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TAXSTRATEGY

Tax Planning in a Down Economy

Covid Tax Tips

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Back in early February, before we all went into lock-down due to Covid, I wrote about implementing a refreeze in a down economy. Who knew back then that the economy would continue to drop like it did. So it made me consider what other tax planning strategies to consider, in addition to a refreeze, while our economy is still down (if you haven't read my February article, consider doing so).

Triggering losses

I think it would be a safe bet to say that your investments might have taken a hit in the last few months. So you may want to consider which of your losers you might want to cut loose. By triggering the loss in 2020, you can carry it back three years to offset against any capital gains in previous years, or you can carry forward the capital loss indefinitely to offset against future gains. Note: If you are lucky enough to have gains in 2020, you have to first use the losses against current year gains.

NOTE: Beware of the superficial loss rules when triggering a loss. If you're selling on the market to take a loss, and you buy back an identical investment within 30 days before or after the sale, the loss will be denied. Although these rules are designed to counter artificial losses, they could apply inadvertently - for example if you sell, then change your mind and buy in again, maybe after the stock has dropped further. The rules will also apply if your spouse buys back in within the 30-day period (or a controlled company), but not if a child or parent reinvests. The rules apply not only to stocks, but to mutual funds as well. But they only apply if you repurchase an identical asset. So if you sell Bank A and buy Bank B, you're OK.

Note 2: When assessing whether you're in a loss position, don't forget that capital gains are calculated in Canadian dollars - so currency fluctuations can be a key consideration. If the Canadian dollar has appreciated against the currency there will tend to be losses.

Crystallizing gains

On the flip side, instead of triggering losses, you may want to also look at triggering a capital gain. There has been much speculation about whether the CRA will increase the capital gains inclusion rate (currently at 50 per cent) in the 2020 Federal Budget. Before Covid, the concern was due to the political climate (i.e. the Liberals had a minority government and the NDPs had campaigned on increasing taxes). The 2020 Budget was delayed with the onset of Covid; and now the speculation is that perhaps the government might increase the capital gains inclusion rate as a way to raise money to fund the various government relief measures released as a result of Covid. So if you anticipate a liquidity event in 2020, you may want to consider crystallizing your capital gain prior to the release of the 2020 Federal Budget, just in case. And if you are not sure if there will be a liquidity event or not, you can consider a strategy that would put the

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pieces in place to trigger a gain, but still defer that decision until after the Budget is released (you should reach out to your tax advisor to discuss possible strategies). As to when the 2020 Federal Budget is going to be released, your guess is as good as mine. So you should have these discussions with your tax advisor sooner than later.

Capital Dividend Clean UP

If you hold your investments in a corporation, and are thinking of triggering losses as discussed above, then the first thing to do is to first check your corporation's capital dividend account (CDA) balance. What is a CDA? Well, as you know, only 50 per cent of a capital gain is subject to tax. So when your corporation realizes a capital gain, it only pays tax on 50 per cent of the gain. The other 50% "tax-free" portion of the capital gain is added to the corporation's CDA. A tax-free capital dividend can then be paid out of the corporation to you, the shareholder (as long as you are a Canadian resident). However, if the corporation realizes a capital loss as part of a loss selling strategy, those losses will grind down the CDA balance and you will lose the ability to take money out tax-free. So it is very important to make sure you clear out your CDA by declaring a tax-free capital dividend to you before you trigger any losses. And if you don't have any cash to pay the capital dividend, the corporation can satisfy the capital dividend with a demand promissory note so you can always pull that amount out tax-free in the future.

Income Splitting opportunities

The Tax Act is full of various rules to prevent you from trying to sprinkle income to low-tax family members (known as income splitting). The "attribution rules" for example, would apply where you transfer property or funds to your spouse (including common law spouse) minor children, minor grandchildren or minor nieces/nephews ("Family Members"), unless you fall under certain exceptions. But in down economies, these exceptions to the attribution rules generally get spotlighted.

One of these exceptions is the prescribed rate loan strategy. As I have discussed in previous articles, you can avoid the attribution rules if you, the higher-income family member, loan funds to the low-income Family Members, provided that they pay you interest at the "prescribed rate" in effect at the time the loan is made. Moreover, the interest on this loan has to be paid by no later than January 30 each year. If you miss even one January 30 deadline, the attribution rules will apply forevermore. The prescribed rate has been at 2 per cent for the last little while, but it is going down to 1% on July 1st, 2020 – so the opportunity to income split through a prescribed loan will become a lot more attractive.

If you don't have cash to loan to your Family Member, consider doing a loan "in kind". For example, if you have a securities portfolio in your name, transfer the portfolio to your low-income spouse and have your spouse issue a demand promissory note reflecting the prescribed interest rate for an amount equal to the fair market value of the portfolio at the time of the transfer. However, this transfer may be subject to capital gains tax by you, the transferor, as the transfer would have to be made at the portfolio's fair market value. But if your portfolio has gone down in value, then now is time to make that transfer.

NOTE: if you want to loan to any minor Family Members, you should do so through a family trust, as minors cannot legally borrow from you.

Defer RRSP Contributions

If your income / salary has gone down this year due to Covid, you may want to consider deferring any RRSP contributions until next year, especially if you expect to be in a lower tax bracket for 2020. So hopefully, when you are back into the top bracket next year, you can double up your RRSP contributions for 2021. ❏