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TAXSTRATEGY

Seeking safety in income producing investments can get complicated

Tax traps holding cash

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For those of you who are conservative investors, the urge to keep your money in cash or the equivalent is hard to overcome, despite today's low interest rates.

And yet, seeking safety in income-producing investments and cash may sometimes buy you a tax problem. In those situations, you may need to change your investment plan.

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 – here are some ways that you may be able to shelter or offset the capital gains tax:

Bad Loans. Included here are things like bad mortgage investments or junk bonds (or even a no-good advance to your company or bad loan to a business associate).

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. Therefore, no loss is available to begin with.

An exception 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, and if 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, 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 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.

Income splitting has always been a long, traditional way to minimize tax

Beware, however, that if you claim an ABIL, it has become standard procedure for the CRA to follow up with more questions to ensure that the ABIL is being properly claimed.

Bonds purchased at a premi-

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um If you have invested in a bond (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.

That also assumes, however, 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 can 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 (or 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 $11,138 of income (for 2014).

And with the 50 per cent capital gains inclusion rate, this means that kids with no other income can now earn just over $22,000 of capital gains annually, without paying a cent of tax.

And what if the gain exceeds this amount? Since your kid pays tax on the gain in the lowest tax bracket, the tax rate is still only about half of what a high-income earner would pay. (Note: the parent who funds the kid's investment must normally pay tax on interest and dividends generated by the investment until the year the child turns 18.)

Sometimes, people hold an investment for their kids (e.g., as a gift) but it is registered in the name of the adult. This isn't necessarily a show-stopper.

For one thing, if the account is registered in your name "in trust," this may show that it is really for your kids. Another option 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.

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 are looking to get out of stocks, there's a chance that for every stock that has an accrued gain, you probably have another one that is sitting in a loss position. So, simply engage in tax-loss selling, and sell off some of your losers 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, and capital class units. But again, cash in your hand means investment income that must be reported in your tax return.

Income splitting has always been a long, traditional way to minimize tax on investment income. However, the attribution rules and the kiddie tax have more than curtailed this avenue. 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 person-

al expenditures, which can even include 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 commingled with money that comes from the higher-income spouse, such as 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 separate "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 one 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 after.

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.

That means 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.

There is, however, one complication. Because there are legal restrictions for accounts in the name of minors, many financial institutions require investment accounts for those under legal age to be set up in the name of a parent. 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 powerful financial planning weapon known as a "discretionary family trust" can help you to hedge your bets. ❐

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