Understanding Capital Losses

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Each year, fluctuations in the stock markets leave investors with plenty to think about. Does my portfolio need repositioning? If so, which stocks do I keep and which do I sell? When investments are held in non-registered accounts, these decisions can have immediate tax implications. For example, if you've decided to sell a security that has an accrued gain, you've increased your taxable income. When you sell a security that has an accrued loss, the capital loss will reduce your capital gains for the particular tax year. And, when losses exceed gains in a given year, there is no further reduction to your current taxable income; however, a net capital loss may be used to reduce your capital gains in other tax years.

This article discusses capital losses, superficial losses and summarizes the Canada Revenue Agency's ("CRA") administrative policies regarding identical properties. For specific income tax advice regarding your personal situation, consult with your tax professional prior to the implementation of any tax-loss selling strategy.

To sell or to hold?

If your portfolio has an investment that has declined in value to the point that its market price is below your original cost, you have what is called an accrued loss. An accrued loss is a paper loss and for tax purposes, until the loss is realized when the investment is disposed (i.e., sold), it doesn't yet exist.

A capital loss is not considered a tax deduction; the benefit of a capital loss occurs only when there are capital gains. The loss is first applied against capital gains realized in the same tax year. Any excess capital losses are accumulated and can be carried back to any of the three prior years, or carried forward to any future year where there are capital gains. As a rule of thumb, always look first to past years to determine if there were any capital gains in those years. A capital loss that is carried back reduces income taxes payable in that year and can result in a refund of taxes already paid.

Since October 18, 2000, the inclusion rate of capital gains and losses has been 50%. Accordingly, at the top marginal rate the tax paid on capital gains (and the tax recoverable on the application of capital losses) will be approximately 25%, depending on the province of residence.

Tax-loss selling

With assistance from your BMO financial professional, you should periodically review your portfolio to consider possible investment reallocations. If it makes sense to sell an underperforming security from an investment perspective, it may be beneficial to review your tax situation to consider the possibility of engaging in a "tax-loss selling" strategy before the end of the year to reduce your overall tax liability or receive a refund of previously paid taxes.

Briefly stated, under this strategy investments that have declined in value are sold to generate a capital loss for tax purposes, to offset capital gains already generated in the year. Alternatively, an aggregate net capital loss in the year can be carried back to be applied against net capital gains realized in the three preceding years. The amount of capital gains subject to tax each year is based on the calculation of net capital gains, which is the sum of all capital gains less all capital losses realized in the year. Therefore, to the extent an investor realizes capital losses in the same taxation year that a significant capital gain is triggered, the tax liability on the capital gain can be reduced. Accordingly, it may be worthwhile to review your portfolio with your BMO financial professional to consider the sale of certain investments with unrealized losses, provided a sale makes sense from an investment perspective.

Before employing this tax strategy, consider the following:

- Since capital losses can be applied in the current year, with the ability to carry any unapplied net capital losses back for up to three years, you should review your capital gains and losses realized year-to-date, as well as your tax returns for the three immediately preceding tax years, to determine if you reported net capital gains in any of these years. If so, check with your tax advisor to understand the possible tax benefit of applying current year net capital losses to offset these gains.
- Remember that capital gains or losses on foreign securities denominated in another currency are generally calculated in Canadian dollars, so that fluctuations in the foreign currency relative to the Canadian dollar over the period of ownership will also factor into the analysis.
- Speak to your accountant or other tax advisor to ensure that you are aware of the actual tax cost base of your investments, since the tax cost will often be different from the original purchase price due to corporate re-organizations, tax elections, distributions such as return of capital, or the requirement to calculate a weighted average cost for tax purposes with other identical securities held in all non-registered accounts.
- If you are selling an investment near the end of the calender year and your intent is to have the loss be included in that tax year, you must sell the property early enough for the trade to settle by December 31.
- Finally, be aware of the superficial loss rules and "stop-loss" rules which may deny a capital loss realized on the disposition of an investment property. These rules are discussed below.

Superficial losses

- When realizing capital losses, it is important to be aware of the superficial loss rule which may deny a capital loss realized on a sale of property, including investments. This rule generally applies on the disposition of a property by an individual if:
  i) during the period that begins 30 days before the disposition and ends 30 days after the disposition, you or another affiliated person (see definition to the right) acquired the same or identical property; and
  ii) at the end of the period you or another affiliated person owned or had a right to acquire the same or identical property (the CRA refers to this as a substituted property).

If the superficial loss rule is triggered, the capital loss realized personally on a disposition is denied and the capital loss is added to the cost of the substituted property.

For example, if you purchased a security for $7,000 and later sell it for proceeds of $5,000, there is a $2,000 capital loss that can be used to offset capital gains. However, if you purchase an identical/substituted investment property within 30 calendar days of the sale, let's say for $5,200, the superficial loss rule is triggered if you continue to own the security at the end of this 30-day period. This means that the $2,000 capital loss is denied, but it is added to the cost base of the substituted property, so the "new" adjusted cost base of the substituted property becomes $7,200 (the $5,200 cost plus the $2,000 denied loss).

Affiliated persons

An affiliated person includes yourself, your spouse or common-law partner, a corporation controlled by you or any of these individuals, or a partnership of which you are a majority-interest partner. A person will also be affiliated with a trust if the person is, or is affiliated with, a majority-interest beneficiary of the trust. This would mean that a person would be considered affiliated with their Registered Retirement Savings Plan ("RRSP"), Registered Retirement Income Fund ("RRIF") and Tax-Free Savings Account ("TFSA"), and their spouse's/common-law partner's RRSP, RRIF and TFSA.

Identical properties

The superficial loss rule is triggered when an individual has acquired or has the right to acquire an identical property within the time frame described previously. In some cases it is evident that the two securities are identical (e.g., XYZ Class A common are sold at a loss and XYZ Class A common are repurchased). The CRA has defined "identical properties" in its (archived) Interpretation Bulletin, IT-387R2, to include properties which are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to another.

However, it isn't always clear. As a result, it is necessary to examine all of the inherent qualities or elements that give each property its identity. The CRA has previously provided some examples in various technical interpretations and in its Interpretation Bulletin. In cases where uncertainty still exists, consultation with your tax advisor is recommended. The following provides guidance on what constitutes an identical property, based on the CRA's Interpretation Bulletin:

Gold: Gold bullion and gold certificates are considered identical properties.

Mutual Funds: A S&P/TSX Composite Index-based mutual fund would generally not be considered identical to a S&P/TSX 60 Index-based mutual fund. However, a S&P/TSX Composite Index-based mutual fund of one financial institution would be considered identical to the S&P/TSX Composite Index-based mutual fund of another financial institution.

Bonds, debentures, notes: A bond, debenture, bill, note or other similar obligation issued by a debtor is deemed to be identical to another such obligation issued by the same debtor, if both obligations are identical in respect of all rights attached to the debt without reference to the principal amount of the debt. Strip bonds are identical to other strip bonds of the same issue, but they are not considered to be identical to bonds of the same issue from which the interest coupons have not been detached.

Escrowed shares: In general, escrowed shares that prevent the owner from selling them, and shares of the same class and kind of the capital stock of the same corporation which are not restricted (free shares), are considered to be identical properties even though the value of the escrowed shares may be less than the value of the free shares.

Capital stock: Shares of two different classes of the capital stock of a corporation are not identical if they do not have the same interests, rights and privileges. For example, Class A common shares of a corporation and Class B common shares of the same corporation which are the same in all respects, except that the Class A shares are voting and the Class B shares are non-voting, are not considered to be identical since they provide for different rights. However, conversion features of shares may impact the analysis, as discussed in the next section.

Convertible or exchangeable shares

Occasionally, the holders of one class of shares are entitled to exchange them for a different class of shares. Continuing with the previous example, let's assume the holders of the Class B shares are entitled to exchange them for Class A shares. If the investor exchanges Class B shares for Class A shares, the Class A shares acquired on the conversion are identical to any Class A shares already held or subsequently acquired by the taxpayer. In addition, for the purpose of these rules, the right or privilege of conversion or exchange is deemed to be a property that is identical to the property it can be exchanged for. This is an important concept that the CRA has specifically addressed in its Interpretation Bulletin. In our example, if an individual disposes of Class A shares and realizes a loss on the sale, and within 30 days subsequently acquires (and retains) Class B shares, the loss on the sale of the Class A shares would be a superficial loss by virtue of the conversion feature allowing the Class B shares to be exchanged for the Class A shares.

Partial dispositions

In situations where fewer securities are acquired during the relevant period than were disposed of during the period, or when fewer securities are left at the end of the period than were acquired during the period, the CRA has previously outlined its administrative position on how to calculate the superficial loss. The CRA has provided the following formula to determine the amount of the superficial loss:

Superficial loss = (Least of: S, P and B)/S x L; where:

S	is the number of items disposed of at that time
P	is the number of items acquired in the 61-day period (i.e., sale day and 30 days before and after the sale)
B	is the number of identical items left at the end of period (30 days after the sale)
L	is the capital loss on the disposition as otherwise determined

For example, where a taxpayer sells all 100 Class A common shares of XYZ Inc. at a loss and acquires 5 identical shares within 30 days subsequent to the disposition, and still owns the shares at the end of the 30-day period, the superficial loss provisions will apply to reduce the loss in respect of 5 out of the 100 shares disposed of to nil. The superficial loss is added to the adjusted cost base of the 5 shares subsequently acquired. Using the CRA's formula, where:

S = 100 P = 5 B = 5

Superficial loss = 5/100 x Capital loss

Working with the superficial loss rules

1. A capital loss is not denied when an identical security is purchased by a child, grandchild or parent of the seller within the relevant time frame, since these individuals are not considered "affiliated persons."

2. An unrealized capital loss can be transferred to a spouse/common-law partner to potentially allow them to offset their capital gains. This strategy is complex and, therefore, consultation with a tax advisor is required. However, briefly stated, the strategy involves electing on a sale between spouses/common-law partners to treat the sale/transfer of the loss securities at fair market value (the Income Tax Act otherwise treats transactions between spouses/common-law partners as having been done at cost), and avoidance of potential attribution rules. The superficial loss rules are triggered since the acquiring spouse/common-law partner has purchased the security within 30 days of the transfer. This loss is denied, but is added to the purchaser's cost base so when the acquiring spouse/common-law partner (who has realized capital gains on other securities) sells the security after 30 days of acquisition, the loss is realized and can be used to offset these capital gains.
3. As a result of earlier changes to the legislation described above dealing with affiliated persons, a capital loss realized in a non-registered account will be denied if an identical security was purchased by the individual's (or the individual's spouse/common-law partner) RRSP within the 30-day period. A capital loss is also denied if a security is transferred "in-kind" directly to the RRSP. These rules also apply to RRIFs and TFSAs to deny capital losses on direct (or indirect) transfers.

"Stop-loss" rules

Corporate investors (such as an "investment holding company") should be aware that comparable anti-avoidance rules will apply to corporations in circumstances similar to the "superficial loss" rules described above for individuals. However, these "stop-loss" rules will instead deny and "suspend" the capital loss in the corporation where it can ultimately be realized by the corporation once the property is no longer held within the affiliated group.

Corporate investors should also be aware of another "stop-loss" provision that will deny a capital loss in a situation where a dividend was received on a share prior to the sale of the share at a loss. Since taxable dividends from Canadian corporations are generally deductible from the recipient corporation's taxable income, a specific provision in the tax legislation seeks to deny a capital loss on the sale of a share of the dividend-paying security by a corporate investor, on the presumption that the payment of a (deductible) dividend contributed to the capital loss. However, this rule will not apply if the dividends were received on shares owned by the corporate investor throughout the 365-day period immediately preceding the loss sale, provided the investor (and other non-arm's length persons) did not own greater than 5% of the issued shares of any class in the dividend-paying corporation.

Similar rules can apply to corporate (and individual) investors on loss sales where non-taxable capital dividends were received on shares prior to the sale of these shares which resulted in the capital loss.

Securities no longer publicly traded

If your portfolio contains securities for which there is no market, you may be able to take advantage of the tax loss (without an actual sale) if you make an election in writing and include it with your income tax return for the year.

The tax rules that permit a capital loss on a worthless security are very specific and only allow a loss when the corporation has, during the year, become:

- Bankrupt; or
- Insolvent and is in the process of winding-up in accordance with the Winding-up and Restructuring Act.

Or, if at the end of the year, the corporation is:

- Insolvent;
- Neither the corporation nor a corporation controlled by it carries on business;
- The fair market value of the shares is nil; and
- It is reasonable to expect that the corporation will be dissolved or wound up and will not commence to carry on business.

The election deems the individual to have disposed of (i.e., sold) the security for nil proceeds and can therefore claim a capital loss equal to the adjusted cost base of the security. In this situation, the superficial loss rules do not apply even though the individual continues to hold the identical security immediately after the deemed disposition

The "new" adjusted cost base for that security is deemed to be nil. However, if the individual (or a non-arm's length party) continues to own the security, and if the corporation resumes operation within 24 months of the deemed disposition (and capital loss), a capital gain equal to the amount of the capital loss originally claimed will result.

Seek advice

As you review your investment portfolio with an eye to making adjustments, it is important to remember that while taxation is a factor you will consider, it should not be the primary motivation for an investment decision. Your investment goals, risk tolerance and the fundamentals of the particular investment should guide your decision. Please speak with your personal tax advisor before implementing any tax-loss selling strategy.

For more information, speak with your BMO financial professional.

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