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TAX MATTERS

Five more tax strategies to plan for tough economic times

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As Canadians look to the economic challenges we're facing today and try to arrive at answers, maybe we can all blame my aunt. I was talking with her this week, and she said, "Tim, sometimes I wonder if all these economic problems are happening because I didn't forward that e-mail to 10 other people." I know the type of e-mails she was talking about. Maybe that's the answer. Regardless, when times get tough, the tough get planning. As a follow-up to my article last week, here are more ideas to consider in tough economic times.

Portfolio adjustments. The reality is that the S&P Canada Aggregate Bond and U.S. Aggregate Bond indexes are down 10.6 and 9.6 per cent year-to-date, respectively, which are the largest declines in the past 40 years. In our office we've been suggesting to clients that now may be a good time to add bonds to a portfolio. Bonds can still serve as a hedge against stock market drawdowns if the economy does spiral into a recession in the midst of rising interest rates. Some analysts believe that a coming bull market in bonds will likely outperform stocks over the next 12 months.

Capital dividends. Given market declines this year, you may be tempted to sell some of the losers in your portfolio. If these are held in a corporation, examine your company's capital dividend account (CDA) first. The CDA is a notional account that represents an amount you can pay to yourself tax-free from your company in the form of capital dividends. Your company may have a CDA balance if it has realized capital gains in the past or has received life insurance proceeds.

The problem? If you sell any investments for a capital loss, that loss will reduce the balance in the CDA. So, before you do this, consider paying capital dividends out of your company's CDA first, then go ahead and sell your losers.

Also, now could be a good time to realize capital gains on assets if you believe that tax rates on capital gains will be going up in the future. This is a distinct possibility given our government's level of pandemic spending and the need to raise tax revenue. Today, the capital gains inclusion rate is just 50 per cent (meaning that one half of capital gains are taxable), but the rate was 75 per cent throughout most of the 1990s. Realizing capital gains in your corporation will increase the CDA balance and can be done without actually disposing of your company's assets. You can then use the CDA to pay out tax-free dividends, or to redeem fixed-value preferred shares you might own (maybe shares used in an estate freeze). Speak to a tax pro about the CDA and these ideas.

Charitable gifts. When economic times get tough, charities feel the pain as much, or more, than anyone. Don't forget to donate to the charities that matter to you if you can. Donating publicly traded securities that have appreciated in value will eliminate the capital gain on those securities, in addition to providing a donation tax credit. But markets have declined, and you may have losers in your portfolio, so, what if you donate some losers to charity? Or simply sell the losers and donate the cash. This can make sense because you'll be entitled to claim the capital loss on the securities, plus you'll be entitled to a donation tax credit (or deduction if it's a corporation) for the fair market value of what you've donated.

Gifts to kids. When markets decline, it's always a good time to think about your estate planning. You could give some of your investments that have declined in value to your children. This will trigger a capital loss in your hands, which can offset any capital gains this year or in the past three years. Further, it will transfer assets from you to your children, reducing the value of your estate, which can reduce taxes and probate fees on your death. Your children or grandchildren might also appreciate the financial aid if they're looking to buy a home or are otherwise in a stage of life where they could use the help.

Stepping-up your ACB. When the value of an investment declines, it's an opportunity to reduce taxes by increasing the adjusted cost base (ACB) of other investments. Here's how: If you sell an investment at a loss, you can then sell another investment for a capital gain. The capital loss on the loser can offset the gain on the winner, so no taxes are paid. You can then repurchase the winner, which will increase your ACB on those securities to today's value. That higher ACB will mean a lower taxable capital gain or larger capital loss later when you ultimately sell that winner. This will save you taxes.

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