or her in 2014. That is like joining a party as it is winding down—you are saddled with the clean up.

Charitable Donations

You can do good and save money in the process donating shares with accrued capital gains. Donations eliminate the accrued capital gain on the securities and also allow the taxpayer to claim a tax credit of about 50 percent, which is the best of all worlds. For example, if an individual purchased shares for $20,000 and sold them for $120,000, the taxable capital gain of $50,000 would 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.

Income Splitting

Although Mr. Harper’s income splitting proposals will not help higher income employees, investors have their own ways to split income. If your spouse is in a lower tax bracket, consider making a loan before 2015. You can charge interest at the prescribed rate, which is only 1 per cent. Your spouse can invest the loan to earn a higher rate of return.

Timing of transactions is essential to legitimate tax planning. The *Income Tax Act* allows tax sheltering for gains and investments, but the rules are technical and the timelines are strict. We can use the gains of the past year in particular to reduce our tax bills, but do so before the end of the year.

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