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¶TAXSTRATEGY

Turning your investments into cash:

The downside

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My eldest daughter recently decided that she wanted to open an investment account into which she can put part of her earnings from her part-time job. The idea of investing with her own money made her quite excited, and pretty soon she was talking about what she was going to do with all of her money when she eventually found the next GameStop and cashed out her investments. Of course, we had to explain the concept of the stock market to her and that sometimes in a down economy, or where the stock market might take a hard turn downwards, it might be best to keep her savings in cash and cash equivalent instruments, usually the first thing investors might look to. No doubt the low risk associated with such investments is hard to ignore. However, it should be worth noting that sometimes seeking safety in income producing investments and cash may also buy you a tax problem. since it may likely require you to change your investment position.

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Triggering Capital Gains

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

☛ Bad Loans - Included here could be such items as bad mortgage 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. 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 losses 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 active, 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. A word of warning: if you claim an ABIL, assume that you will receive a standard letter from the CRA asking for information to support your claim.

☛ Bonds purchased at a premium – If you have invested in a bond (i.e., outside your RRSP), it is possible that you purchased it at a premium over its redemption price because the coupon rate on the bond itself was higher 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 it.

☛ "Last chance" capital gains election. 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 to the cost base of the particular item, which in turn will reduce your capital gain; however, that also assumes that you have held the particular investment since before 1994. (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 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 your kids own an investment, 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 $ 13,808 of income (for 2021). And with the 50 per cent capital gains inclusion rate, this means that kids with no other income can now earn just over $26,000 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 significantly lower than that of a high-income earner. (Note: if the parent funded the kid's investment, such parent must normally pay the tax on interest and dividends generated by the investment until the year the child turns 18, unless a prescribed loan strategy was put in place (which requires you to lend funds to your kids (or usually a trust for the benefit of your kids) and charge the prescribed rate of interest which is currently 1 per cent).

Sometimes, people hold an investment for their kids, e.g., as a gift for them, but it is registered in the name of the adult. This isn't necessarily a showstopper. For one thing, if the account is registered in your name "in trust," this may show that it is really for your kids. Another possibility is to visit a tax advisor to discuss the possibility of documenting the fact that the investment is for your kids, e.g., by filling out a legal declaration of trust. Of course, this is assuming that there originally was a gift to the child.

☛ 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.

☛ And, this goes without saying, if you looking to getting 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 some of your losers to triggers some losses to offset your gains. ❑