Transferring Capital Gains to Your Spouse

Splitting capital gains with your spouse may reduce your family's tax bill

Are you interested in a strategy of transferring a portion of your unrealized capital gain to your spouse?

You might be if your spouse is taxed at a lower marginal income tax rate (or will be once your marginal tax rate increases as a result of triggering this large capital gain). You might also be if your spouse has unused capital losses that he or she could use to offset your gain.

If your portfolio has a large unrealized capital gain, you may be able to transfer up to 25% of it to your spouse. This article explains the tax-saving strategy you can use to reduce your overall tax bill as a couple. Note that any reference to spouse also refers to a common-law partner.

This article is provided for information purposes only and is not intended as nor does it constitute tax or legal advice. Readers should consult with their own lawyer, accountant or other professional advisor when planning to implement a strategy to ensure their own particular circumstances are addressed.

A Simple Share Transfer Does Not Work

Given that Canada's personal incomes tax system is based on progressive tax rates, splitting taxable income, including capital gains, with your spouse is a great way to reduce your combined tax burden, especially if your spouse has unused capital-loss carry forward that you can use to offset a portion of the capital gain. However, a simple transfer or gift of your securities does not work.

If you simply transfer or gift your securities to your spouse, the income attribution rules will prevent the gain from being taxed in your spouse's hands, and you will not achieve your goal. This is because when assets that are transferred from one spouse (the "transferor") to another (the "transferee") are not transferred at fair market value (FMV), the capital gains/losses and future income are attributed back to the transferor.

However, the income attribution rules do not apply to spouses:

- When the transferee pays the transferor the FMV for the securities (i.e. the spouse receiving the securities pays the other spouse for the securities); and
- When the transferor reports the disposition for tax purposes at FMV

A Strategy That May Work

In order to successfully transfer a portion of your unrealized capital gain to your spouse, you and your spouse may be able to implement the following strategy:

Step 1: You gift half of the securities to your spouse.

Step 2: You sell the other half of the securities to your spouse at FMV.

Step 3: Your spouse sells all the securities on the market.

Due to the combination of the weighted-average cost rules and attribution rules, 25% of the gain could be taxed in your spouse's hands rather than yours. This is the maximum amount of the gain that may be transferred under this strategy.

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Gifts between spouses do not trigger a tax liability; they transfer at cost.

Consider the Following Example

Mark currently holds a security position with an adjusted cost base (ACB) of $40,000 and an FMV of $140,000. He wants to sell the securities to diversify; however, he is concerned about the high-income tax liability he will face on the $100,000 capital gain by selling the position. His spouse, Irene, is currently on maternity leave and consequently her income is much lower this particular tax year. Mark and Irene wonder if there's a way they can take advantage of her lower marginal tax rate to ease the tax bite on his capital gain. Their advisor suggests Mark split the capital gains with his wife using this strategy.

Step 1: Mark Gifts Half of the Securities to Irene

Since it is a gift, Irene does not pay Mark for the securities. Gifts between spouses do not trigger a tax liability; they transfer at cost. Mark's total ACB for the securities is $40,000. Since he gifts half of the securities to Irene, half of his ACB ($20,000) becomes her ACB.

After completing step 1, Irene now owns half of the securities with an ACB of $20,000. And while Mark has to report this disposition on his tax return, since it is a disposition at ACB, it will not trigger a tax liability.

Step 2: Mark Sells the Other Half of the Securities to Irene at Fair Market Value

Mark sells the other half of the securities to Irene at an FMV of $70,000 (i.e. half of $140,000). It is imperative that Irene purchase the securities from Mark at fair market value with her own money so that the income attribution rules do not apply to this portion. Since Irene pays the FMV for the securities, her ACB for these securities is $70,000.

If Irene does not have the available funds to pay Mark the $70,000, there may be an opportunity to implement a spousal loan strategy using the prescribed interest rate. This strategy will provide Irene with the funds required for the purchase of half of Mark's securities while ensuring that the income attribution rules do not apply. Please ask your advisor for details about spousal loans using the prescribed interest rate.

After completing step 2, Irene now owns all of the securities and her total ACB is $90,000 ($20,000 from step 1 + $70,000 from step 2). Mark's capital gain that he will have to report on his income tax return is $50,000 ($70,000 – $20,000 ACB).

Step 3: Irene Sells All of the Securities on the Market

Irene sells the entire position on the market. Assuming the value of the securities has not changed, her proceeds from the disposition are $140,000. Since her total ACB for all the securities is $90,000, her capital gain is $50,000. However, given that one half of the securities was received as a gift, one half of Irene's $50,000 capital gain will be attributed to Mark. The remaining half of the gain will be reported on her income tax return. As a result of this step, Irene and Mark will each have to report a gain of $25,000 from the sale.

We recommend you consult a tax advisor prior to implementing this strategy. As a result, the financial benefit of implementing this strategy may be partially reduced by any professional fees incurred.

The following table summarizes the overall tax implications of this example:

Summary of the tax implications for Mark	
Capital gain on the securities gifted to Irene (transferred at cost)	$0
Capital gain on securities sold to Irene at FMV (proceeds of $70,000 less his ACB of $20,000)	**$50,000**
Capital gain attributed from Irene (see above)	**$25,000**
Capital gain to be reported by Mark	**$75,000**

Summary of the tax implications for Irene	
Proceeds of disposition upon final sale in the market	**$140,000**
ACB ($20,000 in step 1 + $70,000 in step 2)	**($90,000)**
Capital gain	**$50,000**
Amount attributed back to Mark	**($25,000)**
Capital gain to be reported by Irene	$25,000

Tax Savings for the Couple

In order to calculate the overall tax savings for the couple, we need to determine Mark's tax savings on the $25,000 transferred to Irene, then subtract Irene's incremental tax on the same amount. The following calculation shows the approximate tax savings assuming Mark is in the top marginal tax bracket and Irene's other income for the year (excluding the capital gain) is approximately $24,000.

Reduction in Mark's taxes as a result of the transfer ($25,000 x 50% inclusion rate x 46% tax rate*)	$5,750
Increase in Irene's taxes as a result of the transfer ($25,000 x 50% inclusion rate x 26% tax rate*)	($3,250)
Total tax* savings	$2,500

If Irene has unused capital-loss carry forwards that she could use, the tax savings could be even greater. Let's assume her capital-loss carry forwards are enough to fully offset the taxes she owes.

Reduction in Mark's taxes as a result of the transfer ($25,000 x 50% inclusion rate x 46% tax rate*)	$5,750
Increase in Irene's taxes as a result of the transfer offset by her capital-loss carry forward	($0)
Total tax* savings	**$5,750**

We recommend you consult a tax advisor prior to implementing this strategy. As a result, the financial benefit of implementing this strategy may be partially reduced by any professional fees incurred.

** Based on approximate provincial average*

Please contact us for more information about the topics discussed in this article.

Other Considerations

Please note that the Canada Revenue Agency (CRA) has challenged a taxpayer that used this strategy on private company shares on the basis of the GAAR (General Anti-Avoidance Rule). As such, there may be greater risk in applying this strategy using private company shares. Please consult your tax advisor prior to implementing this strategy.

Use of the Proceeds From the Sale of Securities on the Open Market (Step 3)

Income attribution will continue to apply to the proceeds from the sale of half of the transferor's securities that were originally gifted to the spouse (in step 1 above) if they are re-invested to earn income. For example, in step 3 if after disposing of the shares for $140,000 Irene was to use these funds to acquire other securities, half of the revenue generated by these securities will attribute back to Mark due to the income attribution rules because half of them were gifted to Irene. The income attribution rules can be avoided if the funds are not reinvested in income producing assets and instead are used to pay for all living expenses for the family and the family's tax liabilities. Re-gifting the assets back to your spouse may result in a challenge of this strategy by the CRA under GAAR.

If the spousal loan strategy using a prescribed rate loan was used to make the purchase of the other half of the securities as discussed in step 2 and the proceeds from the sale of these securities in step 3 are not used to repay the loan or reinvested in interest and dividend producing securities, the interest payable on the loan, which is normally deductible to the transferee spouse, may no longer be deductible even though the interest received by the transferor spouse is taxable.

Conclusion

In summary, you may transfer 25% of your unrealized capital gain to your spouse, if you follow these three steps:

- Gift half of your securities to your spouse.
- Sell the other half to your spouse at fair market value.
- Get your spouse to sell all the securities on the open market.

You should consider the following with respect to the proceeds of the sale:

- Use the proceeds from the sale of the gifted securities to pay for your family's living expenses if you wish to avoid future income attribution.
- Use the proceeds from the sale of shares purchased using the spousal loan strategy to repay the spousal loan or to re-invest in interest and dividend paying stock to maintain deductibility of the interest paid on the spousal loan.

This strategy may help you lower your family's overall income tax liability if your spouse's marginal tax rate is lower than yours and/or your spouse has unused capital losses that he or she may use to offset the gain by 25%.

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