November 24, 2011

FINANCIAL ADVISORY SUPPORT

2012 January/February Tax Planning Tips

Important deadlines and strategies available in the first two months of the year

The holiday season provides a time for many to reflect on the past year and to begin planning for the New Year. Many investors are aware of the importance of tax planning near the end of the year to minimize their income tax liability. However, an often-neglected area of tax planning are the important deadlines and tax planning strategies to consider in the first two months of the following calendar year. The purpose of this article is to summarize some of these deadlines and strategies.

You should obtain professional advice from a qualified tax advisor before acting on any of the information in this article. This will ensure that your own circumstances have been considered properly and that action is taken on the latest information available.

RRSP contribution Deadline for the 2011 Tax Year

The deadline for you to make a contribution to a registered retirement savings plan ("RRSP") that can be claimed as a 2011 RRSP tax deduction is the 60th day after 2011, which is Wednesday, February 29, 2012.

Retiring allowance

If you received a retiring allowance in 2011 but did not utilize the special RRSP contribution allowance (based on $2,000 per year of service on or before 1995 plus $1,500 per year of service on or before 1988 if you were not a member of a pension plan), you also have until February 29, 2012 to make this special contribution to your RRSP (but not to a spousal plan). This special contribution does not affect your normal contribution room. Unlike regular unused RRSP deduction room, if this special RRSP contribution allowance is not utilized by February 29, 2012, it is lost forever.

In-kind RRSP contributions

If you have RRSP contribution room and you make an in-kind contribution of securities to your RRSP between January 1, 2012 and the February 29, 2012 RRSP deadline, you can claim the fair market value of the securities at the time of the transfer to your RRSP for a deduction on your 2011 income tax return.

However, note that an in-kind transfer from your non registered account to your RRSP account is considered to be a taxable event which may result in a capital gain or loss. The good news is that if the security is in a gain position, you will still receive an RRSP deduction on your 2011 tax return, while deferring the tax payable on the capital gain until the year 2013 when you file your 2012 tax return. Alternatively, if the security you transfer in-kind to your RRSP is in a loss position, your ability to use the resulting capital loss will be lost forever (i.e., you will neither be able to claim the capital loss in the current year nor carry it back or forward to other taxation years).

If you would like to be able to use your loss, consider instead selling the securities in your non registered account for cash, report the capital loss on your 2012 tax return, and contribute the cash to your RRSP by February 29, 2012 to claim the RRSP deduction while being careful not to trigger superficial loss rules by waiting for at least 30 days before repurchasing identical securities.

2012 Taxation Year RRSP contributions

While some individuals procrastinate contributing to their RRSPs until the February or February 29 deadline of the following year, it is generally a good idea to contribute to an RRSP as soon as possible in the current year to maximize your tax deferred growth.

If you wish to maximize your RRSP contribution for 2012 as soon as possible, you will need to estimate your 2012 RRSP deduction limit as you will likely not have all of the information necessary to calculate this limit this early in the year (i.e., such as your 2011 earned income and pension adjustment, if any). Your annual deduction is limited to 18% of your previous year’s (2011) earned income up to the RRSP dollar limit ($22,970 for 2012), less any 2011 pension adjustment. Once you have estimated your available RRSP contribution room, you can consider one the following two contribution strategies:

1. Make a lump sum contribution for 2012
2. Establish a pre-authorized regular (e.g., monthly) RRSP contribution plan

Finally, if you have not already done so, consider making an over-contribution by the allowable $2,000 limit which is not subject to the over-contribution penalty tax. Although the additional $2,000 over-contribution amount would not be tax-deductible, it can be deducted in a future year as long as it is within that year’s RRSP deduction limit.

Tax-Free Savings Account (TFSA)

The TFSA allows you to make a $5,000 annual (subject to annual indexation to inflation in $500 increments) non-tax-deductible contribution each year. Therefore, in 2012, another $5,000 contribution (plus indexation, if applicable) is permitted and you can carry forward any unused contribution room indefinitely. In addition, if you withdrew an amount from your TFSA in 2011, you can re-contribute this amount to your TFSA in 2012. Since any income earned in the TFSA is non-taxable, contributing early can increase your savings by maximizing the amount of tax-free growth.

You can contribute securities in-kind to your TFSA provided the security is a qualified investment and not a prohibited investment. The amount you contribute in 2012 will be equal to the fair market value of the securities transferred in-kind. This may trigger unrealized capital gains that will be taxable on your 2012 tax return. You may also trigger unrealized capital losses; however, due to the superficial loss rules, these losses will be denied and the ability to use them will be lost forever.

Labour-sponsored investment fund purchases

Another strategy for reducing your 2011 income tax liability after the end of 2011 is to consider purchasing shares of labour-sponsored funds by February 29, 2012 to take advantage of a 15% federal labour-sponsored funds tax credit on a maximum contribution of $5,000 (maximum $750 federal tax credit). An additional provincial tax credit may also be available depending on your province of residence and the type of fund purchased. Labour-sponsored funds can be purchased in registered and non-registered accounts. If they are purchased by February 29, the tax credits can be claimed on your 2011 or 2012 tax returns, similar to the way RRSP deductions work.

The tax advantage of purchasing a labour-sponsored fund must be weighed against the investment merits (generally higher risk) and the requirement to hold the investment for at least eight years. Cashing in a labour-sponsored fund before the required 8-year holding period has expired will result in a full repayment of the tax credits (except in the case of death).

Mutual funds purchases

If you delayed purchasing mutual funds at the end of 2011 due to the potential tax disadvantages of a year-end purchase, now might be a good time to consider such purchases in the beginning of the year based on their relative merit in meeting your investment objectives.

Family income splitting loans

If you set up a prescribed rate loan with your lower income spouse to split income, it is critical that your spouse pay you the interest on the loan for the 2011 taxation year on or before January 30, 2012. If this deadline is missed, the 2011 investment income and all future years' investment income related to the loaned funds will be attributed back to you even if your spouse pays you all future loan interest income by the January 30 deadline in the following years.

Loans are based on Canada Revenue Agency (CRA) prescribed rates that are subject to change quarterly. Once the loan is set up, however, the rate at the time it is set up remains in effect until the loan is wound up even if the CRA prescribed rate increases.

As the prescribed rate for loans with your spouse remains at an all time low of 1% for the first quarter of 2012, this may be the opportune time to consider this income splitting strategy.

2011 Home Buyers' Plan withdrawals

If you participated in the Home Buyers' Plan (HBP) in 2011, but borrowed less than the maximum $25,000 tax-free from your RRSP in 2011, you may be eligible for another tax-free RRSP withdrawal (up to the $25,000 maximum permitted) in January 2012 which CRA will consider to have been received in 2011 for HBP purposes as long as your HBP withdrawal was not made after 30 days from the date of ownership of the first-time home. For example, if you made an HBP withdrawal in March 2011 and your home closed in September 2011, you would not be able to make a second tax-free HBP withdrawal in January 2012 since it has been more than 30 days after the closing date of your home purchase.

After January 2012, further RRSP withdrawals will be subject to full withholding tax as they cannot be designated as tax-free HBP withdrawals.

Non-registered account fixed income purchases with January maturities

Although this strategy can be accomplished any time during the year to achieve maximum tax deferral, you could consider purchasing fixed income securities that accrue interest (T-bills, strip bonds, etc.) with January maturity dates. Canadian tax rules require that you accrue the interest annually (even though you do not actually receive any proceeds until you either sell the security or it matures) for tax purposes based on the anniversary date of the security. The anniversary date is every 365 days based on the day before the issue date. For example, a strip coupon issued on January 15, 2011 has a January 14 anniversary date. Assume you purchase a strip coupon, with a January 15, 2013 maturity date, on January 15, 2012. You are required to report the accrued interest from January 15, 2012 to January 14, 2013 on your 2013 income tax return, which you need to file by April 30, 2014. Since you purchased the fixed income instrument after the anniversary date, you will have no interest to report in 2012, the year of purchase.

Prior to implementing this tax deferral strategy, ensure that the tax advantages of timing your non-registered account fixed income purchases do not override the investment merits of the fixed income instrument.

Other alternatives to defer or avoid tax on accrued interest on fixed income instruments include purchasing fixed income instruments in a:

1) Registered plan (avoids the annual tax reporting altogether until withdrawals are made from the registered plan).
2) TFSA as there is no tax on the interest generated in this account.

2011 tax loss selling repurchases

Near the end of December 2011, you may have taken advantage of selling some securities in a loss position, but are keen to repurchase the same securities due to their investment merits. In order to repurchase identical securities so that the capital loss can be claimed on your 2011 tax return, you, your spouse, a corporation controlled by you and/or your spouse, or a trust in which you or an affiliated person is the majority interest beneficiary must wait at least 30 days after the 2011 sale. This 30-day rule is known as the ‘superficial loss’ rule.

If you placed your sale trade on the last trading day for 2011 settlements (i.e., December 23, 2011 for Canadian listed equities), your trade’s settlement date was December 30, 2011. Therefore, in order to claim a capital loss for the 2011 taxation year, you must wait at least 30 calendar days (including weekends and holidays) after the settlement date before you can own the identical security, and the first day that you can own the identical security is Monday, January 30, 2012. Since it takes three business days for the security to settle, you could place your purchase trade on Wednesday, January 25, 2012 for settlement on January 30, 2012.

Owner-managers may consider paying bonuses

If you own your own business with a year-end after June 30, you may consider paying reasonable bonuses to employees, including yourself, within 179 days after year-end. Canadian 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. However, the employee must declare the bonus for personal tax purposes on their tax return in the year of receipt of the bonus. For example, assume your corporation has a December 31, 2011 year-end. It can pay a bonus in January 2012 to an employee for services they rendered in

2011. Your corporation can deduct this bonus on its 2011 corporate tax return, but the employee should report this bonus on their 2012 tax return.

If, however, your corporation pays the bonus directly to the employee in cash, your corporation is required to withhold tax. Our tax rules allow, but do not require, an employer to directly transfer a bonus to an employee's RRSP without withholding tax if the employer believes on reasonable grounds that the employee has sufficient unused RRSP deduction room to deduct the contribution. In this case, the employer receives an immediate tax deduction benefit and the employee receives the bonus in their RRSP with no immediate tax to pay.

Sale of private business shares in 2011

You may have disposed of "qualified small business corporation" shares in 2011 and realized a capital gain that cannot be fully exempt under the $750,000 qualified small business exemption. If this is the case, you may be able to defer all or some portion of the taxable capital gain if you reinvest in a new eligible small business corporation any time in the year of disposition or within 120 days after the end of that year. As these deferral rules are complex, you should consult with a qualified tax advisor if you intend to explore this option.

T4 filing deadlines for employers

If you have employees in your own business or even an employee as a nanny or babysitter, then you must file the appropriate T4 Summary forms to CRA by February 29, 2012. In addition, a copy of the T4 slip must be delivered or mailed to the employee(s) by February 29, 2012. If you, as an employer, fail to file the appropriate T4 forms to CRA by the February 29, 2012 deadline, you may be subject to onerous penalties.

LIRA conversion to LIF/LRIF

If you have a LIRA (or Locked-in RRSP) and are planning to convert your locked-in plan to a LIF or LRIF in the year 2012, then you may want to consider converting in January 2012 rather than later in the year. The reason for the conversion in the first month of the year is that it gives you added flexibility in withdrawing more monies from your LIF/LRIF in the first year. That is, in the first year of a LIF/LRIF, the maximum withdrawal limit is prorated in some provinces, such as Alberta, Ontario, Newfoundland & Labrador and federally regulated plans) for the number of months remaining in the year at the time of conversion. Therefore, the earlier in the year the LIRA (or Locked-in RRSP) is converted to a LIF/LRIF, the greater the amount that can be withdrawn in the first year. A full year's maximum can be withdrawn regardless of when the LIF was opened in provinces, such as Quebec, New Brunswick, Nova Scotia, Manitoba and in British Columbia, where prorating is not required. Note that in the year that the LIRA (or Locked-in RRSP) is converted to a LIF/LRIF, there is no minimum payment that must be withdrawn.

Conclusion

While it is important to consider tax planning strategies at the end of each taxation year, it is also important to consider certain tax planning opportunities that are available within the first two months of the following year. Due to the complexity of some of the strategies discussed, however, consult your qualified tax advisor to explore their appropriateness well in advance of the important January and February deadlines.