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CESTNICK

TAX MATTERS

Consider capital gains planning to save tax

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I get a kick out of listening to comedian Avi Liberman, who has been concerned that his tax preparer might be too aggressive. "Avi, did you go to China last year?" his tax preparer asked. "No, I haven't been to China," Avi replied. "You ever eat Chinese food?" was the next question. "Yeah," Avi replied. "That'll work," his preparer said. "Now, do you have any pets that talk, like a parrot?" Avi was asked. "No, I don't," Avi replied. Too bad, it seems his tax preparer might have claimed it as a dependant.

There's a difference between good tax planning, and tax evasion. Claiming your parrot as a dependant won't work, unfortunately. The good news? There are some legitimate planning ideas you might want to consider in the short term. Today, I want to talk about capital gains.

THE HISTORY

On Sept. 25, 1962, our government appointed the Royal Commission on Taxation, also known as the Carter Commission, to study taxation in Canada. The commission recommended that capital gains should be taxable in Canada. Many of the recommendations made by the Carter Commission were enacted for the 1972 tax year, including the taxation of capital gains. At the time, just one half of capital gains were subject to taxes.

Over the years, the portion of capital gains that is taxable has changed. From 1972 to 1988 the "inclusion rate" (the portion of gains that is taxable) was one half. This increased to two-thirds in 1988 and 1989, then jumped to 75 per cent from 1990 to 1999. In 2000, the inclusion rate dropped twice and has been 50 per cent ever since October of that year.

Many tax professionals are expecting the inclusion rate to increase again given the need for more tax revenue to pay for the assistance the government has provided during the pandemic. And make no mistake, this government is intent on increasing taxes for affluent Canadians, and capital gains have long been considered a type of income of the wealthy.

If you're in the camp that believes the capital gains inclusion rate is likely to increase, what should you be thinking of doing today? Consider the following strategies.

THE STRATEGIES

1. Consider disposing of assets today. If you own assets that have appreciated in value and were planning to dispose of these in the short term anyway, you might consider disposing of them before any announcement is made to increase the inclusion rate – potentially as soon as the next federal budget (likely in February or March).

Let's suppose, for example, that you own an investment worth $100,000 with a cost amount of $60,000. If you were to sell today at the current inclusion rate, half of your capital gain of $40,000 ($100,000 minus $60,000), or $20,000, would be subject to tax. If you're in the highest tax bracket, you'd pay about $10,000 of taxes, assuming a 50-per-cent marginal tax rate (about the average across Canada). This amounts to a 25-per-cent tax rate on your capital gains. Now, suppose the inclusion rate increases to 75 per cent. If you were to sell the same investment after that change, your tax bill on the capital gain would be $15,000, or 37.5 per cent. That's a big increase. Taking advantage of today's inclusion rate could make sense.

2. Reduce your capital gains reserve. There are many who have sold real estate or other assets and are collecting their sale proceeds over time. In this case, you're allowed to claim a reserve (deduction) for a portion of the gain since you haven't collected your full sale proceeds yet. Our tax law will allow you to pay tax on that gain over a period as long as five years. If you're entitled to a reserve, you may want to voluntarily accelerate the reporting of your capital gains to take advantage of the current inclusion rate. After all, the tax rate that applies to your gains is the rate in effect in the year you pay your taxes on the gain, not the year you sold the asset.

3. Transfer assets to a corporation. How do you trigger a capital gain without actually giving up control over an asset? You might consider transferring the asset to a corporation that you control. This can be done in such a way that you can elect, or choose, the amount of the capital gain that you realize at the time of the transfer. Be sure to speak to a tax professional about this first regarding the specific assets you're hoping to transfer, and the pros and cons of the strategy.

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