The Advisor

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2011 YEAR-END TAX PLANNING

Final opportunities to reduce your 2011 tax bill

As year-end approaches your thoughts may be turning to the holidays, winter sports, spending time with family and friends, and of course ... year-end tax planning! Well, to be fair, perhaps tax planning is not the first thing you think of, however, taking a few minutes to review your financial affairs can yield significant tax savings. To ensure that you leave no stone unturned, we have summarized some popular year-end tax planning techniques. Prior to implementing any tax planning strategies, a qualified tax advisor should be consulted.

Tax loss selling

The strategy of selling securities at a loss to offset other capital gains realized during the year is probably the most popular year-end tax planning technique. With all of the volatility in the markets over the past few years, there may be opportunities for tax loss selling this year.

When disposing of an investment, you must remember that the sale for Canadian tax purposes will be deemed to have taken place on the "settlement date". Assuming the normal three-day settlement, in order to utilize this strategy for the 2011 tax year, transactions must be initiated by December 23, 2011 for Canadian transactions and by December 27, 2011 for U.S. transactions in order to actually settle during 2011. Note that since December 27, 2011 is a holiday in Canada, you may also want to consider placing any U.S. transactions by December 23, 2011 with your advisor to ensure 2011 settlement. Canadian and U.S. option transactions have a one-day settlement, therefore option transactions must be initiated by December 30, 2011 to ensure 2011 settlements.

Superficial loss rules

In order to ensure that your capital loss can be claimed, you must adhere to the "superficial loss" rules. A superficial loss will occur when a security is sold for a loss and both of the following occur:

- the identical property is acquired or re-acquired during the period beginning 30 days before the disposition and ending 30 days after the disposition of the original security; and

- at the end of the above period, the identical property is still held.

Among other situations, the superficial loss rules also apply if you sell an investment at a loss and it is acquired by your spouse OR a corporation controlled by you and/or your spouse, OR a trust of which either you or your spouse is a majority-interest beneficiary during this time period.

If you trigger the superficial loss rules your capital loss will be denied. Your denied loss amount will then be added to your cost base of your substituted investment effectively resulting in your original cost base being transferred to your newly repurchased shares. However, if you delay the repurchase until after the 30-day period, you may claim the capital loss.

Note that the 30-day waiting period is counted from settlement day of sale to settlement day of repurchase and includes all holidays and weekends. Furthermore, the superficial loss rules also apply to mutual funds sold at a loss.

Selling the loss security in a non-registered account and repurchasing the identical security in your or your spouse's RRSP/RRIF/TFSA/RESP within 30 days and owning it on the 30th day after the sale will also deny the use of the capital loss. Furthermore, a direct transfer of the loss security to you or your spouse's RRSP/RRIF/TFSA/RESP will result in the capital loss being permanently lost.

Gifting the loss security in-kind to a non-spouse individual (like a minor or adult child) will allow you to claim the capital loss as this gift is a disposition at market value and does not trigger the superficial loss rules.

Any capital losses generated that cannot be used in the current year can be carried back three years to be applied against capital gains of prior years (i.e., 2008, 2009 or 2010) or carried forward indefinitely. Note that this is the last year which you can carry your losses back to 2008 and offset them against your 2008 capital gains.

In order to increase the effectiveness of tax loss selling, portfolios should be reviewed with your advisor to determine which investments are in a loss position and no longer meet your investment objective. Hence, if the investment still has strong fundamentals and meets your investment objectives, consider all costs, including transaction costs before selling investments solely for the purpose of triggering the tax loss.

Note that if you plan on triggering a capital loss in a corporation, you should speak to your accountant prior to triggering the loss as it may be advantageous to pay out the capital dividend account (CDA) balance prior to triggering the loss.

Loan to your spouse at the 1% prescribed interest rate

With recent confirmation that the Canada Revenue Agency (CRA) prescribed interest rate will remain at a historical low of 1% for the fourth quarter of 2011, it is an opportune time to consider establishing or modifying a spousal loan.

A prescribed rate loan is one of the most effective income-splitting strategies available. The goal of this strategy is to take advantage of a lower marginal tax rate by shifting investment income (interest, dividends and capital gains) from the higher income earning spouse to the lower income earning spouse. One way to achieve this tax planning strategy is by way of a spousal loan at the current prescribed interest rate. Investors who take advantage of this strategy will be locked in at the rate in effect at the time the loan is established, regardless of subsequent rate increases by the CRA. With current rates at an unbelievable low of 1% until December 31st, now is the ideal time to lock in.

If you have securities in a loss position, this may be an ideal time for you to consider a spousal loan because you can sell the securities now and use the capital losses yourself (see above for other details regarding tax-loss selling), lend the funds to your spouse to invest so that any future investment income will be taxable to your spouse. Please note that if you establish a spousal loan and your spouse wishes to repurchase all or some of the identical securities, the superficial loss rules may apply.

Speak to your advisor for further details on the Spousal Loan Strategy.

Establishing a family trust with assets currently in a loss position

If you have assets which are currently in a loss position and expect them to appreciate in value in the future and you have children or grandchildren who have little or no income, this might be the ideal time to consider establishing a family trust in order to income split with your family.

The RBC Family Trust can be established to take advantage of your children or grandchildren's low marginal tax rate while still providing you with access over the funds you lend to the trust. Here are three potential benefits of setting up a RBC Family Trust:

If your child or grandchild has no other income, they can earn between $15,000 and $20,000 of capital gains tax-free every year (depending on their province of residency) through the trust due to their basic personal tax amount.

You are permitted to lend funds to the RBC Family Trust so that you will never lose access to the loan capital.

Investment income accumulating in the trust can be used to pay for expenses that directly benefit the child or grandchild—such as private school tuition, post-secondary education costs, lessons or camps, etc. (Please note that spending the funds for the benefit of the child or grandchild will not impact the attribution of the interest or dividends.)

If you have securities in a loss position, this may be an ideal time for you consider a family trust because you can sell the securities now and use the capital losses yourself (see above for other details regarding tax-loss selling), lend the funds to the RBC Family Trust to invest so that any future gains will be taxable to your children or grandchildren. If funds are loaned at the 1% prescribed interest rate then all investment income (interest, dividends and capital gains) may be taxable to your children or grandchildren (assuming the trust is properly structured).

Please note that if you establish a RBC Family Trust (Discretionary option) and wish to repurchase all or some of the identical securities within the trust, the superficial loss rules may apply. This is because if you have a spouse, he or she is automatically one of the beneficiaries. Therefore if you have a spouse you will need to ensure you either wait at least 30 days to repurchase the securities in the trust or use another strategy when establishing the trust portfolio in order to avoid the superficial loss rules. If you establish the RBC Family Trust (Age 40 option) the superficial loss rules would not apply since your child or grandchild is the sole beneficiary.

Speak to your advisor for further details about the RBC Family Trust.

Defer realizing capital gains

Deferring a capital gain to the next year is also a popular tax planning strategy. As we approach the end of 2011, if you currently have unrealized capital gains you may want to consider deferring the realization of capital gains until 2012 for the following tax motivated reasons:

- Your marginal tax rate may be lower in 2012 compared to 2011;
- Realizing capital gains at the end of this year means that any tax payable would have to be remitted by April 30, 2012. Realizing capital gains at the beginning of 2012 means that any tax payable would not have to be paid until April 30, 2013 (unless you are required to make tax instalments); and,
- If you have net capital losses in 2011, you can carry back those losses against previously realized capital gains in 2008, 2009 and/or 2010. However, before losses can be carried back, they must first be used to offset capital gains in the current year. Therefore, realizing capital gains at the end of 2011 would reduce the amount of capital losses you could carry back to 2008, 2009 or 2010.

As always, the investment merits of deferring a sale of a security to the following year for the purpose of deferring the realization of a capital gain must be considered first before looking at the tax issues.

Trigger capital gains in an in-trust account

Typically minor children have no taxable income. As discussed above, a minor child can realize $15,000 to $20,000 of capital gains tax-free (depending on their province of residency) due to their basic personal exemption. If the trust is properly structured, the attribution rules will generally not apply on capital gains earned by a minor child. Therefore, if the minor child has no other income, capital gains of $15,000 to

$20,000 (depending on their province of residency) could be purposely triggered in an In-Trust account with no taxes payable. If you still favour the security, it can be bought back immediately thereby increasing the Adjusted Cost Base (ACB) of the security. The higher ACB going forward will mean less tax payable in the future. Of course, a potential disadvantage of this strategy is the incremental transaction fees, if any, associated with the sale and re-purchase. Also note that even though there may be no tax payable on the sale, extra tax return preparation fees may result from this strategy.

Charitable donations

In addition to RRSP contributions and investment tax shelters, making a charitable donation is one of the few remaining ways that you can significantly reduce the personal tax you pay. The final day to make contributions to a registered charity in order to claim the donation tax receipt on your 2011 income tax return is December 31, 2011. Due to the calculation of the donation tax credit, donations above $200 can result in a tax savings equal to the top marginal tax rate in your province of residence (except Alberta where the donation tax credit is equal to 50%). For example, a donation of $10,000 can result in tax savings of approximately $4,300 for residents of British Columbia.

As an alternative to cash, you can also donate publicly listed securities in-kind to qualified charities without being subject to tax on the capital gain. You will receive a donation tax receipt equal to the fair market value of the security at the time of the donation, which can help reduce your income tax on your other income.

Speak to your advisor on the investment merits of donating securities in-kind to a charity prior to year-end. If you plan on donating securities in-kind before year-end, then due to the administration involved in processing an in-kind donation, ensure that you start this process well in advance of the year-end to ensure that the in-kind donation is recorded as a 2011 donation. If you have thought about leaving a legacy but are unsure of the best way to accomplish this, then speak to your advisor on the benefits of donating cash or securities in-kind to your own charitable foundation such as the RBC Charitable Gift Program.

Turning 71 in 2011?

If you are turning age 71 in 2011, you must convert your RRSP, Individual Pension Plan (IPP), Locked-in Retirement Account (LIRA) or Locked-in RRSP to one of the many maturity options that are available by the end of this year. Keep in mind that in order to make your RRSP contribution for 2011 and claim it on your 2011 tax return, you DO NOT have the extra 60 days after 2011 to make your RRSP contribution to your own RRSP since you will not have an RRSP after 2011 to contribute to—contribution cannot be made to a RIF.

In addition, if you are turning age 71 in 2011; you should consider making your year 2012 RRSP contribution in 2011 before converting to a RIF. Why? If you have 2011 earned income, your 2012 RRSP contribution room would not be created until January 1, 2012. If you are turning age 71 in 2011 you cannot have an RRSP after December 31, 2011, therefore you should consider making your expected year 2012 RRSP contribution in December 2011 before converting your RRSP. This early contribution (sometimes called the "Forgotten RRSP Contribution") will allow you to claim the RRSP deduction on your 2012 income tax return. Although you have over contributed to your RRSP now, the tax savings realized should easily outweigh the over contribution penalty of 1% per month. For instance, the over contribution penalty on a $22,970 RRSP contribution for 2012 would only be a maximum of $230 (1% of $22,970) if you made this 2012 RRSP contribution in December 2011. However the tax savings on the $22,970 RRSP deduction in 2012 could be as high as $11,048.

If you have a younger spouse, you could always consider making your RRSP contributions to a spousal RRSP until the year your spouse turns age 71, thereby avoiding the over contribution penalty.

› Please contact us for more information.