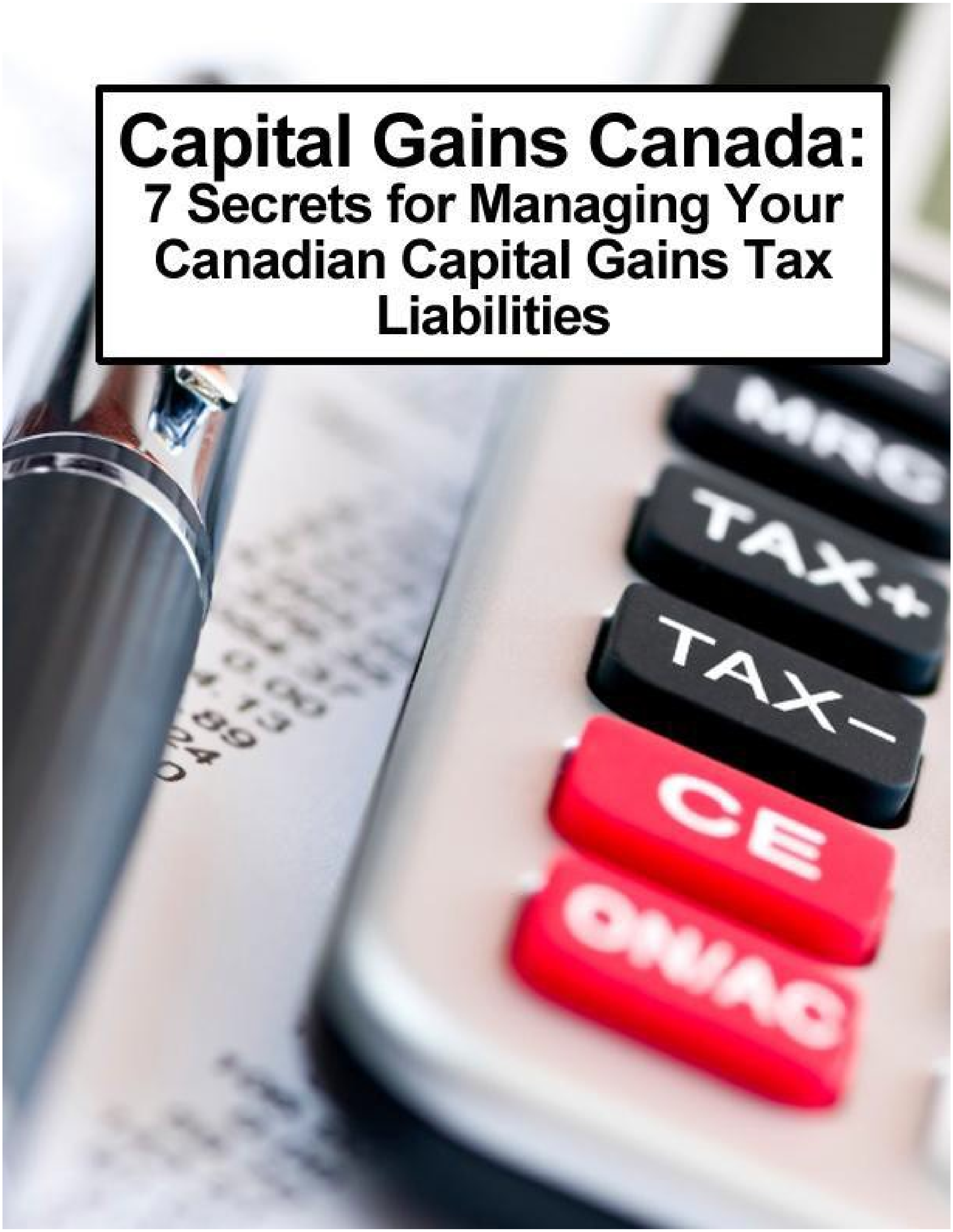
Capital Gains Canada:
7 Secrets for Managing Your Canadian Capital Gains Tax Liabilities



FREE REPORT

CAPITAL GAINS CANADA: 7 SECRETS FOR MANAGING YOUR CANADIAN CAPITAL GAINS TAX LIABILITIES

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What is capital gains tax?

There are three main forms of income from investments in Canada: interest, dividends and capital gains. Each is taxed differently. Smart investors can use that to their advantage.

You have to pay capital gains tax on profit you make from the sale of an asset. An asset can be a security, such as a stock or a bond, or a fixed asset, such as land, buildings, equipment or other possessions. However, you only pay the tax on a portion of your profit. This is called the "capital gains inclusion rate."

Let's look at an example. Say you purchased 1,000 shares of CN Railway at $50 per share a few years ago, and when it reaches $90 per share, you decide to sell. Your proceeds from the sale are $90,000 ($90 per share multiplied by 1,000 shares, not including brokerage commissions) and your cost (the cost of purchase) is $50,000 ($50 per share multiplied by 1,000 shares, again, not including brokerage commissions). This means that your profit on the sale, also known as your capital gain, is $40,000.

Capital gains offer big tax advantages

Several years ago, the Canadian government cut the capital gains inclusion rate (the percentage of gains you need to "take into income") from 75% to 50%.

This enhanced the favourable tax treatment that capital gains get in Canada. You only pay tax on 50% of the amount of your capital gain. So, based on the CN Railway example above, the amount of your taxable capital gain is only $20,000 ($40,000 multiplied by 50%). If you live in Ontario, and you are in the highest income-tax bracket, your combined federal and provincial tax rate would be 53.53%. So, you would pay $10,706 in taxes ($20,000 in taxable capital gains multiplied by a 53.53% tax rate).

In contrast, interest income is fully taxable. That same income of $40,000 at a tax rate of 53.53% would cost you $21,412 in tax ($40,000 in interest income multiplied by a tax rate of 53.53%). That's double the tax you would pay on the income from a capital gain.

Dividend income from Canadian companies is eligible for a dividend tax credit in Canada. Factoring that into the tax rate payable on dividends, you'll pay 31.62%, or $12,648 on $40,000 in dividend income.

Type of Income	Combined Tax Rate (Ontario)	Tax Payable on $40,000
Interest	53.53%	$21,412
Dividends	31.62%	$12,648
Capital Gains	26.76%	$10,706

So, if you structure your portfolio so that you get more of your income from capital gains and dividends than from other types of income, you will pay less tax overall.

Of course, all forms of income have their place in a properly planned portfolio, but by planning ahead you can minimize your overall tax burden and maximize the money you save (and the size of your investment portfolio). To help you do that, we’ve assembled 7 “secrets” for managing the part of your tax burden that’s attributable to capital gains.

Secret #1: You choose when you pay capital gains taxes

Capital gains tax has an added plus when it comes to investing in stocks. That’s because you control when you pay capital gains on a stock profit.

You pay capital gains tax on a stock only when you sell, or “realize” the increase in the value of the stock over and above what you paid for it. (Although mutual funds generally pass on their realized capital gains each year. More on that a little further on.) Further, if you sell after you retire, you may be in a lower tax bracket than you are when you are earlier in your investing career.

This maximizes your savings on capital-gains tax. In contrast, you have to pay tax on dividends and interest in the years you earn them.

Secret #2: Capital losses in your RRSP are more expensive

Don’t hold speculative investments inside of your RRSP. If you hold them in an RRSP and they drop, you not only lose money, you also lose the tax-deduction value of a loss outside your RRSP. Outside your RRSP, you can use capital losses to offset taxable capital gains in the current year, the three previous years, or any future year.

A loss inside your RRSP simply reduces the tax you’ll pay on your final withdrawal from your RRSP savings, perhaps when you reach age 90 and close out your RRIF.

You'll have less money to take out at that time, so you'll pay less tax. But this defers the deduction so far into the future as to make it meaningless.

Secret #3: You can use your RRSP to defer mutual-fund taxes

At year end, mutual funds distribute any capital gains they have made during the year, after deducting any capital losses, to their unitholders. So, you may have to pay capital gains taxes on your mutual-fund holdings, even though you haven't sold.

If you hold mutual funds outside of your RRSP, you'll have to pay capital gains tax on half of those realized capital gains. So you are best to hold mutual funds in an RRSP, and common stocks outside.

As we noted in Secret #1, you only realize capital gains on common stocks when you sell.

Secret #4: You'd be surprised what counts as a principal residence!

Your principal residence is one of the few investments that's exempt from capital-gains taxes. This includes more than just your house. Here's a list of all dwellings that qualify:

- a house
- an apartment or unit in a duplex, apartment building or condominium
- a cottage
- a mobile home
- a trailer
- a houseboat
- a leasehold interest in a housing unit
- a share of the capital stock of a co-operative housing corporation

The main stipulation, according to the Canada Revenue Agency, is that the property is your principal residence. That is, it must be occupied by the taxpayer, or by his or her spouse or common-law partner, child, or former spouse or common-law partner.

As well, the land that the residence occupies is considered part of the principal residence, under current tax rules. In fact, if a portion of the land has been "severed" (split off into a separate parcel of land), the principal residence capital gains tax exemption applies on gains from the sale of the severed land.

Secret #5: Maximize your charitable giving —and avoid capital-gains taxes

There is now a way to donate funds you hold in shares of publicly traded companies that not only maximizes the donation for the charity, but also lets you pay no capital gains taxes. This change came into effect as a result of the May 2006 federal budget.

This amounts to a double benefit for investors. When you donate stocks or mutual funds directly to a charity, you get a tax credit on the entire value of the shares. Plus, any capital gains you recognize on these investments are tax free.

Using the CN Railway stock example mentioned above, if you were to sell the shares first, and then donate the proceeds to charity, your profit, or capital gain on the sale would be $40,000.

You only pay tax on 50%, or $20,000 of your capital gain. Assuming you have already donated $200 in the year, and your marginal tax rate is 53.53%, you would owe $10,706 in capital-gains tax, leaving the charity with a total donation of $49,294, for which you would receive a tax credit of $26,387. Therefore, your net cost would be $33,613.

However, if you are in the same tax bracket and donate the shares directly, you will receive a tax credit for the entire value of the shares at the 53.53% tax rate, for a total of $32,118, and at the same time avoid paying taxes on the accumulated capital gains. So, by donating your shares directly, your net cost would be $27,882, for a savings of $5,731. And the charity would receive the entire value of the shares ($60,000).

Secret #6: Artificial capital gains carry big risks

Artificial capital gains schemes can backfire in a big way if the Canada Revenue Agency decides to disallow them.

When the agency disallows a fraudulent tax shelter, the victim has to repay the tax benefit with interest, and possibly pay a penalty as well. You also lose a substantial part of whatever you invested in the tax shelter, and no shelter promoter provides a money-back guarantee.

For example, consider some of the charitable-donation tax shelters that have backfired on their victims in the past few years.

Under these shelters, you basically bought some art, medicine or whatever from the shelter promoter or an affiliate; you then donated the purchase to a registered charity and got a tax receipt for a multiple of your cost. The tax benefit on the donation more than covered the cost of the donation, and left you with a substantial profit (even after the wide profit margins that promoters of these schemes enjoyed.)

If you secured unbiased legal advice on these deals, you probably got an opinion that led you to run in the other direction. But if you consulted a lawyer recommended by the tax shelter promoter, you got a much more favourable legal opinion — one that probably spurred you to buy.

The lawyer probably didn't receive any commissions on the sale (none that you can prove, at any rate). But the shelter promoter may have rewarded the lawyer for his favourable legal opinions in other ways. For example, he may have provided the lawyer with a steady stream of client referrals, or hired the lawyer to speak at investor conferences.

Unscrupulous promoters will continue to come up with dubious tax shelters that purport to beat taxes, including capital gains taxes. But the Canada Revenue Agency is now more vigilant than ever in ruling against these shelters. Instead of taking a chance with a dubious tax shelter, you're better off just paying the taxes.

Secret #7: Make sure you claim all of your deductions against capital gains

Commissions and brokers' fees aren't the only expenses you can deduct when you sell your capital property. You can deduct many other outlays and expenses that you incur to sell your property, including fixing-up expenses, finders' fees, surveyors' fees, legal fees, transfer taxes and advertising costs. To ensure that you're claiming all of the deductions you can, and doing so correctly, we advise that you consult a knowledgeable tax professional.

Case Study: Trying to avoid all capital-gains taxes can lead to bad investment decisions

The secrets listed above are all excellent ways to cut your tax bill. However, while tax considerations are an important factor in investment decisions, we continue to recommend that you avoid making any changes to your portfolio for tax purposes alone.

The story of a client of our Successful Investor Wealth Management service provides an example of how too much focus on taxes (including capital gains taxes) can hurt your profits.

Our client was unhappy to see that she had earned capital gains of around $80,000 in the previous tax year, and would need to come up with about $20,000 to pay her capital gains tax bill. Her first reaction was, “How did this happen? What can I do to stop it from happening again?”

This was her first experience with a concept that is ignored in some commission-earning circles: Sometimes it’s better to just pay the taxes.

Too much focus on capital gains tax can hurt profits

Back when she was dealing with a broker and sold anything at a profit, her broker would always suggest that she sell anything on which she had a loss. That way, she could “nail down a tax loss” and reduce or eliminate any capital gains tax she had to pay that year.

As a side benefit, she rarely suffered a big loss on any stock, since she sold most of her losers before they fell too far. However, she often noted that she also sold all too many of her best stocks at just the wrong moment, when they were going through a short-term downturn just prior to a big rise. She rarely had a big loss, but big gains were even rarer.

When a series of gains put her in a position to pay capital gains tax, she offset it by catching up with RRSP contributions or buying tax shelters. The tax shelters were highly effective at sheltering her income from tax. They were less effective at making any money for her. In fact, none of her tax shelters left her with anything better than a modest gain. She lost money on some of them, even after allowing for the tax benefits.

Most of her gain was from a holding in **Tim Hortons**, on which we more than doubled her money for her. **Burger King Worldwide** (now Restaurant Brands International, Toronto symbol QSR) bought Tim Hortons in December 2014. We had no control over the timing of that sale. We could have sold some of her losers to offset a modest part of her Tim Hortons gain, but we felt the timing was exceptionally poor in light of the drop in share prices.

In the end, of course, it's not as if she has missed out permanently on a tax advantage. That's because, as we mentioned in Secret #2, to offset capital gains you can carry capital losses back three years, or forward indefinitely.

The only drawback is that carrying the loss forward to reduce taxes in a future year amounts to an interest-free loan to the government. But with today's low interest rates, that's the least costly approach to dealing with capital-gains.

Who is Pat McKeough?

A professional investment analyst for more than three decades, Pat has developed a stock-selection technique that has proven reliable in both bull and bear markets. His philosophy puts an emphasis on safety, yet generates growing and often spectacular gains for his subscribers. He focuses on stocks that provide exceptional quality but whose hidden value is often overlooked. Many savvy investors consider it the most powerful stock-picking method ever created.

Pat is the editor and publisher of our four investment advisories:

1. ***The Successful Investor –*** Pat McKeough's flagship advisory is for conservative investors who want growing gains with reduced risk, mainly in Canadian stocks. Click here to learn more.

2. ***Power Growth Investor*****—**If you like the idea of "a conservative approach to aggressive investing", this advisory has Canadian and U.S. stocks with escalating growth potential. Click here to learn more.

3. ***Wall Street Stock Forecaster*** - An advisory that focuses on conservative portfolio investing in U.S. stocks, with an emphasis on finding hidden value on the U.S. market. Click here to learn more.

4. ***Canadian Wealth Advisor*** - An advisory reporting "safe money" strategies on well-established Canadian dividend stocks, Real Estate Investment Trusts (REITs) and Canadian and international exchange-traded funds (ETFs). Click here to learn more.

5. ***TSI Dividend Advisor –*** Our newest advisory helps assure your financial future with dividend stocks. Whatever success you have had with dividend stocks, you can now expect to have much more. We have developed powerful new proprietary ratings that will help you unlock the full power of dividend stocks. Click here to learn more.

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