

Tax Planning Opportunities in a Depressed Market

Capital Gains | Corporate Law | Income Splitting | Tax | Tax Law | Tax and Estate Planning

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The recent decline in financial markets may present opportunities to obtain refunds of tax paid in prior years. They may also present opportunities for income-splitting if you believe that market prices will recover and rise in future years.

Carrying Back Capital Losses to Prior Years

If you realized a taxable capital gain in any of the last 3 years (2017, 2018, or 2019), you may consider triggering a capital loss in 2020 and carrying back the capital loss to offset all or part of the capital gain in any of those 3 years and claiming a refund of tax paid in that year. Capital losses may also be carried forward indefinitely and applied against capital gains in future years.

If you do realize a capital loss by disposing a security in a loss position, it is important that you or an affiliated person (which includes your spouse, common-law partner, or a corporation controlled by you) do not reacquire the same or an identical security within 30 days of the disposition. Otherwise, the capital loss will be a superficial loss and will be denied.

Invest Cash to Achieve Income Splitting with Children on Future Capital Gain

If you take this approach and liquidate securities, or if you happen to have cash available to invest, the next question becomes what to do with that cash. Instead of simply reinvesting the cash in your name, depending on your circumstances, other options may be worth considering. If you believe that markets will recover and rise in future, there are planning opportunities to have the resulting capital gains taxed in the hands of a family member in a lower tax bracket.

Under the *Income Tax Act*, when an individual gifts or loans funds interest-free to certain family members who in turn use those funds to earn investment income, such investment income (and in the case of your spouse, capital gains) is taxed in the hands of the individual who gifted or loaned the funds. This is known as attribution.

In general, there is attribution of income from property (dividends and interest) when funds are loaned to a spouse or minor child. There is no attribution of such income from funds loaned to an adult child.

For capital gains, there is attribution when funds are loaned to a spouse only. There is no attribution of capital gains from funds loaned to a minor or adult child, or to a trust the beneficiaries of which are minor or adult children.

If you are in a high tax bracket and have minor or adult children with little or no income, the following income-splitting strategy may be attractive:

- You loan funds interest-free to a trust of which your child is the beneficiary and you are the trustee.
- The trust structure allows you to maintain control of the funds in the trust rather than giving your child outright ownership.
- The trust invests the loaned funds with the primary objective of earning capital gains.
- The capital gains realized by the trust would be allocated to your child.
- The tax on the capital gains will be payable by your child at a lower tax rate than if the capital gains were realized by you.

Any dividends or interest earned by the trust and distributed or allocated to a minor child will be attributed to you and taxed in your hands.

Note that all proceeds distributed from the trust to your child legally belongs to the child, and you would have no further control of those funds once your child is an adult (18 or over). However, as trustee, you may direct such distributions to be used for the benefit of your child, such as costs for education, health care, lessons, tuition, etc.

If this planning is used for adult children aged 18 and over, it will be necessary to consider whether an adult child has other taxable income and the child's tax bracket in the year when the capital gains are realized and distributed by the trust.

Income Splitting with a "Prescribed Rate Loan" Structure

Income splitting of dividends, interest, and capital gains with minor children or a spouse can be achieved without being subject to attribution where you make a prescribed rate loan to your minor children, your spouse, or to a trust for your minor children and/or spouse, which minor children, spouse, or trust invests the proceeds of the loan to earn dividends, interest, and capital gains. A prescribed rate loan is an interest-bearing loan with an annual interest rate at least equal to the "prescribed rate", which at the time of writing is 2% per year. The interest paid is taxable to you as the lender of the funds, and the interest expense is deductible to the borrower if the funds are used to earn investment income. The interest payable on the loan must be paid to you by the borrower within 30 days of the end of each calendar year while the loan is outstanding. The prescribed rate is set quarterly by the Department of Finance. If the prescribed rate is reduced in future, this income splitting strategy will become more attractive.

Example

To illustrate the potential benefit of the above planning opportunities, let's say for example:

- Mr. A has two minor children, C and D.
- Mr. A had capital gains of \$50,000 in 2019.
- Mr. A owns securities with unrealized losses of at least \$50,000, and other investments of \$500,000 with market value equal to cost (no accrued gain or loss).
- Mr. A sells the securities and realizes a capital loss of \$50,000 in 2020 and carries back the loss to offset the \$50,000 capital gain in 2019. Mr. A will receive a tax refund of approximately \$13,383, if he pays tax at the highest marginal rate in Ontario, when he files his return for 2020.
- Mr. A liquidates his other investments without triggering a capital gain for proceeds of \$500,000.
- Mr. A loans the proceeds of the sale of the loss securities and other investments and the tax refund interest-free to a trust for the benefit of C and D.
- The trust invests the funds in investments focused on capital gains.
- After 1 year, the trust has accrued capital gains of \$100,000 (in the post-COVID-19 market recovery) and a market value of \$600,000.
- The trust liquidates its investments and distributes \$50,000 of capital gains to each to C and D.
- Assuming C and D have no other income, they will pay tax of approximately \$3,000 each, or \$6,000 in total. This compares to taxes of \$26,765 if Mr. A had realized the \$100,000 capital gain himself and Mr. A pays tax at the highest marginal rate. The tax saved would be \$20,765.

If you think a similar arrangement may be suitable for you, please speak with one of our tax and trusts professionals.

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