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Tax Mistakes when Investing

Investment decisions made by individuals may have a negative impact on their tax situations.

Although the decisions may make economic sense, they sometimes are not in line with CRA policies. The cost to the taxpayer may be additional tax cost. If the taxpayers knew beforehand of the tax consequences of their decisions, in some cases their plans could be re-arranged to minimize taxes.

Tax-Free Savings Account (TFSA)

Every individual can contribute up to $5000 per year; the income generated by the TFSA is tax free. Four common tax mistakes relate to this investment.

1. Miscalculating the amount of the annual contribution
2. Facing a penalty for not filing the required form when an overcontribution occurs
3. Not ensuring that all the family members over the age of 18 utilize the TFSA
4. Not using the right investments in the account to maximize the tax advantage

There are no income tax consequences for withdrawing funds from the account, but contributions in excess of $5000 per annum are subject to a penalty of 1 percent per month.

For example if you contribute $5000 on January 15, 2011, then withdraw $3000 on June 30 and on September 1 you re-deposit $3000, you will have overcontributed $3000 and will be subject to penalty at 1 percent per month, unless you withdraw the excess contribution or a new calendar year has started.

The working spouse with the higher income can give or lend the money to the other family members to cover their TFSA contributions.

There is another penalty for overcontributing to a TFSA if a form is not filed by June 30 of the year following the end of the calendar year in which there was an overcontribution. The penalty is 5 percent of the amount owing plus 1 percent of the balance owing for each full month the return is late, to a maximum of 12 months.

A tax planning opportunity is to ensure every family member takes advantage of this account. For example, a family with a child over 18 who attends university may contribute $5000 and the parents may each contribute $5000; thus their total allowable contribution for the year would be $15,000.

The working spouse with the higher income can give or lend the money to the other family members to cover their TFSA contributions. The tax benefit to the lender is that this strategy is not restricted by attribution rules. After a few years, a significant portion of the investment income that has been generated from the loan can be removed from the lender's income—which otherwise would have been taxed at higher income tax marginal rates—and sheltered from tax. There is no impact on the person in whose name the TFSA is registered because the income generated by the TFSA is tax free.

The other issue that concerns the TFSA is the type of investments to be held in the account. Some types of investment incomes receive preferential tax treatment, for example, Canadian dividends for the dividend tax credit, and capital gains because only 50 percent is taxable.

Investments that don't receive special tax treatment include interest income and dividends from foreign stocks. If a taxpayer has a portfolio including RRSPs, RESPs, and TFSAs, he or she should consider investing nonpreferential investments in the TFSA. Also a capital gain in an RRSP will be fully taxable at the time of withdrawal so it is better to invest investments with capital gain potential in a TFSA rather than an RRSP.

Dividends and Old Age Security Payments

Benefits received from the government are income-based; taxpayers may see their benefits reduced or eliminated if their income is over the threshold level. In 2010, for example, a pensioner with a net income over $66,733 must repay a portion of the Old Age Pension. The repayment amounts are deducted from their monthly payments. Dividends from public corporations are grossed up by 45 percent but this is offset by the dividend tax credit. The result is that income from these dividends is taxed at a lower rate than interest income.

For pensioners, the reduced income tax paid on this type of income may be offset by the impact of the dividend gross-up on the net income. For example, a $10,000 dividend is included in income at $14,500, which affects the calculation of net income. In the end, the Old Age payments may be reduced by a greater amount than if the senior had the same amount of interest income.

Transferring Assets to an RRSP

If a taxpayer does not have cash, assets can be transferred directly to an RRSP, typically a self-directed RRSP. For example, an individual can contribute $20,000 to his RRSP but does not want to use cash. If he has a portfolio investment, the option is to transfer $20,000 worth of stocks to the self-directed RRSP. This strategy results in a tax saving to the extent of the taxpayer's marginal tax rate with no use of cash.

The transfer to the RRSP is considered a deemed disposition and any gain will be taxable, but a capital loss will be disallowed. To avoid the stop-loss rule when transferring an asset at a loss, one strategy is to sell the investment and use the cash to invest in the RRSP.

Transferring Capital Losses between Spouses

It is not uncommon that an individual has a capital loss but cannot utilize the loss to offset a capital gain, and the spouse has a capital gain in the same year but has no available capital losses. It is possible to transfer the capital loss from one spouse to another if done in time before the end of the year.

The superficial loss rule is used in this case to the advantage of the taxpayer. This rule disallows a loss on a share when it is sold and repurchased within 30 days by an affiliated party. The loss disallowed is added to the cost of the newly acquired shares.

For example, a taxpayer purchased shares for $100,000; their current value is $20,000. He sells the shares for $20,000 and the next day, the spouse re-purchases the shares. The result is the capital loss is denied for the husband and the spouse is deemed to acquire the shares at the $20,000 actual cost plus the disallowed loss of $80,000. Thirty days after the sale of the shares by the husband, the spouse can sell the shares again at $20,000 and realize a capital loss of $80,000, which can be used against capital gains on the shares she owns.

Capital Loss Carry-Forwards and Death

Net capital losses can be carried back 3 years and carried forward indefinitely. At the time of death, executors of an estate must ensure that capital losses are used appropriately. In the year of death, the deceased is deemed to have sold all his assets at market value; any capital loss carry-forwards may be utilized to reduce these capital gains from the deemed disposition.

In the event the capital losses exceed capital gains, the excess losses can be used on the final tax return of the deceased to offset income from other sources, such as pension or investment income. If a loss still exists after it is applied to the year of death, the executor can carry back the loss to the tax return of the preceding year. ▲

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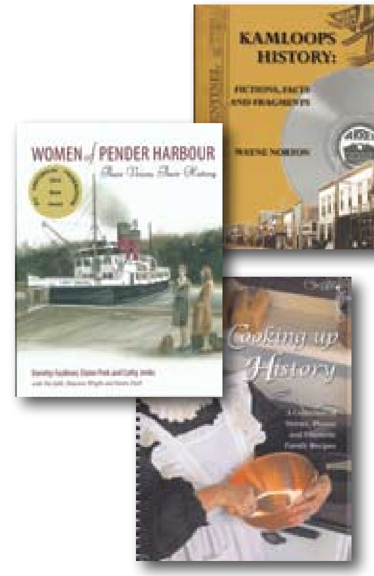
Recommended Reading



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