Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Managing the tax impact of diversifying

Please contact us for more information about the topics discussed in this article.

Experienced investors know the "golden rule" of diversification: a portfolio should not be too heavily weighted in one region, sector or asset class. You may find yourself holding a concentrated position of a certain security but concerned about the tax implications of selling if you have a large unrealized capital gain. This article focuses primarily on the tax implications of selling a concentrated position in your investment portfolio and potential strategies that may help mitigate and manage the tax implications in order to preserve your wealth.

Tax implications of diversifying

If you diversify by selling some or all of the concentrated position you hold, the tax implications will depend on where you hold the securities. If you hold them in a registered account like a tax-free savings account (TFSA) or a registered retirement savings plan (RRSP), then selling those securities will have no immediate tax impact to you.

If instead you hold the position in a non-registered account, the sale of the securities will likely trigger a capital gain, which may be quite significant. A capital gain is calculated as the sale proceeds less the adjusted cost base (ACB) of your security less any brokerage fees and other outlays you incurred to sell the property. Determining your ACB is a key component in accurately reporting your capital gain, so the next section discusses some of the considerations involved in determining your ACB.

Once you have determined your capital gain on the sale, half of the capital gain is your taxable capital gain. You will generally have to include the taxable capital gain as income in the year you sell the position.

Determining your ACB

The Canada Revenue Agency (CRA) describes the ACB as "the cost of a property plus any expenses to acquire it, such as commissions and legal fees." After using this as the initial starting point to determine the ACB of your security, you would then factor in any purchases and sales and corporate events like stock splits and reorganizations that may affect the ACB.

Although an investment firm may provide cost numbers to you, the firm's numbers may not reflect special elections or transactions that you have undertaken or the firm may not have used the weighted-average method (discussed in the next section) to calculate the cost of the same security held in multiple non-registered accounts.

In addition, there are some unique historical tax events that can impact the calculation of the ACB of a security, especially one that has been held for a long period of time. These events relate to certain dates where the taxation of capital gains and losses changed. For a more detailed discussion on these historical tax events and other situations that may impact your ACB, please ask your RBC advisor for our article on calculating your ACB.

Identical properties

If you own identical properties in your non-registered account, such as shares of the same class of the capital stock of a corporation or units of a particular mutual fund trust, you have to calculate the average cost of all identical properties to determine its ACB. To calculate the average cost, you divide the total cost of a particular identical property by the total number of shares or units you hold at that time. Therefore, when selling a particular security that you have acquired at different prices over a period of time, you must consider the cost of all identical properties, even if you hold them in different non-registered accounts.

Stock option shares

If you have exercised stock options and now own the shares, there are several unique rules that apply when determining the ACB of your stock option shares. For example, as a starting point, when you exercise the stock options, the ACB of your newly acquired shares will generally be the fair market value of the shares at the time you exercised them. In addition, the averaging rule previously mentioned for identical properties also generally applies, however there are certain exceptions. For more details on how to calculate the ACB of your stock option shares, please ask your RBC advisor for our article on the taxation of employee stock options.

Strategies for reducing the tax impact

Here are a few tax planning and wealth transfer strategies that may help mitigate and manage the tax implications of diversifying in order to preserve your wealth.

Spread out the capital gain

Diversifying doesn't have to take place all in one year; it can be executed over time. Spreading out a capital gain over a number of taxation years may be an easy way to reduce and defer the tax impact of diversifying.

In Canada, we pay taxes based on a progressive tax system where, as our taxable income increases, our marginal tax rate increases as well. As such, by spreading out a realized capital gain over a number of taxation years, you may be able to avoid paying tax at the highest marginal rate.

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Tax loss selling and utilizing tax loss carryforwards

If your portfolio contains investments that have decreased in value and are no longer aligned with your investment strategy, consider selling these investments in order to realize the capital loss. The capital loss realized can be used to reduce the capital gains realized from diversifying securities in a gain position.

Capital losses realized in the current year must first be claimed against capital gains realized in the current year. Any unused net capital losses (i.e., capital losses that were not able to be offset by current year capital gains) can then be carried back to be claimed against taxable capital gains realized in the three previous years or carried forward indefinitely to be claimed against taxable capital gains realized in a future year. Along these lines, if you happen to have an unused net capital loss balance carried forward from a previous year (the balance can be found on your Notice of Assessment or Reassessment), this balance may also be used to reduce the tax impact of diversifying.

If you intend to repurchase the investment you sold at a loss, it's important to ensure you don't trigger the "superficial loss rules". These rules prevent you from claiming the capital loss, defeating what you were trying to achieve. A superficial loss may occur when you sell property (say, shares or mutual funds) and then you or someone affiliated with you (including your spouse or common-law partner) acquires that identical property within 30 days and continues to hold it on the 30th day. For more information about the superficial loss rules, please ask your RBC advisor for the article on this topic.

Make an RRSP contribution

If you or your spouse are 71 or younger, another simple way to reduce your taxes for any given year is to make a contribution to your RRSP, including a spousal RRSP. Provided you have unused RRSP contribution room, contributions to an RRSP are deductible against all sources of taxable income, including taxable capital gains.

In terms of planning, if you anticipate triggering a large capital gain in a future year, it may be advantageous to contribute to your RRSP now, but defer the tax deduction

to the year you realize the significant capital gains. Not many people know that you are not required to claim an RRSP deduction in the year you make the contribution, but can instead carry it forward to use in a future year. While this strategy delays the benefit of the tax deduction, choosing to deduct it in a year where you have a higher marginal tax rate may allow you to maximize your tax savings while your contribution still benefits from tax-deferred growth within the RRSP.

Make an in-kind donation of securities

To encourage charitable giving, a tax credit is available when you make a donation to a registered charity. This donation tax credit can be used to reduce your taxes payable and the tax impact of diversifying. A further tax benefit may be provided if you donate publicly listed securities in-kind as the capital gains triggered when these securities are donated may be eliminated.

You may want to consider making an in-kind donation of a portion of the concentrated position you wish to diversify. The donation tax credit on the portion of the securities that you donate may eliminate the tax liability on the capital gain triggered on the disposition of the remaining portion (i.e., the portion not donated).

Although there is no limit to the amount you can donate in a year, for tax purposes, you can generally only claim a charitable donation of up to 75% of your net income in a taxation year. This limit is 100% of your net income for residents of Quebec. If you are unable to claim the full donation in one year due to this limitation, you may carry forward your unclaimed donations for up to five years.

If you have thought about leaving a charitable legacy, consider establishing a private foundation or speak to your RBC advisor regarding the option to set up your own charitable fund through the RBC Charitable Gift Program. This may allow you to combine the immediate tax benefits with the flexibility to support your favourite charities over time.

Transfer capital losses between spouses

If your spouse has unrealized capital losses that they are unable to use personally, consider a strategy that may allow your spouse to “transfer” their unrealized capital losses to you. Even if your spouse can use the losses, this strategy may be effective if you are in a higher marginal tax bracket than your spouse for the year.

Your spouse may be able to transfer a portion of their unrealized capital losses to you by selling the securities in a loss position to you at fair market value. Your spouse would need to report the sale to you on their tax return. You would need to use your own funds to purchase these

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securities and would have to hold these securities for at least 30 days. You could then sell the securities in the market to realize the loss. It is important you consult with your tax advisor prior to implementing this strategy to determine if you can benefit from it.

For further details on this strategy, please ask your RBC advisor for the separate article on this topic.

Consider tax-advantaged investment choices

The government provides tax incentives to encourage investment in certain areas of the economy. For example, flow-through investments may provide you with tax deductions or tax credits that may offset the tax impact of capital gains from diversifying.

While evaluating investments based on the tax merits is important, you should also consider other factors such as the investment risk, diversification, opportunity for capital appreciation, liquidity and so on. It’s important to recognize that flow-through investments are considered higher-risk investments and typically must be held for a set period of time. Also, certain investments, such as limited partnerships, require more complex tax reporting. You should factor in any restrictions and increased filing complexities when evaluating whether an investment is right for you.

For more information on flow-through investments, please ask your RBC advisor for our article on this topic.

Plan ahead

Diversification is an important component to investing. It can help you reach your long-term financial goals while minimizing risk. In order to diversify, you may need to sell a concentrated position of appreciated securities which will likely result in significant tax implications. There may be opportunities to minimize tax and preserve your net worth. Speak with a qualified tax advisor to see if any of the tax planning opportunities discussed in this article are suitable for you in your circumstances.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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