Strategies to Minimize Capital Gains Tax

Towards the end of the year, many investors often review their investment portfolios to determine the anticipated tax impact of capital gains and losses realized during the year. For investors who have realized any significant capital gains in the year, this article examines various strategies to reduce the impact of a potential tax hit on realized capital gains as well as other related considerations of the voluntary or involuntary sale of a security or other investment resulting in the realization of a capital gain.

Potential Tax-Minimization Strategies

1. Create Tax Deductions

For some investors, the possibility of claiming other tax deductions to offset increased income may lessen the tax liability created by the realization of capital gains in a non-registered portfolio. 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 tax payable in the year a large capital gain is generated.

2. 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 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 tax liability.

3. Capital Gains Reserve

If proceeds of disposition from a sale triggering a capital gain are not all receivable in the year of the sale, it may be possible to defer a "reasonable" portion of the gain from taxation until the year when the proceeds become receivable. Generally, this *capital gains reserve* can be claimed for up 5 years, with a minimum (cumulative) 20% income inclusion each year.

This 5-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.

4. 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.

As a reminder regarding foreign securities, when a Canadian resident sells a foreign investment, the sale must be reported on his or 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 exchange rate. The fluctuation of the exchange rate will impact the net capital gain or loss on the sale and can either increase a 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.

Another type of strategy 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 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 is 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 often unaware of capital losses generated several years ago that are still available for application. If you don't have sufficient records of your tax history, you can contact the Canada Revenue Agency to determine your available capital loss carryforward balance.

5. Charitable Donation of Securities

There are significant additional tax savings available to investors with charitable intentions who donate qualifying publicly-traded securities. In particular, the 2006 federal budget introduced rules that eliminate the taxation of capital gains realized on the disposition created by the transfer of 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% 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. Ask for our publication *Donating Appreciated Securities* for more information on the benefits of this alternative.

Other General Tax Considerations

(i) 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, but will often have 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 prior year or current year unremitted tax liabilities from realized investment income (such as interest, dividends and capital gains). An unexpected large capital gain – occurring even 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 current year 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 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 – with assistance from your BMO Nesbitt Burns Investment Advisor.

(ii) 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 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 as a means of reducing the OAS clawback or loss of the age tax credit. In addition, more flexibility is provided with the introduction 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 Nesbitt Burns Investment Advisor for a copy of our publication entitled Pension Income Splitting Provides Tax Planning Opportunities for Couples for more information or speak to your Investment Advisor to discuss the possible benefits of a TFSA in your situation.

Other Considerations

The income tax considerations discussed in this publication are complex and any planning will require consultation with your tax advisor. However, your BMO Nesbitt Burns Investment Advisor can also assist in this process by providing the relevant investment information to help determine an appropriate strategy.

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[1] Please note that a 2011 Federal budget proposal seeks to limit the future tax benefits associated with this strategy when flow-through shares are donated to charity. Please see our publication *Federal Budget Review 2011* or contact your tax advisor for the current status of this proposal.