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Your Guide to Tax-Saving Strategies

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Keeping Your Cash

Tax 101

Samantha Prasad LL.B.

For those conservative investors out there, the urge to keep your money in cash and cash equivalent instruments is hard to overcome (despite the low interest payable). However, it should be worth noting that sometimes seeking safety in income producing investments and cash may also mean that you have to think about how to offset any resulting tax.

Triggering Capital Gains

If you hold stock that has an accrued gain, but are convinced that it's still safer to trigger a capital gain on the sale of stock and hold the funds in cash, even though there will be tax to pay, then here are some ways that you may be able to shelter or offset that tax:

■ **Bad Loans** - Included here could be such items as bad mort-

gage investments or junk bonds (or even a no-good advance to your company, bad loans to a business associate, and so on.).

To obtain a deduction, the loan must generally be interest-bearing. So, if you made a loan to a relative on an interest-free basis, for example, the CRA can take the position that the loan was not taken out for income-earning purposes and therefore no loss is available to begin with. An exception to this arises if you are a shareholder of a Canadian corporation and have advanced the money to it on a low or no interest basis. In this case, provided that certain conditions are met, the CRA will give you at least a capital loss on the bad loan.

When is a loan bad? The government's position is that claiming a bad debt loss on a loan is basically an all-or-nothing proposition: the whole of the loan must be uncollectible; or, when a portion of the debt has been "settled", the remainder must be uncollectible. Also, the party line

is that either you must have exhausted all legal means of collecting the debt, or the debtor must have become insolvent, with no means of paying the debt.

■ **Out-of-business companies.** Another overlooked source of tax loss is investments in companies that have gone bankrupt or are now worthless because of insolvency and cessation of business activities. This may often include a company that has been delisted from a stock exchange.

Note: If a bad investment is in a Canadian private company which was devoted to active business, the loss could qualify as an "Allowable Business Investment Loss" (ABIL); if so, this type of loss can be deducted against any type of income, whereas a normal capital loss can only be deducted against capital gains. So ABILs are the "holy grail" of losses. But with that power, comes much responsibility (or so they say). Translation: beware as CRA will generally send you a questionnaire looking for information on the ABIL; be prepared to have your documents in order and ensure you speak with your tax advisor before you claim that ABIL.

■ **Bonds purchased at a premium** – If you have invested in a bond (outside of your RRSP), it may be the case that you purchased it at a premium over its redemption price because the coupon rate on the bond itself may have been high-

Samantha Prasad, LL.B., is a tax partner with the Toronto-based law firm Minden Gross LLP, a member of Meritas Law Firms Worldwide, and a Contributing Editor of The TaxLetter, published by MPL Communications.
sprasad@mindengross.com

er than comparable interest rates when you bought the bond - in these cases, there will probably be a capital loss at maturity or if you have sold the bond.

■ “Last chance” capital gains election. This might be a long-shot, but if you have been a long-time investor, it doesn’t hurt to check your 1994 return to see if you have made the “last chance” election to take advantage of the now-defunct \$100,000 capital gains exemption. For most investments, this will result in an increase in the cost base of the particular investment item. On the off-chance that you have held on to that investment for the last 25 years, and decide that now is finally the time to dump it, then your capital gains tax might be reduced based on the bumped-up cost base (again, this is a long-shot). (If your gain is on a mutual fund and you made the election on it, you may have a special tax account - known as an “exempt capital gains balance” - which can be used to shelter capital gains from the fund.)

■ Check your loss carryforward balances. Another thing you should do is check to see whether you incurred capital losses in a previous year, which you never used. This is quite possible, because deductions for capital losses can only be claimed against capital gains and unclaimed capital losses can be carried forward indefinitely. If you don’t have back records, another idea is to contact the CRA to request your personal carryforward balances.

■ Have your kids report Capital Gains. If an investment is owned by your kids, the gain can be reported on their tax return.

This could dramatically slash - even eliminate - the tax bite. Here’s why: Every Canadian individual - irrespective of age - is legally entitled to the basic personal exemption, which covers off the first \$12,069 of income (for 2019). And with the 50 per cent capital gains inclusion rate, this means that kids with no other income can now earn just over \$24,000 of capital gains annually, without paying a cent of tax. And even if the gain exceeds this amount, since your kid pays tax on the gain in the lowest tax bracket, the tax rate is only about half of what a high-income earner would pay.

■ Defer with Reserves. If you sold an investment for a capital gain, but you are not entitled to receive the cash proceeds until the end of the year, you are allowed to defer a portion of your capital gain until next year by claiming a “reserve.” Basically, reserves may enable you to defer your tax on capital gains over a five-year period, where the full amount of proceeds are payable over time.

☞ Check your losers. And, this goes without saying, if you looking to get out of stocks, there’s a chance that for every stock that has an accrued gain, you probably have another stock that is sitting in a loss position. So simply engage in tax-loss selling - sell of some of your losers to trigger some losses to offset your gains.

Increasing your Investment Income

In the search for yield, investors have turned to such things as monthly income funds and income trusts, structured notes, capital class units, and so

on. But again, cash in your hands means investment income that must be reported on your tax return.

Income splitting has always been a long traditional way to minimize tax on investment income. However, the attribution rules and the tax on split income (TOSI - formerly the kiddie tax) have more than curtailed this. Happily, there are a number of key strategies which can allow you to trump CanRev at its own game.

■ Making the Most of Independent Capital. Make sure that the lower-income spouse invests his or her own capital, while the higher-income spouse’s capital is used for day-to-day living expenses. Examples of independent capital can include just about anything that doesn’t come from the higher-income spouse - e.g., a gift or inheritance from a parent, or earnings from a job.

You can maximize a spouse’s independent capital in a number of ways. For example, use the higher-income spouse for personal expenditures - even paying the lower-income spouse’s taxes. Likewise, if a parent of one of the spouses is thinking of giving some money to the family, it’s better tax planning if the gift is made to the lower-bracket spouse.

Tax Tip - Make sure that the lower-income spouse’s earnings and other independent capital are segmented in his or her own bank account and not co-mingled with money that comes from the higher-income spouse - e.g., joint accounts and the like. That way, there should be no question about who pays the tax on the income. Make sure that these “pure” accounts continue to “track”. For example, a sepa-

rate “pure” brokerage account in the sole name of the lower-income spouse should be opened for the investments.

■ The Loan Manoeuvre.

The Income Tax Act also allows a spouse to pay tax on investment income (and capital gains) if the investment is funded by a loan from you, provided that the spouse pays you interest at the “prescribed rate” in effect at the time the loan is made – currently 2 per cent.

In order to qualify for this tax break, the interest on the loan for each year must be paid no later than January 30 after the year end. Otherwise, the attribution rules will apply and the profits will be taxable in your hands, not your spouse’s. Furthermore, if you miss even one deadline, the attribution rules will apply on the particular investment forever more.

Note: Once you make the prescribed loan, the interest rate can be locked in, based on the prescribed rate in effect at the time, even if interest rates go up.

■ Capital Gains Splitting.

As the attribution rules potentially apply to children (and grandchildren), they generally state that income from an investment is taxed in the hands of the funding parent while the child is a minor. However, the attribution rules do not apply to kids’ capital gains. This means that if a parent funds an investment in an account for a child (either by way of gift or loan), the attribution rules do not apply to capital gains, even though they do apply to interest, dividends, and the like until the year in which the child (or grandchild) turns 18. This important exception to the attribution rules will apply even if you do nothing more than put some money in the child’s name to make an investment. And as noted above, just over \$24,000 in capital gains could be sheltered tax-free by each of your children.

However, there is one complication I should mention. Many financial institutions require investment accounts for minors to be set up in the name

of a parent, because there are legal restrictions for accounts in the name of minors. These are called “in-trust” or “in-trust for” accounts.

A number of years ago, there had been some confusion as to whether these accounts will thwart capital gains splitting. But in a series of Technical Interpretations, CanRev has indicated that this should not generally be the case.

Having said this, larger-scale investors should seriously consider documenting these in-trust accounts. In fact, in many cases, it may make sense to set up a formal trust. Remember, a separate in-trust account should be set up for each child - and the investments in the account really belong to the child, not you. So, a formal trust may make sense if you’re uncomfortable with this. For example, if you may change your mind in the future as to which child should benefit from the investments, a discretionary family trust can help you to hedge your bets. □