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2011 Year End Tax Tips

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With 2011 drawing to a close and the holidays coming fast and furious, Canadians need to ensure they do not get so caught up with the excitement and chaos of the season that they neglect crucial year end tax planning strategies, many of which need to be implemented by December 31st to be effective. 2011 brought numerous changes to the tax rules, heralding in both new opportunities as well as new peril to navigate through. What follows are the five most important strategies to focus on over the month ahead.

1. Tax-Loss Selling

Tax-loss selling involves selling investments with accrued losses at year end to offset capital gains realized elsewhere in your portfolio. Any capital losses that cannot be used currently may either be carried back three years or carried forward indefinitely to offset capital gains in other years. Due to Canada's strengthening dollar, securities you purchased in a foreign currency may actually be in an accrued loss position once you take the foreign exchange component into account.

To ensure your loss is immediately available for 2011 (or a prior year), the settlement must take place in 2011, which means the trade date must be no later than December 23, 2011.

Superficial loss

If you plan to repurchase a security you sold at a loss, beware of the "superficial loss" rules that apply when you sell property for a loss and buy it back within 30 days before or after the sale date. The rules also apply if property is repurchased within 30 days and is still held on the 30th day by your spouse (or partner), by a corporation controlled by you or your spouse, or by a trust of which you or your spouse are a majority beneficiary (such as your RRSP or TFSA). Under the rules, your capital loss will be denied and added to the adjusted cost base (tax cost) of the repurchased security. That means the benefit of the capital loss can only be obtained when the repurchased security is sold.

Transfers and swaps

While it may be tempting to transfer an investment with an accrued loss to your RRSP or TFSA to realize the loss without actually disposing of the investment, such a loss is specifically denied under our tax rules.

New legislation introduced this year for RRSPs and RRIFs and in 2009 for TFSAs also results in harsh penalties for "swapping" an investment from a non-registered account to a registered account for cash or other consideration.

To avoid these problems, consider selling the investment with the accrued loss and contributing the cash from the sale into your RRSP or TFSA. Your RRSP or TFSA can then buy back the investment after the 30-day superficial loss period.

2. Retirement Considerations

With the first wave of baby boomers turning 65 this year, here are some tips for retirees.

Convert your RRSP to a RRIF by age 71

If you turned age 71 in 2011, you have until December 31 to make any final contributions to your RRSP before converting it into a RRIF or registered annuity.

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You may also want to consider a one-time overcontribution to your RRSP in December before conversion if you have earned income in 2011 that will generate RRSP contribution room for 2012. While you will pay a penalty tax of 1% on the overcontribution (above the $2,000 permitted overcontribution limit) for December 2011, new RRSP room will open up on January 1, 2012 so the penalty tax will cease in January 2012. You can then choose to deduct the overcontributed amount on your 2012 (or a future year's) return.

This may not be necessary, however, if you have a younger spouse or partner, since you can still use your contribution room after 2011 to make spousal contributions until the end of the year your spouse turns 71.

Canada Pension Plan (CPP) Retirement Benefits

If you are between the ages 60 and 64 in 2011 and are considering taking CPP pension benefits prior to age 65, you may wish to apply by December 31, 2011. If you start CPP benefits in 2011, your pension will be reduced by a "downward monthly adjustment factor" of 0.5% for each month before age 65 that you began receiving it. Starting in 2012, however, the downward monthly adjustment factor will increase to 0.52% (and will gradually continue increasing to 0.6% by 2016), thus decreasing your CPP pension. (For Quebec residents, the Quebec Pension Plan (QPP) downward monthly adjustment factor will increase starting in 2014.)

A quick heads up for 2012 (for non-Quebec residents): If you work while receiving CPP retirement benefits prior to age 65, starting next year, you will have to make CPP contributions which will increase the CPP pension you receive at age 65 but could cost you up to $2,300 annually ($4,600 if you are self-employed) until age 65.

Old Age Security (OAS) benefits

If you turned 65 in 2011 and have not yet applied for OAS benefits, you should do so as soon as possible since retroactive payment of benefits is limited. You must meet certain residency requirements to be eligible for the benefits and OAS payments are "clawed back" (reduced or eliminated) if your net income exceeds $67,668 in 2011.

To minimize the clawback and maximize your OAS benefits, consider the following strategies:

- Delay converting your RRSP to a RRIF (to a maximum of age 71), to avoid annual RRIF minimum withdrawals and minimize net income prior to conversion.
- Eligible Canadian dividends can accelerate OAS clawback, since 141% of the dividend is included in net income due to the gross-up. Consider the composition of your non-registered investments to reduce the clawback impact, perhaps looking to half-taxable capital gains.
- Consider deferring the start of your CPP pension after you reach age 65 to reduce your annual net income and the impact of the clawback. In addition, starting in 2012, the "upward monthly adjustment factor" will rise to 0.64% (0.7% for 2013 and beyond) up from 0.57% for each month after age 65 that you begin receiving it, up to age 70.

3. Review asset allocation

Non-registered Investments

Investment income can be taxed in different ways, depending on the type of income (e.g. interest, Canadian dividends, or capital gains), and the type of account in which investments are held (non-registered or registered). Year end is an excellent time to review the types of investments that you hold and the accounts in which you hold them.

In non-registered accounts, eligible Canadian dividends are still taxed more favourably than interest income due to the dividend tax credit; however, the tax rate on eligible dividends is increasing. Looking ahead to 2012, in all provinces except Alberta, the highest marginal tax rate on eligible dividends will exceed the highest marginal tax rate on capital gains. Consider whether tilting a non-registered portfolio towards investments that have the potential to earn capital gains is the right move for 2012.

Registered Investments

Of course, tax on investment income can be eliminated altogether by investing within registered accounts such as TFSAs, RRSPs or RRIFs. While there is no time limit for TFSA contributions and you have until the end of February 2012 to make RRSP contributions for the 2011 tax year, you should make contributions as early as possible to maximize tax-free growth.

Pay close attention to both your RRSP and TFSA contribution limits, particularly since TFSA contribution rules continued to cause confusion for many Canadians in 2011. Many TFSA holders misunderstood the rules and innocently withdrew funds from one TFSA and then re-contributed to another TFSA in the same year without having the necessary contribution room, resulting in penalties on overcontributions. Investors who wish to transfer funds or securities from one TFSA to another should do so by way of a direct transfer rather than a withdrawal and recontribution to ensure they don't accidentally get caught with an overcontribution

problem.

If you are planning a TFSA withdrawal in early 2012, consider withdrawing the funds by December 31, 2011, so you do not have to wait until 2013 to re-contribute that amount.

Prohibited Investments

If you hold private company shares in your TFSA, RRSP or RRIF, ensure you are aware that these could now be considered to be "prohibited investments" and subject to harsh tax penalties.

For example, common shares are a "prohibited investment" for your RRSP, RRIF or TFSA if you, together with non-arm's length persons, own at least 10% of the outstanding shares.

2011 saw a change in the rules for RRSP/RRIF holdings of private company shares. Prior to the change, it was possible to own private company shares in your RRSP/ RRIF, even if you held more than 10% of the outstanding shares, provided you and related persons didn't control the company and the cost of shares was below $25,000.

With the new rules, many individuals who continue to own private company shares in their RRSPs or RRIFs are scrambling to get onside to avoid harsh new penalty taxes that could now apply.

For example, any income or capital gains earned after March 22, 2011 (the date of the original budget announcement) from a prohibited investment in an RRSP or RRIF is considered to be an advantage taxable at 100%.

There are a couple of ways to avoid this harsh new tax by taking advantage of special transitional relief provisions available until December 31, 2021 but which require a special election.

Under the transitional rules, the advantage tax can be reduced from 100% to your normal marginal tax rate on any income or gains accruing from March 23, 2011 to December 31, 2021, provided the income or gain is withdrawn and paid to you within 90 days after the end of the year in which the income is earned or the capital gain is realized.

To take advantage of this transitional rate, you must file a special election before July 2012.

You should also consider removing the prohibited investment from your registered plan altogether which can be done effectively by "swapping" it for cash or other property with the same value, provided you do so before 2022. To do this, it's best to get an independent valuation of the fair market value of the private company shares you want to swap.

4. Contribute to an RESP & RDSP

Registered Education Savings Plans (RESPs)

RESPs allow for tax-efficient savings for children's post-secondary education. The government provides a Canada Education Savings Grant (CESG) equal to 20% of the first $2,500 of annual RESP contributions per child or $500 annually. While unused CESG room is carried forward to the year the beneficiary turns 17, there are a couple of situations in which it may be beneficial to make a 2011 RESP contribution by December 31.

Each beneficiary who has unused CESG carry-forward room can receive up to $1,000 of CESGs annually, with a $7,200 lifetime limit, up to and including the year in which the beneficiary turns 17. If enhanced catch-up contributions of $5,000 (i.e. $2,500 X 2) are made for just over 7 years, the maximum CESG will be obtained. If you have less than 7 years before your child turns 17 and haven't maximized RESP contributions, consider making a contribution by December 31.

Also, if your child or grandchild turned 15 in 2011 and has never been a beneficiary of an RESP, December 31 is your last chance to contribute at least $2,000 to an RESP in order to collect the 20% CESG for 2011 and create CESG eligibility for 2012 and 2013.

Registered Disability Savings Plans (RDSPs)

RDSPs are tax-deferred savings plans open to Canadian residents eligible for the Disability Tax Credit, their parents and other eligible contributors. Up to $200,000 can be contributed to the plan until the beneficiary turns 59, with no annual contribution limits. While contributions are not tax deductible, all earnings and growth accrue tax-deferred.

Federal government assistance, up until the year the beneficiary turns 49, may be deposited directly into the plan in the form of matching Canada Disability Savings Grants (CDSGs) and Canada Disability Savings Bonds (CDSBs). The government will contribute up to a maximum of $3,500 CDSG and $1,000 CDSB annually, depending on the net income of the beneficiary's family. Eligible investors may wish to contribute to an RDSP before December 31 to get this year's assistance, although this has become less of a priority now that unused CDSG and CDSB room can be carried forward for up to ten years.

New for 2011, RDSP holders with shortened life expectancy can withdraw up to $10,000 annually from their RDSPs without repaying grants and bonds. A

special election must be filed with CRA by December 31 to make a withdrawal in 2011.

5. Ensure certain payments made by December 31

Charitable donations

December 31 is the last day to make a donation and get a tax receipt for 2011. Keep in mind that many charities offer online, internet donations where an electronic tax receipt is generated and e-mailed to you instantly.

Gifting publicly-traded securities, including mutual funds, with accrued capital gains to a registered charity or a private foundation not only entitles you to a tax receipt for the fair market value of the security being donated, it eliminates capital gains tax too. Note that changes introduced in 2011 for flow-through shares may decrease the tax savings that were formerly available for donation of these shares.

Other expenses

Certain expenses must be paid by year end to claim a tax deduction or credit in 2011. This includes investment-related expenses, such as interest paid on money borrowed for investing, investment counseling fees for non-RRSP accounts, and safety deposit box rental fees. Other expenses that must be paid by December 31st include child care expenses, medical expenses, interest on student loans, and spousal support payments.

Prepayments

While expenses must be paid by December 31 to claim a tax deduction or credit in many cases, the related good or service does not always need to be acquired in the same year. This provides an opportunity to prepay certain items and claim the tax benefit currently.

A tax credit can be claimed when total medical expenses exceed the lower of 3% of your net income or $2,052 in 2011. If your medical expenses will be less than this minimum threshold, consider prepaying expenses that you would otherwise pay in 2012. For example, if you expect to pay monthly instalments for your child's braces in 2012, consider paying the full amount upfront in 2011 if it will raise total medical expenses over the threshold.

Prepayments can also be used for expenses that qualify for the children's fitness tax credit (up to $500) and the new children's arts credit that was introduced in 2011 (based on up to $500 of qualifying expenses for artistic, cultural, recreational or developmental activities). For example, if you plan to enroll your child in soccer or piano lessons for 2012, you can claim the credit(s) in 2011 if you pay for the activities by December 31.

Accelerate purchase of business assets

If you're self-employed or a small business owner, you may wish to consider accelerating the purchase of new business equipment or office furniture that you may been planning to purchase in 2012. Under the "half-year rule", you are permitted to deduct one half of a full year's tax depreciation (capital cost allowance) in 2011, even if you bought it on the last day of the year. For 2012, you can then claim a full year's depreciation.

CONCLUSION

These five tax tips are just some of the many ways you can act now to reap the tax savings you will realize when you file your return next spring. But keep in mind that tax planning is a year round affair. Be sure to speak to your accountant or tax advisor well in advance of tax filing season to ensure you are paying the least amount of tax legally possible.

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