Tax Efficient Investing — The Capital Gains Reserve

Wealth Management Taxation, The Bank of Nova Scotia

An issue that concerns many investors is the minimization of tax on capital gains. When it comes time to dispose of an investment, whether it be for the purpose of rebalancing a portfolio, or to free up cash for personal use, there are potential strategies available to mitigate the immediate tax burden when a capital gain is realized.

The capital gains reserve — how it works

It is possible to spread the payment of tax resulting from a taxable capital gain over a period as long as five years by claiming the "Capital Gains Reserve". The reserve can be claimed when you have sold and realized a gain on any capital asset, and you are not legally entitled to receive or enforce payment of the full proceeds from the sale in the year of sale.

Generally, on the sale of an asset, a person will prefer to take payment at the time of the sale. Practically, on a sale of securities, cash proceeds are almost always received at the time of the sale, since these transactions usually occur between arms-length parties with standard transaction terms. For this reason, it may not be common for an individual to be able to claim the capital gains reserve. The individual would certainly enjoy having an immediate cash in-flow, but, it would be more desirable to have both the immediate cash in-flow, and the tax-deferral associated with a capital gains reserve.

There is a way to claim the capital gains reserve without negatively impacting your family's cash flow: One spouse can sell their investments (that have appreciated in value), to the other spouse. The purchaser-spouse will pay fair market value by way of a promissory note (bearing interest at prescribed rate) for the full value of the assets being sold. The promissory note must dictate the payment to be made over multiple tax years - up to five years, to be exact. The seller-spouse will now spread the payment of tax over a period of up to five years.

The purchaser-spouse can then sell the assets on the open market immediately after acquiring those assets and receive cash. There will be no gain or loss to the spouse selling on the open market since his/her cost will equal the fair market value on the day he/she acquired the assets from the first spouse. In the end, the purchaser-spouse will have cash in the bank from the sale on the open market, and the seller-spouse will pay tax over 5 years.

Example

Bill wishes to sell securities which he purchased years ago for $50,000, and which are currently valued at $250,000. Without planning, Bill would realize a taxable capital gain of $100,000 on the sale, and would be required to pay tax on the gain in the year of the sale. At an assumed tax rate of 53%, Bill would incur tax of $53,000 on the sale. However, with planning, Bill can spread payment of his tax liability from the sale over 5 years, paying $10,600 in tax in each of the 5 years. (See illustration on next page.)

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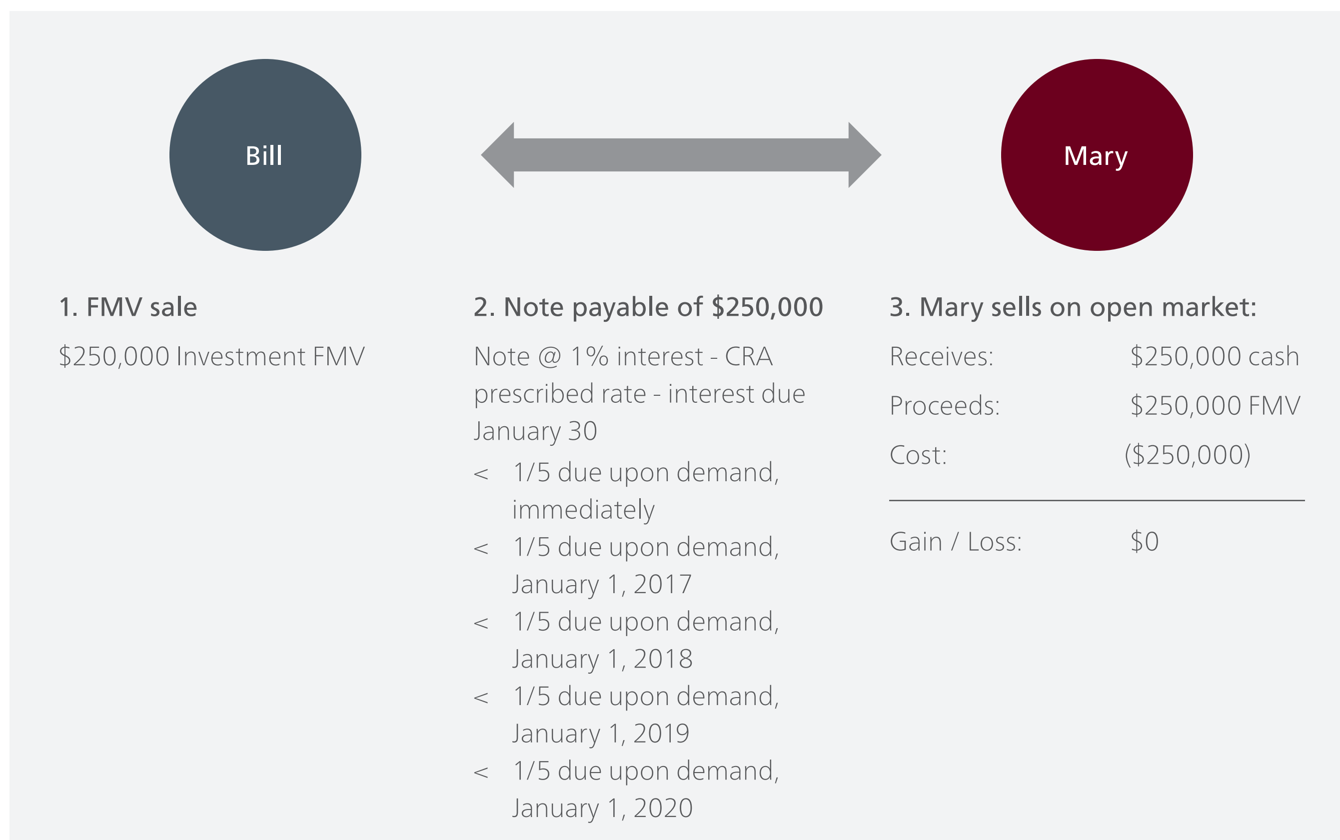

Summary

The capital gains reserve can be an effective way of mitigating the immediate tax burden on the sale of securities. In addition to a sale to a spouse, the strategy may also be completed through a sale to other family members, including children. Note that the capital gains reserve may not be available on a sale to a privately held corporation or a partnership, and cannot be claimed by a non-resident of Canada.

Speak with your tax advisor to determine if this strategy may be effective for you.

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