Strategies to Minimize Capital Gains Tax

Towards the end of the year, many investors review their investment portfolios to determine the anticipated tax impact of any capital gains and losses realized during the year. For investors who have realized significant capital gains, this article examines various strategies to help reduce the impact of a potential tax liability of these gains, regardless of whether they were the result of a voluntary or involuntary sale.

Potential Tax Minimization Strategies

1. Create tax deductions

For some investors, the tax liability created by realizing capital gains in a non-registered portfolio can be reduced by claiming an offsetting tax deduction. For example, the extra cash flow from the sale of an investment could be directed towards a larger RRSP contribution, especially where the individual has significant unused RRSP contribution room from prior years. Alternatively, in the right circumstances (subject to the investor's tolerance for risk and upon consideration of all tax implications, including the potential for alternative minimum tax), the purchase of a tax-favoured investment – such as flow-through shares – can be used to defer the tax payable in the year a large capital gain is generated.

2. Application of capital losses

The amount of capital gains subject to tax in a taxation year is based on the calculation of net capital gains, which is the sum of all capital gains less all capital losses realized in the year. Therefore, to the extent an investor realizes capital losses in the same taxation year that a significant capital gain is triggered, the tax liability on the capital gain can be reduced. Accordingly, it may be worthwhile to review your portfolio to consider the sale of certain investments with accrued losses to offset capital gains realized earlier in the year, provided a sale makes sense from an investment perspective. However, it is important to be aware of the superficial loss rule which may deny a capital loss realized on a disposition of property.

The rule generally applies if:

i. During the period that begins 30 days before the disposition and ends 30 days after the disposition, you (or any person or entity considered to be affiliated with you for tax purposes) acquired the same or identical property; and

ii. At the end of the period, you or an affiliated person or entity owned or had a right to acquire the same or identical property.

Similarly, it may be possible to trigger a capital loss on a worthless security without an actual disposition by filing a tax election in qualifying circumstances.

With respect to foreign securities, when a Canadian resident sells a foreign investment, the sale must be reported on his/her Canadian income tax return in Canadian dollars. Therefore, the net return will be a combination of the actual return on the investment and the gain or loss in the currency exchange rate. The fluctuation of the exchange rate impacts the net capital gain or loss on the sale and can either increase the capital gain or turn a profitable investment into a net loss. A capital gain or loss on a foreign investment is taxed in the same manner as a gain or loss on a Canadian investment (i.e., 50% inclusion rate for capital gains).

To the extent that a spouse (or common-law partner) has securities with accrued, but unrealized losses, it may be possible to transfer these losses to the other spouse (or common-law partner), subject to the tax rules governing superficial losses and income attribution.

There is another strategy that could be employed if capital losses are trapped in a corporation that you own. Briefly stated, an investment with an accrued capital gain owned personally could be transferred on a tax-deferred basis to an "affiliated" corporation and subsequently sold by the

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corporation, which would realize the accrued gain, and could apply its unused capital losses to offset this gain.

More information on the strategies involving capital losses outlined in this section is available in our publication entitled, **Understanding Capital Losses**. However, consultation with your tax advisor is necessary due to the complexity of these tax rules.

It's important to remember that an aggregate net capital loss realized in the current year can be carried back three years, or carried forward indefinitely to offset net capital gains realized in other years. Since capital losses do not expire, many people are unaware that capital losses they generated several years ago are still available for application today. If you haven't kept sufficient records of your tax history, you can contact the Canada Revenue Agency to determine your available capital loss carry forward balance.

3. Charitable donation of securities

There are significant additional tax savings available to Canadians with charitable intentions. For example, those who donate qualifying publicly-traded securities can avoid the taxation of capital gains realized upon the disposition created by transferring these securities to a charity (or other qualified donee). When combined with the benefit of receiving a charitable donation tax credit (based on the current value of the security), that can reduce taxes payable on other income, the added benefit of eliminating any associated capital gains tax on the transfer creates a strong incentive to donate appreciated securities, instead of donating the after-tax cash proceeds following an external sale of the security.[1] Charitable donation claims are generally limited to 75%[2] of net income (100% in the year of death and the prior year); however, unused donations can be carried forward for up to five years. Our publication, **Donating Appreciated Securities**, provides more information on the benefits of this alternative.

As previously noted, the fair market value of securities donated to charity will reduce your taxes through a charitable donation tax credit. For donations made after 2015 that exceed $200, the calculation of the federal charitable donation tax credit allows higher income donors to claim a federal tax credit at a rate of 33% (versus 29%), but only on the portion of donations made from income that is subject to the higher 33% top marginal tax rate that came into effect on January 1, 2016. When combined with the provincial donation tax credit, the tax savings can approximate 50 per cent of the value of the donation (depending on your province of residence).

4. Tax-deferred roll-over

Many corporate takeovers allow the disposing shareholders to exchange all, or a portion of their shares for shares of the acquiring corporation. This option generally provides a Canadian shareholder with the opportunity to defer tax on any accrued gains on the old shares by filing the necessary tax election forms prior to the prescribed deadlines. This tax-deferred roll-over is generally available in share-for-share exchanges involving Canadian companies, and is sometimes available in certain cross-border exchanges (if properly structured). However, a share acquisition where the only consideration received is cash will generally result in the realization of any accrued capital gain/loss, thereby potentially generating a current tax liability.

In addition, it should be noted that a recent change in the tax law amended a related tax provision such that an exchange of shares of a mutual fund corporation that results in the investor switching between funds will no longer occur on a tax-deferred roll-over basis. Instead the exchange will generally be considered a disposition at fair market value for tax purposes. This measure applies to dispositions of mutual fund shares that occur in 2017 and later years, with some limited exceptions.

5. Capital gains reserve

If proceeds from a disposition trigger a capital gain, but not all proceeds are received in the year of the sale, it may be possible to defer taxation of a "reasonable" portion of the gain until the year when the remaining proceeds become receivable. Generally, this capital gains reserve can be claimed for up to five years, with a minimum (cumulative) 20% income inclusion each year.

This five-year time frame can be extended to 10 years in certain situations, such as the sale of Qualifying Small Business Corporation ("QSBC") shares to a child or grandchild. Contact your tax advisor for assistance in determining the ability (and appropriateness) of claiming this reserve in your particular situation.

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Other General Tax Considerations

Income tax instalments

The realization of a significant capital gain on the voluntary (or involuntary) sale of an investment can create a large tax liability, and often has other tax implications. One of the more likely implications is the potential impact on an investor's quarterly income tax instalment requirements. Many investors who have a sizable non-registered investment portfolio are required to make quarterly tax instalments, based on the prior or current year's unremitted tax liabilities from realized investment income (such as interest, dividends and capital gains). An unexpected large capital gain – even occurring late in the year – could impact the required amount of all quarterly tax instalments for the year, particularly where the individual bases their instalment requirements on the current year's estimated income. Failure to adequately plan for capital gains, which are generally more unpredictable than interest or dividend income, could lead to the assessment of interest and other penalties for insufficient instalments. In addition, the realization of a large capital gain in a prior year can have potential implications for future quarterly instalments. Therefore, it is important to review and plan for these instalment requirements with your tax advisor, and with assistance from your BMO financial professional.

Retirees

A large increase in taxable income resulting from a significant capital gain may be especially problematic for retirees who receive income-based benefits, such as Old Age Security ("OAS"), that can be clawed-back at higher levels of income. Fortunately, the pension income-splitting legislation may offer some assistance. These rules provide an opportunity to split other sources of (pension) income between spouses to manage income levels in order to reduce the OAS clawback or loss of the age tax credit. Additional flexibility is provided with the use of the Tax-Free Savings Account ("TFSA"), which presents an opportunity to shelter future investment income from tax and minimize, or avoid, reductions in federal income-tested government benefits. Ask your BMO financial professional for a copy of our publication entitled, **Pension Income-Splitting Provides Tax Planning Opportunities for Couples**, for more information, or speak to your BMO financial professional about the possible benefits of a TFSA in your situation.

Other Considerations

The income tax considerations discussed in this publication are complex, and require consultation with your personal tax advisor. However, your BMO financial professional can also assist by providing the relevant investment information to help determine an appropriate strategy for your personal situation.

For more information on any of the topics discussed in this publication, please speak with your BMO financial professional.

[1] Please note that the tax legislation may limit the tax benefits associated with a charitable donation strategy involving flow-through shares.

[2] Changes originating from the 2016 Quebec budget have removed the 75% limitation for 2016 and subsequent taxation years in calculating the qualifying Quebec provincial donation tax credit.

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