Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Managing the tax impact of realizing capital gains in your corporation

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

Canada's 2024 federal budget proposed to increase the capital gains inclusion rate to 66.67% from 50% for all gains realized in a corporation on or after June 25, 2024. As a business owner, and in planning for tax-efficiency, you may have decided to realize capital gains in your corporation by disposing of shares, real estate or other business assets prior to June 25, 2024, at the lower inclusion rate. You may now want to give thought to some of the tax and financial implications of having realized those gains. If your corporation's year-end is approaching, here are some potential strategies that may help mitigate and manage the tax impact of realizing significant capital gains.

This article contains planning considerations for corporations that may or may not be appropriate for individuals or trusts. If you realized significant capital gains personally, please ask your RBC advisor for the article on managing the tax impact of realizing capital gains in 2024. If you realized significant capital gains in a trust, please discuss the potential impacts with your qualified tax advisors.

The tax impact

If your corporation realized significant capital gains prior to June 25, 2024, this may result in a hefty tax bill for your corporation's fiscal year. For example, let's assume you determined that rebalancing your corporation's portfolio was appropriate, and your corporation sold a large amount of securities prior to June 25, 2024. If the aggregate fair market value of the securities sold was $600,000 and the adjusted cost base (ACB) was $100,000, your corporation would have realized a capital gain of $500,000. Assuming the corporate tax rate is 50% and given that those capital gains would be included in income at 50%, the corporation's tax liability solely on the realization of those gains would be $125,000.

A corporation can generally choose any tax year-end, subject to certain exceptions. If your corporation's year-end is approaching, there may still be an opportunity to implement some tax planning strategies that can help mitigate and manage the tax impact of realizing a large amount of capital gains in your corporation.

Strategies to reduce the tax impact

Carefully utilize capital losses

If your corporation's portfolio contains investments that have decreased in value and are no longer aligned with its investment strategy, you may be thinking of selling these investments before the corporation's tax year-end, to realize a capital loss.

For 2024, your corporation is required to separately identify capital gains and losses realized before June 25, 2024 (Period 1) and those realized on or after June 25, 2024 (Period 2). Gains and losses from the same period are first netted against each other. More specifically, any capital losses realized in Period 2, prior to your corporation's tax year-end, will first be offset against capital gains realized in Period 2. After the offset, if there are still excess capital losses, those net losses will be offset against capital gains realized in Period 1. As such, be careful with the amount of capital losses you realize in Period 2, as net losses may end up offsetting capital gains realized in Period 1. This may defeat what you were trying to accomplish by realizing significant capital gains in your corporation, subject to the 50% inclusion rate.

As a note of caution, if you intend to repurchase any investment your corporation sold at a loss, it's important to ensure you don't trigger the "stop-loss rules." The stop-loss rules may occur when your corporation sells property (say, shares or mutual funds) at a loss and then repurchases that identical property within 30 days and continues to hold it on the 30th day. If the stop-loss rules apply, the loss is suspended (unavailable for use) in the corporation until the time the corporation disposes of the substituted property to a non-affiliated party (i.e. into the market).

Carefully utilize capital loss carry-forwards

Any unused net capital losses (i.e. capital losses that were not able to be offset by current-year capital gains) can be carried back to be claimed against taxable capital gains realized in the three previous years or carried forward indefinitely to be claimed against taxable capital gains realized in a future year. If your corporation happens to have an unused net capital loss balance carried forward from a previous year, this unused net capital loss balance may be used to offset capital gains realized in Period 2, that are subject to the 66.67% inclusion rate. Further, when tax planning, it may now be more tax-efficient to carry forward unused net capital losses from prior years to offset capital gains subject to the 66.67% inclusion rate rather than to carry back the loss to offset capital gains subject to the 50% inclusion rate.

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Establish an individual pension plan (IPP)

An IPP is a defined benefit pension plan that would be established and sponsored by your company. It's often established to enhance the retirement benefits for key employees or for you, the business owner, since it can provide greater annual contribution room than a registered retirement savings plan (RRSP). The benefits of an IPP may be extended to your spouse and other family members if they're also employed by your corporation.

Contributions to an IPP provide an immediate tax deduction to your company and are exempt from payroll and healthcare taxes. The deduction can help reduce your corporation's tax bill for its fiscal year. Your corporation may be able to deduct the IPP contributions it makes in a tax year, or up to 120 days after its tax year-end for tax purposes. For the contributions to be deductible, they must relate to service performed in the current tax year or a previous year. Contributions that relate to service after the end of the tax year would not be deductible. Investment management fees may also be tax-deductible if they're paid outside the IPP by your corporation.

In addition to the corporate tax deduction, an IPP has other potential benefits. Personal tax is deferred and only payable when you receive the benefit in a future year (potentially when you're in a lower tax bracket). In addition, you may be able to split your IPP retirement income with your spouse, which may further reduce your family's future overall tax bill. Lastly, the assets in an IPP are also generally protected from creditors should your business ever run into financial difficulty. Overall, an IPP may allow you to set aside a significant amount of tax-deferred income for your retirement while having the assets protected from corporate creditors.

Pay salaries before year-end

Before the corporate year-end, consider paying additional salary or bonus to yourself and/or family members who work in the business. The payment will not only constitute

earned income, which creates RRSP contribution room for the following year, but it also gives your corporation a tax deduction. The salaries paid must be reasonable based on the services performed by you and/or your family members. A good general rule or guideline is to pay your family members what you'd pay someone who isn't related to you for the work performed in the business.

Declare bonuses before year-end

If you want to decrease corporate income without increasing your personal income for the current tax year, consider declaring a bonus before your corporation's tax year-end and paying the amount within 180 days after the corporation's year-end. This will ensure your business gets a corporate deduction for its tax year and you'll only have to include the bonus in your personal income in the year you receive it.

Purchase assets for your business

If you intend on purchasing assets for your business (i.e. a computer, furniture, equipment, etc.), consider making this purchase before year-end. If the asset is available for use, this year-end purchase will allow your business to deduct capital cost allowance (CCA), which represents depreciation on the asset for tax purposes. For most assets, half of the regular allowable CCA can be claimed for tax purposes in the first year of an asset purchase, regardless of when it was purchased during the year.

Donate securities in-kind

Whether you've made a philanthropic commitment or simply want to assist a registered charity, consider donating securities in-kind from your corporation, especially if your corporation doesn't have the cash on hand. This can be an effective donation strategy, especially if your corporation has securities with large accrued capital gains. Why? Because when your corporation donates securities in-kind, it benefits not only from an elimination of the capital gain accrued on the securities, but also from a corporate tax deduction based on the value of the securities donated. This deduction would help reduce the tax liability resulting from the capital gains realized earlier in the year. In addition, the full value of the eliminated capital gain is added to the corporation's capital dividend account (CDA). This increases the amount that can be paid tax-free to the corporation's shareholders. If the securities your corporation donates happen to be in a loss position, the corporation can still benefit by claiming the capital loss as well as the donation deduction.

Before donating in-kind, it's important to contact the registered charity and verify whether they can accept in-kind donations.

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Although there's no limit to the amount your corporation can donate in a year, for tax purposes, a corporation can generally claim a deduction for charitable donations up to 75% of the corporation's net income for the year. If your corporation is unable to claim the full donation in one year due to this limitation, it can carry forward the unclaimed donations for up to five years.

Consider tax-advantaged investment choices

The government provides tax incentives to encourage investment in certain areas of the economy. For example, flow-through investments may provide your corporation with tax deductions that may offset the tax impact of realizing significant capital gains.

While evaluating investments based on the tax merits is important, you should also consider other factors such as the investment risk, diversification, opportunity for capital appreciation, liquidity and so on. Flow-through investments are considered higher-risk investments and typically must be held for a set period of time. Also, certain investments, such as limited partnerships, require more complex tax reporting. You should factor in any restrictions and increased filing complexities when evaluating whether an investment is right for your corporation.

Options for funding the tax liability

If your corporation is left with a large tax liability, even after implementing some strategies to reduce its overall tax bill, it's important to ensure the corporation can meet its tax obligations. Here are a few options for funding the tax liability.

Use passive assets

If you don't have surplus cash in the corporation to pay for the income taxes owing, you can consider liquidating assets, including investments, to generate the funds. Note that if you sell assets after the corporate year-end, this may trigger additional capital gains or losses, impacting the corporation's next fiscal year.

You can then decide whether your corporation should borrow funds to replenish the investments sold. When your corporation borrows money, the interest expense is deductible for tax purposes where the funds are used for the purpose of earning income from business or property (which includes interest income, dividends, rents and royalties).

Use borrowed funds from a financial institution

Your corporation can borrow funds to directly fund the tax liability; however, borrowing comes with costs and potential risks. You need to ensure the corporation has sufficient cash flow to make interest payments. Also, if your corporation borrows to pay the taxes owing, the interest on these borrowings will not be deductible since the borrowing would not be for the purpose of earning income from business or property.

As an alternative, to ensure the interest on the corporation's borrowings is deductible, the corporation can sell some assets in its existing portfolio to pay the taxes and then borrow to replenish the portfolio. The interest on these borrowings may be deductible since the corporation would be borrowing to generate income from property, by investing.

Use borrowed funds from a shareholder

You can consider borrowing money personally to make an interest-free loan or contribution of capital to your corporation. The interest expense on borrowed money used to make an interest-free loan is not generally deductible since the direct use of the funds can't generate any income. However, where it can be shown that this interest-free loan can influence your income-earning capacity, the interest may be deductible. For example, a deduction for interest would generally be allowed where you, in your capacity as a business owner, borrow money to make an interest-free loan to your wholly owned corporation and the contribution of capital has an effect on your corporation's income-earning capacity, thereby increasing the potential dividends to be received by you.

Other tax considerations

Adjustments to the CDA

In simple terms, the CDA is a notional tax account that keeps track of the non-taxable portion of capital gains, the non-allowable portion of capital losses, capital dividends received from other corporations, and life insurance proceeds (in excess of the ACB of the policy). The CDA is calculated at a point in time and when positive, a corporation can pay out a tax-free dividend to its shareholders by electing the dividend to be a "capital dividend."

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The proposed increase to the capital gains inclusion rate impacts the calculation of the CDA in that the non-taxable portion of capital gains and the non-allowable portion of capital losses realized by a private corporation on or after June 25, 2024, will be decreased from 50% to 33.33%.

It's crucial to accurately determine your CDA balance before paying out a capital dividend. If your corporation pays out a capital dividend in excess of its CDA balance, it may be subject to an additional tax. The calculations to determine the CDA for a corporation's transition year (i.e. a tax year that begins before June 25, 2024, and ends after June 24, 2024) are extremely complex; it's advisable to have a qualified tax advisor carefully calculate the CDA balance at a particular point in time before paying out a capital dividend.

Potential tax instalments

There are very specific factors that determine which corporations are required to make tax instalments, but generally, an incorporated business must pay taxes in instalments if the total income tax and tax on capital due for the current tax year and the previous year exceeds $3,000. If generating large capital gains prior to June 25, 2024, triggered a tax liability for the current tax year that exceeds $3,000, your corporation may be required to start making instalments.

Corporate tax instalments are generally due on the last day of each month (although some Canadian-controlled private corporations (CCPCs) can remit quarterly instalments if certain conditions are met). Instalments are essentially a pre-payment of tax that's credited towards the corporation's actual tax liability for the year. If your corporation owes more tax than the required instalments for the tax year, the balance is generally due two months after the end of the tax year. CCPCs may be eligible to pay the balance owing three months after the end of the tax year. If the instalment payments are greater than your corporation's actual tax liability, the Canada Revenue Agency (CRA) will refund your corporation the difference, plus interest.

The CRA will charge interest if your corporation makes late or insufficient payments. They may also charge an instalment penalty when instalment interest is more than $1,000. Since the interest and penalties can be punitive, it's advisable to confirm with a qualified tax advisor whether your corporation needs to make instalments for the year.

Plan ahead

As part of proactive planning for the future, it's important to discuss your corporation's situation with a qualified tax advisor to understand the significance and potential impacts of realizing capital gains in 2024. There may be opportunities to minimize tax and preserve your corporation's net worth. Speak with a qualified tax advisor to determine if any of the tax planning opportunities discussed in this article are suitable for your corporation.

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Wealth Management

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