The Navigator

RBC WEALTH MANAGEMENT SERVICES

2012 Year-End Tax Planning

Final opportunities to reduce your 2012 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 2012 tax year, transactions must be initiated by December 24, 2012 for Canadian transactions and by December 26, 2012 for U.S. transactions in order to actually settle during 2012. Note that since December 26, 2012 is a holiday in Canada, you may also want to consider placing any U.S. transactions by 1:00pm on December 24, 2012 with your advisor to ensure 2012 settlement. Canadian and U.S. option transactions have a one-day settlement, therefore option transactions must be initiated by December 28, 2012 to ensure 2012 settlements.

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:

- **i)** 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**
- **ii)** 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 <u>that cannot be used in the current year</u> can be carried back three years to be applied against capital gains of prior years (i.e., 2009, 2010 or 2011) or carried forward indefinitely. Note that this is the last year which you can carry your losses back to 2009 and offset them against your 2009 capital gains.

In order to increase the effectiveness of tax loss selling, portfolios should be reviewed with your RBC 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.

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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 2012, 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.

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.

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

Establish a Family Trust

If 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:

1. If your child or grandchild has no other income, they can earn approximately $10,000 of interest income, or $30,000 - $50,000 of Canadian public company dividends, or $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.
2. You are permitted to lend funds to the RBC Family Trust so that you will never lose access to the loan capital.
3. 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) then 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 RBC 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 2012, if you currently have unrealized capital gains you may want to consider deferring the realization of capital gains until 2013 for the following tax motivated reasons:

a) Your marginal tax rate may be lower in 2013 compared to 2012;

b) Realizing capital gains at the end of this year means that any tax payable would have to be remitted by April 30, 2013. Realizing capital gains at the beginning of 2013 means that any tax payable would not have to be paid until April 30, 2014 (unless you are required to make tax instalments); and,

c) If you have net capital losses in 2012, you can carry back those losses against previously realized capital gains in 2009, 2010 and/or 2011. 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 2012 would reduce the amount of capital losses you could carry back to 2009, 2010 or 2011.

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 approximately $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 $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 (discussed later), 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 2012 income tax return is December 31, 2012. 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 RBC 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 2012 donation. If you have thought about leaving a legacy but are unsure of the best way to accomplish this, then speak to your RBC 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 2012?

If you are turning age 71 in 2012, 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 2012 and claim it on your 2012 tax return, you DO NOT have the extra 60 days after 2012 to make your RRSP contribution to your own RRSP since you will not have an RRSP after 2012 to contribute to—contribution cannot be made to a RRIF.

In addition, if you are turning age 71 in 2012; you should consider making your year 2013 RRSP contribution in 2012 before converting to a RRIF. Why? If you have 2012 earned income, your 2013 RRSP contribution room would not be created until January 1, 2013. If you are turning age 71 in 2012 you cannot have an RRSP after December 31, 2012, therefore you should consider making your expected year 2013 RRSP contribution in December 2012 before converting your RRSP. This early contribution (sometimes called the "Forgotten RRSP Contribution") will allow you to claim the RRSP deduction on your 2013 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 $23,820 RRSP contribution for 2013 would only be a maximum of $238 (1% of $23,820) if you made this 2013 RRSP contribution in December 2012. However the tax savings on the $23,820 RRSP deduction in 2013 could be as high as $11,910 (depending on province of residency).

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.

Low-income year

If you are expected to be in the lowest marginal tax bracket in 2012 (i.e., less than approximately $40,000 of taxable income) but expect to be in a much higher marginal tax bracket in retirement then you may want to consider making an early withdrawal from your RRSP before year-end to bring your taxable income up to approximately $40,000. In general, this strategy only makes sense for those individuals who are primarily growth investors outside their RRSP and are nearing retirement. The advantage of this strategy is that you can avoid a higher income tax rate on these RRSP funds if withdrawn in the future when your marginal tax rate may be higher. Furthermore, if the RRSP funds withdrawn are reinvested in a non-registered account, you can now take advantage of the preferred income tax treatment on capital gains, Canadian dividends and return of capital. The drawback of this strategy is a prepayment of income tax and lost tax deferral on the RRSP funds withdrawn.

Year-end Bonus Planning

There are pros and cons of receiving a bonus at year-end versus deferring the bonus (if the employer allows) to early 2013. Receiving a bonus prior to year-end allows you to earn RRSP deduction room for 2013 assuming you did not have adequate other 2012 earned income to reach your maximum 2013 RRSP deduction limit already. Furthermore, receiving a bonus prior to year-end may also allow greater employee/employer pension and/or employee profit sharing plan contributions for 2013 if these contributions are based on the prior year's total compensation.

If you are expecting to be in a lower tax bracket in 2013, then there may be a tax benefit of deferring the bonus to 2013. However, if the bonus is paid directly to you there will still be withholding taxes at source on the bonus payment.

If the employer permits, some or all of the withholding taxes on the bonus can be avoided if it is transferred directly to an RRSP. You must have adequate unused RRSP deduction room in the year of transfer.

Note that if the employer's year-end is after June 30, then paying the bonus in December 2012 or early January 2013 will still allow the employer to deduct the bonus payment in their same corporate tax year. That is, our tax rules allow a corporation to deduct a bonus paid to an employee on the corporation's previous year's tax return as long as the bonus is paid within 179 days after their corporate year-end.

Defer mutual fund purchases

If you purchase mutual funds near year-end in a non-registered account this can result in an unexpected tax liability next April.

If you are turning age 71 in 2012, 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.

During the year, a mutual fund will earn taxable income and realize taxable capital gains which will not be taxed at the mutual fund level but instead will be distributed to the unit holders. This distribution is made to all unit holders at a certain point in time, often at December 15th even if a unit holder only just recently purchased the units. Therefore if you purchase mutual fund units just prior to the distribution you will pay income tax on the full distribution amount even though the overall value of your holdings may not have changed.

Once the distribution is made, the Net Asset Value of your mutual fund is reduced by the amount of the distribution and generally the distributions are reinvested which will increase your ACB. Therefore, the problem lies in that you receive no benefit from the distribution since you will simply hold additional units with a lower unit price (with the same total value) and yet are left with a tax liability triggered by the taxable distribution.

If you are expecting to be in a lower tax bracket in 2013, then there may be a tax benefit of deferring the bonus to 2013.

To avoid this premature tax payment, consider waiting until January to make a mutual fund purchase. Another potential solution is to sell the fund prior to the distribution date to avoid receipt of the distribution and then buy back the same fund after the distribution is made. If you made a recent purchase, this would likely result in little or no income tax since your cost base will likely be close to your sale price. Ensure you determine your potential capital gain prior to implementing this strategy or whether the sale would trigger redemption fees. Transfers within the same family of funds using this strategy may trigger a capital gain/loss without incurring redemption fees, but the previously mentioned superficial loss rules may apply.

If a fund makes regular distributions (monthly or quarterly) then selling it at year end would only avoid any remaining distributions during the year-end and may not save as much tax as selling a fund that makes one large year-end distribution.

Keep in mind that if the mutual fund is purchased in a registered account, the taxable year-end distribution is not an issue.

RESP contributions

Registered Education Savings Plans (RESPs) are not only an excellent way to save for a child’s post-secondary educations costs – it’s also a good income splitting strategy. Since 2007, RESPs offer even more flexibility to families who want to save money for education. The annual contribution limit was eliminated and the lifetime contribution limit was increased to $50,000. Since the maximum annual RESP contribution qualifying for the 20% Canada Education Savings Grant (CESG) has increased to $2,500 from $2,000 you'll want to ensure you have contributed at least that amount by December 31, 2012. You DO NOT have 60 days after the end of the tax year to contribute to an RESP like you normally do for RRSP contributions. Though the official deadline to contribute to an RESP for the 2012 tax year is December 31, 2012, any unused government grant room (i.e., CESG) can be carried forward until the year the child turns age 17, subject to annual maximums.

Business owners

Individual Pension Plan

If your company is incorporated and you are looking for both year-end corporate income tax deductions and a structured retirement savings plan for yourself, consider establishing an Individual Pension Plan (IPP) for yourself. An IPP is an employer-sponsored registered pension plan that allows greater tax-deductible contributions than an RRSP for employees who are in their forties or older. Speak to your RBC advisor if you require more information on the pros and cons of an IPP and to learn how RBC could help you establish an IPP if you and your qualified tax advisor determine it is right for you.

Pay yourself before year-end

If you own your own business then consider paying salaries to yourself and family members before year-end. This year-end payment will give the family member earned income so they can make an RRSP contribution the following year and will give your business a tax deduction in the current year. Note that the salary paid before year-end must be reasonable and based on the services performed by the family member in the business. For example, paying a child $30,000 per year for sweeping the office floor every weekend may not be reasonable.

Purchasing assets for your business

If you intend on purchasing assets for your business (i.e., computer, furniture, equipment, etc.) you should consider making this purchase before year-end. If the asset is available for use, this year-end purchase will allow the business to claim depreciation on the asset for tax purposes. However, only half of the regular allowable depreciation can be claimed for tax purposes in the first year.

Tax shelters

Many high-income earners will consider purchasing a tax shelter (i.e.,

Get next year's tax refund early

If you normally get a tax refund when you file your tax return, you should consider applying to the Canada Revenue Agency (CRA) for a waiver to have your employer reduce your tax withheld at source from your paycheques. Why allow the CRA to use your tax refund interest-free during the year? The CRA will normally approve the tax waiver for individuals who expect the following types of deductions: RRSP contributions, alimony payments, carrying charges, childcare expenses, employment expenses, among others.

You must apply for the tax waiver (CRA Form T1213) on an annual basis. Approval of the tax waiver by the CRA usually takes about six weeks; therefore, for the 2013 tax year you should start applying in late October/early November of year 2012.

limited partnership, flow-through shares, etc.) before year-end in order to receive significant tax deductions. A tax shelter is generally structured so that the expenses incurred by the tax shelter in the first few years are flowed directly to you the individual investor so that you may deduct them against any of your other taxable income. However, as the saying goes "a good tax shelter that is a bad investment is really a bad tax shelter." In other words the investment potential of the tax shelter and not just the initial tax savings should be your prime consideration when deciding whether to invest in a tax shelter or not. Before making any investment in a tax shelter, you should consider the following questions:

- What are the specific features and inherent risks associated with this investment?
- What is the issuer's track record?
- Is there a prospectus or offering memorandum?
- Has the tax shelter received an Advanced Income Tax Ruling from the CRA regarding certain aspects of the investment? If so, ask to see a copy.
- Is future financing required (i.e., additional future instalment payment or liability for debts incurred by the partnership)?
- When will the tax deductions be available to you?
- Will the tax deductions trigger Alternative Minimum Tax?
- How liquid is your initial investment?
- How does the tax shelter investment affect your overall asset allocation strategy and your risk tolerance?
- How long do you plan to hold the investment and what are the tax implications on disposition?

You should be comfortable with the answers to the above questions before jumping in. Although the temptation may be high to invest in a tax shelter solely for the immediate tax benefits, you should ensure that there is a reasonable expectation of profit after taking the tax benefits into account. In addition, the opportunity cost of investing in a particular tax shelter should outweigh other investment alternatives at that time.

Moving within Canada

Individuals pay provincial tax rates on their taxable income based on their province of residence on December 31st. Since marginal tax rates vary from province to province (e.g., top rate in Alberta is 39% and the top rate in Nova Scotia is 50%), if you are moving to a province with a lower tax rate, you may consider moving prior to year-end. If you are moving to a province with higher tax rates, you may consider delaying your permanent move until early 2013.

If you are moving to a province with a lower tax rate, you may consider moving prior to year-end. If you are moving to a province with higher tax rates, you may consider delaying your permanent move until early 2013.

Tax instalments

If you are required to make quarterly tax instalment payments to the CRA, you should make your final payment on or before December 15, 2012 to avoid late interest charges. If you missed an earlier instalment payment deadline, then you may want to consider making a larger final instalment payment or make your final instalment payment earlier than the December 15, 2012 deadline to minimize late interest charges.

You may have the opportunity to reduce or defer your tax instalment liability by switching the method you use to calculate your instalments. For example, it may be more advantageous to base your instalments on the current year's estimated taxes, rather than on taxes owing for the prior year. However, you must be very careful when paying less than the amount on the CRA tax instalment statements. If you underestimate your tax instalments for the current year based on your own calculation, then you could be subject to interest and penalties for not paying the full amount on the CRA tax instalment reminder statements.

And finally...

You should remember to pay all investment management fees, tuition fees, safety deposit box fees, accounting and legal fees if deductible, childcare expenses, alimony, medical expenses and any business expenses (if taxable on your personal tax return) by year-end if the intent is to deduct them on your 2012 tax return.

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