An Individual's Tax Saving Strategies in Uncertain Times

Kelly and Peter are retired and were confident their personal savings were enough to allow them to carry out retirement as they had planned, but the recent market volatility caused them to question the feasibility of those plans. They contacted their financial advisor to discuss how to take advantage of the current market to reduce taxes both today and in the long term. Here are some strategies open to them.

1. REDUCED RRIF MINIMUMS

Reducing the required RRIF minimum withdrawal by 25% from the original minimum amount for 2020 is part of the federal government's COVID-19 economic response plan. The new reduced minimum applies to all RRIFs and LIFs. This creates a tax saving opportunity for Kelly and Peter. An individual can decide to take more than the reduced mi nimum amount but taking the reduced minimum reduces taxable income in 2020 and leaves more capital in the RRIF to continue to work on a tax-sheltered basis. Unfortunately, the currently legislation does not allow recontribution if an investor has already taken the original minimum payment from their plan. Withholding tax will not apply unless the amount withdrawn is more than the original minimum amount (i.e. the RRIF minimum before the 25% reduction).

2. DOLLAR COST AVERAGING ("DCA") or VALUE COST AVERAGING ("VCA")

DCA where an investor places a fixed dollar amount into a given investment on a regular basis, or VCA where, in a declining market, an investor increases investing, may reduce the overall cost of investment, ultimately magnifying gains and mitigating losses when it is time to sell. Usually DCA and VCA involve a transfer investing cash into an investment through an automatic transfer from a bank account. However, Kelly and Peter liquidated a substantial portion of their holdings into cash and have a large balance in a money market fund. They may consider converting all or part of their money market fund balance to a fund in a different asset class to participate in the market again.

3. CRYSTALIZE LOSSES – "Tax Loss Selling"

Realizing capital losses today can offset taxable capital gains, reducing taxes payable for 2020 or other years. Excess losses can be carried back three years to recover tax paid on capital gains in those years or may be carried forward indefinitely[1]. To reap the tax benefits associated with capital losses, it is important to avoid the stop loss provisions of the Income Tax Act ("ITA") which operate to deny taxpayers the use of losses in certain circumstances, including application of **the superficial loss rules**.

The superficial loss rules apply when an investment is sold and the 'same or identical' property (also known as substituted property) is repurchased within 30 days of the sale by the investor or a person they are affiliated with[2] While the superficial loss rules deem the individual's loss to be nil at the time of disposition, the loss does not disappear, it is added to the adjusted cost base (ACB) of the identical or substituted property.

In the right circumstances, **superficial losses can effectively transfer losses between spouses resulting in tax savings**. For instance, assume Kelly's spouse Peter is in a higher tax bracket and has capital gains to offset Kelly's loss, while she does not. The superficial loss rules can work to their advantage.

For instance, assume, Kelly triggers a $3,000 capital loss on the sale of 1,000 units of DBCL mutual fund. Within thirty days, Peter purchases 1,000 units of the same fund for $8.00/unit, triggering the superficial loss rules to deny the $3,000 loss to Kelly. The capital loss denied to Kelly is added to Peter's ACB, so his cost base rises from $8,000 to $11,000. If Peter waits until the superficial loss period expires before

[1] Your CRA notice of assessment shows your net capital losses (based on the relevant inclusion rate) for the current year and your unused net capital losses from previous years.

[2] Subsection 251.1(1) of the Income Tax Act defines "affiliated persons" as (i) individuals including yourself or your spouse, (ii) corporations controlled by you or your spouse, (iii) partnerships controlled by you or your spouse, or (iv) trusts where you or your spouse are a majority beneficiary such as your RRSP, RRIF, TFSA or RESP wherein you or your spouse is a subscriber.

disposing of the shares (i.e. another 31 days), assuming the shares have not gone up in value since the repurchase, he can realize the loss. Kelly's capital loss is effectively transferred to Peter in these circumstances.

Another example would be if Kelly transfers capital property in a loss position to Peter, she can use the losses to offset gains from other sources providing certain other steps are taken. First, to ensure the loss will not attribute back to her, she elects the transfer to occur at FMW and takes back proceeds from Peter equal to the FMV. Then, Peter must wait until the 61-day period expires before selling the shares.

For more information on this strategy read: Superficial Losses and How to Plan Around Them.

4. GIFT ASSETS TO ADULT CHILDREN/GRANDCHILDREN

Gifting assets to children and grandchildren during life (inter-vivos) or upon death (testamentary) is an estate planning staple and a taxable event that may benefit Kelly and Peter by reducing estate taxes in the future. Testamentary gifting typically increases the tax liability of an estate and the value of the gift is also subject to probate in provinces with probate fees. Inter-vivos gifting, particularly in a down market, can reduce tax and probate fees in the future. However, the attribution rules apply when gifting income producing assets to minor children and attribute future income (other than capital gains) back for tax purposes. Attribution does not apply to testamentary transfers.

Again, assume Kelly is a resident of British Columbia. She plans on transferring her investment account to her daughter when she dies. The unrealized capital gain of her investment account on February 1st was $1 million. Had she realized those gains it would have resulted in tax of about $250,000. The gain in her portfolio has since dropped to $700,000. If she realized the gains today, the income tax payable would be about $175,000. Kelly is confident the market will improve. Therefore, assuming Kelly does not require the funds she might consider gifting the portfolio to her daughter today

5. TRANSFER ASSETS TO A FAMILY TRUST

Family trusts can be used to maintain control over assets and to income split with lower income beneficiaries such as spouses and children. Kelly might transfer assets to a family trust in exchange for an interest-bearing promissory note owing by the trust back to her. Usually, she would transfer cash as gains on the assets being transferred are realized on the transfer to the trust. The current economic environment provides Kelly an opportunity to transfer assets to a family trust with little or no capital gain. Loss restriction rules must be considered where a loss is realized on the transfer. To achieve income splitting, Kelly must charge interest at least at the prescribed rate in effect at the time the transfer is made. Finally, as a result of the TOSI rules, the family trust cannot be viewed as carrying on a related business.

6. PRESCRIBED RATE LOAN STRATEGY

The prescribed rate that must be paid on the promissory note discussed above is currently 2%. Income splitting is achieved where the trust allocates its investment income net of the 2% interest cost to lower income beneficiaries. If Kelly's marginal tax rate is 52%, and she transfers $1,000,000 to a family trust earning an 8% return, and the trust allocated its 6% net return to beneficiaries (spouse and minor children) who had no other income, estimated tax savings would be $31,200 per year. The prescribed interest rate is determined every calendar quarter based on the average rate of three-month treasury bills sold during the first month of the previous quarter. If the prescribed rate decreases to 1%, estimated annual tax savings increase to $36,400. For this strategy to be effective, interest must be paid to Kelly by January 30th of the following year. Similar tax planning can be executed without a family trust, but without the asset protection features a trust structure provides.

7. POST-MORTEM TAX PLANNING

Unless transferred to a spouse (or spousal trust) or dependent child, Canadians are deemed to have disposed of their property at fair market value on their date of death. Real estate, private company shares, art and non-registered investment accounts receive capital gain treatment. While TFSAs are tax exempt, the **full value** of RRIFs and RRSPs are taken into income. If Kelly was single, and passed away in 2020 prior to COVID-19 impacting markets, her estate may have significant capital gain or income inclusions and therefore taxes owing when her final tax return comes due. As asset values have declined, what can her personal representative do to soften this impact and preserve estate assets for her heirs?

1. **Realize post-death losses in the estate with relative urgency.** An estate may file an election under subsection **164(6)** to carry back capital losses of the estate realized within the first year after death to apply against capital gains reported on the Final T1 of the deceased[3]. This includes losses on the sale of real estate.
2. **Net capital losses for the year of death** can be applied against capital gains for the year of death or in the prior three years. In addition, unused capital losses for year of death can be applied against ANY source of income for the year of death or the year prior to death.[4]

[3] Provided the estate is a Graduate Rate Estate.

[4] Subject to limitations if the deceased had claimed the capital gain deduction.

3. **Unused net capital losses from years prior to death** can be carried forward and applied against any source of income for the year of death or the year prior, subject to the same limitations regarding previous capital gain deduction claims.
4. **If Kelly dies during market decline elect fair market value disposition** as opposed to spousal rollover to trigger capital losses. The losses can be applied against all income sources for the year of death or the year prior.
5. If there is a **post-death decline in RRSP or RRIF values** when the final distribution is made:
   a. If the final distribution from the RRSP or RRIF is made in the year of death, or the year after death, the decline can be claimed as a deduction on the final tax return, or via filing a T1 Adjustment to the final tax return, respectively; If the final payment is made after the end of the year following the year of death, the post-death decline may not be deductible. The CRA has discretion in this area.

CONCLUSION

Investment objectives and long-term goals take priority over short-term tax planning. However, the tax strategies described above may prove helpful both now and over the longer term. In addition to these strategies Kelly and Peter's advisor may wish to discuss with them the various federal and provincial economic programs introduced in response to the covid19 pandemic.

For more information on these programs read: COVID-19 Economic Response Plan and Federal & Provincial Economic Response to COVID-19

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