

Consider Tax-Loss Selling in Your Year-End Planning

Before the end of the year, it is a good idea to review your investment portfolio and consider engaging in a tax-loss selling strategy. In doing so, you can potentially reduce your overall tax liability (especially in 2024, due to the recent increase in the capital gains inclusion rate)¹, or receive a refund on your previous year's taxes paid.

With a tax-loss selling strategy, investments that have declined in value are sold to generate a capital loss for tax purposes, which can be used to offset capital gains that are generated during the year. Alternatively, an aggregate net capital loss in the current year can be carried back and applied against net capital gains realized in the three preceding years, or carried forward for use in a future year.

Historically, the amount of capital gains that are 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. The tax liability on capital gains can be reduced or eliminated if capital losses occur in the same taxation year that significant capital gains are triggered. However, because of the recent changes to the taxation of capital gains, the determination of net capital gains – and the implementation of a tax-loss selling strategy – in considerably more nuanced in 2024.

Therefore, as the end of the year approaches 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 strategy perspective, and you have considered the nuances in calculating your 2024 net capital gains/losses.

Capital gains planning considerations for 2024

Effective for capital gains realized on or after June 25, 2024, the capital gains inclusion rate increased from one-half to two-thirds for corporations and trusts, and from one-half to two-thirds on the portion of capital gains realized annually in excess of \$250,000 by individuals. In other words, individuals will be allowed an annual \$250,000 threshold below which the capital gains inclusion rate will remain at the previous rate (50%).

As previously noted, net capital losses may be carried back three years, and forward indefinitely, to offset capital gains of other years. Net capital losses of other years are deductible against current-year taxable capital gains by adjusting their value to reflect the inclusion rate of the

capital gains being offset. This means that a capital loss realized when a different inclusion rate applied can still fully offset an equivalent capital gain realized in a year during which another inclusion rate applied.

For taxation years that begin before, and end on or after June 25, 2024, two different inclusion rates would apply. As a result, taxpayers will be required to separately identify capital gains and losses realized before June 25, 2024 (Period 1), and those realized on or after June 25, 2024 (Period 2). Gains and losses from the same period would first be netted against each other. Taxpayers would be subject to the higher inclusion rate in respect of their net gains arising in Period 2 (excluding the portion that does not exceed the \$250,000 threshold in the case of individuals), to the extent that these net gains are not offset by a net loss incurred in Period 1. (Similarly, a net capital loss for Period 2 will offset net capital gains realized in Period 1.)

The annual \$250,000 threshold for individuals would be fully available in 2024 (i.e., it would not be prorated)² and would apply only in respect of net capital gains realized in Period 2, less any net capital loss from Period 1.

Please see the following example which illustrates this methodology:

Robert realizes a capital gain of \$600,000 on June 1, 2024, a capital loss of \$75,000 on July 25, 2024, and a capital gain of \$475,000 on October 1, 2024.

Robert has a capital gain of \$600,000 in Period 1 on which the one-half inclusion rate would apply, resulting in a taxable capital gain of \$300,000.

Robert has a net capital gain of \$400,000 in Period 2. A one-half inclusion rate would effectively apply to the first \$250,000, and a two-thirds inclusion rate would apply to the remaining \$150,000, resulting in a taxable capital gain of \$225,000 in Period 2.

The total taxable capital gain for the 2024 tax year would be \$525,000.

Robert could consider a tax-loss selling strategy to offset the net capital gains realized in Period 2 – particularly the \$150,000 capital gains which will be subject to the higher 2/3 inclusion rate. However, to the extent that Robert engages in a tax-loss selling strategy in late 2024 to realize (gross) capital losses exceeding \$150,000, these additional capital losses will offset capital gains subject to only a 50% inclusion rate because of the \$250,000 threshold for individuals (which is not prorated for 2024). Depending on the likelihood of realizing future capital gains in 2025 (or thereafter), that exceed his annual \$250,000 threshold and would be subject to the higher 2/3 inclusion rate, it may be more tax-efficient for Robert to realize these accrued losses in a future year (notwithstanding the delayed tax savings, albeit at a higher rate). Similarly, to the extent Robert seeks to realize net capital losses in Period 2 exceeding \$400,000, the net loss thereby created in Period 2 will offset the net capital gains in Period 1, which may defeat any planning which was undertaken pre-June 25, 2024, to optimize the use of the 50% inclusion rate.

The impact of the increase in the capital gains inclusion rate (above \$250,000) can be significant, resulting in a higher tax rate of 8 – 9% for individuals at the top marginal tax rate (and similar rate increases for corporations and trusts). Accordingly, many individuals took steps to implement a sale (or disposition, such as a gift/transfer) of investments or real estate properties with significant accrued gains before June 25, 2024, to capture the previous 50% inclusion rate (since the extent of net capital gains realized from January 1 to June 24, 2024 (Period 1), will not impact the \$250,000 threshold in the June 25 to December 31, 2024 timeframe (Period 2)). Accordingly, in undertaking a tax-loss selling strategy for 2024, it will be important to consider this planning – and the nuances of the separate calculations required for the pre/post June 25, 2024 periods described above.

Therefore, when engaging in a tax-loss selling strategy for 2024, it will be first necessary to consider the extent of the net capital gains realized thus far in the post-June 24, 2024 timeframe (Period 2), since the amount of net capital gains realized in Period 1 does not impact the \$250,000 threshold for Period 2. To the extent that a net capital gain in Period 2 exists, consider whether a net capital loss realized in Period 1 (or net capital losses available from a prior taxation year) will reduce the capital gains subject to the higher inclusion rate in Period 2 (if any).

To the extent that a net capital gain in Period 2 remains after reviewing the full (combined) 2024 taxation year to-date, a further consideration is the capital gains inclusion rate that would apply, since only the portion of net capital gains arising in Period 2 that exceeds the \$250,000 threshold, will be subject to the higher (2/3) capital gains inclusion rate.

Although most investors will be below the annual \$250,000 threshold and continue to be subject to the 50% capital gains inclusion rate, determining the relevant inclusion rate for the aggregate 2024 net capital gains will be helpful in calculating any tax savings to be achieved by engaging in a year-end tax-loss selling strategy. Specifically, high-income individuals who may be subject to the higher 2/3 capital gains inclusion rate in future years (for net capital gains > \$250,000 annually), but not in 2024, may benefit from deferring the realization of accrued capital losses on investments until these higher rate capital gains are realized, to optimize the tax savings from these losses (subject to time value of money considerations). Similarly, engaging in a tax-loss selling strategy without initially segregating the net capital gain/loss calculations into two separate periods (i.e., by viewing the 2024 taxation year in aggregate) could inadvertently cause net capital losses from tax-loss selling in Period 2 to offset net capital gains realized in Period 1 (at the 50% rate), thereby negating the benefit of any pre-June 25, 2024 capital gains planning undertaken.

Moreover, it will be worthwhile to strategically consider the application of capital loss carryforwards from prior years or capital loss carrybacks from future years, in light of the amount of tax paid on net capital gains reported in the 2024 or prior taxation year(s), since a loss applied to a capital gain with a 2/3 inclusion rate will be more beneficial. Furthermore, since the ordering rules in the tax legislation will effectively apply net capital losses carried forward first to offset capital gains subject to the higher 2/3 inclusion rate, the strategic application of unused capital losses can lead to tax efficiencies.

Finally, some higher income individuals that will continually be subject to the higher capital gains inclusion rate each year (by annually exceeding the \$250,000 threshold) may seek to pro-actively realize net capital gains to this threshold annually, to reduce future capital gains tax at the higher 2/3 inclusion rate on dispositions that would otherwise occur in the near term (or at death)³.

Other considerations before implementing a tax-loss selling strategy

1. Losses can be applied to current or previous year's gains

Capital losses are first applied to offset capital gains in the current year⁴, however, any unapplied (aggregate) net capital losses can be carried back for up to three years. It is therefore important to review your 2024 capital gains and losses realized to-date, taking into account the nuances noted above for 2024, and your tax returns from 2021, 2022 and 2023 to determine if you reported net capital gains during any of these years. If so, check with your tax advisor to understand the possible tax benefit of applying any net capital losses from 2024 to offset previous gains, versus carrying forward these losses to offset gains of a future year (that may be subject to a higher capital gains inclusion rate).

2. Foreign currencies

Remember, capital gains or losses on foreign securities denominated in another currency are calculated in Canadian dollars, even if the sales proceeds remain in the foreign currency. The foreign currency exchange rate at the time of purchase is used in the calculation of the tax cost base, and the foreign currency exchange rate at the time of sale is used to calculate the proceeds on the sale. Therefore, fluctuations in the foreign currency relative to the Canadian dollar over the period of ownership will also factor into the analysis.

Be aware that a capital gain or loss (in excess of \$200) may be realized for tax purposes on U.S./foreign cash balances, to the extent that the funds were sold or disposed (e.g., converted into Canadian dollars, used to purchase another stock/security, or used to pay expenses or make a purchase).

3. Confirm the tax cost base of the security

Speak to your accountant or tax advisor to confirm the actual tax cost base of your investments. The tax cost base will often be different from the original purchase price as a result of corporate re-organizations, tax elections, distributions (such as return of capital), or the requirement to calculate a weighted-average cost for tax purposes of a security that is held across more than one non-registered account.

4. Be aware of the superficial loss rule

The superficial loss rule within the Canadian tax legislation may deny a capital loss that is realized on a sale or disposition of an investment. The rule generally applies if:

- i. During the period that begins 30 days before the sale and ends 30 days after the sale, you – or any person or entity considered to be affiliated with you for tax purposes – acquired the same or identical security; and

- ii. At the end of the period, you – or an affiliated person or entity – owned or had the right to acquire the same or identical security.

5. Pay attention to the settlement date

Since it is the settlement date of the trade which is relevant for tax purposes (i.e., it generally takes one business day from the trade date for an equity trade to settle), ensure that there is sufficient time remaining after the trade date to allow the transaction to settle in 2024. The last day to make an equity trade that settles in 2024 is expected to be December 30, 2024.

Corporate tax-loss selling

Although the focus of this publication is individuals, tax-loss selling strategies are often undertaken by corporations with investment portfolios. However, there are other nuances, not addressed herein, due to the refundable tax system on investment income earned by private Canadian corporations, including impacts to the capital dividend account (CDA) and the small business deduction. Notably, there is no annual \$250,000 threshold to manage corporate capital gains, such that all net capital gains realized after June 24, 2024 will be subject to the higher capital gain inclusion rate, which could increase the importance of a corporate tax-loss selling strategy.

Corporate investors should be aware of rules similar to the superficial loss rule for individuals described previously that will deny and suspend the capital loss in the corporation. In addition, another “stop-loss” provision can deny a capital loss where a deductible (Canadian) dividend was received by the corporation on a share prior to the sale of the share at a loss, unless the corporate investor held the share for the preceding 365 days and did not own more than 5% of any share class in the dividend-paying company.

Seek professional advice

Important changes to the Canadian tax legislation in 2024 have dramatically affected the taxation of capital gains, thereby impacting the strategy of tax-loss selling. Accordingly, be sure to consult with your tax advisor prior to implementing a tax-loss selling strategy to ensure that it captures the nuances of the 2024 transitional rules, is appropriate for your situation and is executed properly.

Please contact your BMO financial professional if you have any questions about tax-loss selling in your BMO investment account.



¹ As of the time of writing, the 2024 changes to the capital gains inclusion rate remain draft legislation, so it is possible that these amendments may not ultimately be enacted into law as described (or at all). Accordingly, please consult with your tax advisor for the current status of these legislative changes and for specific direction in your particular situation.

² Note that the annual \$250,000 threshold can be combined to reduce the taxation of stock option benefits, at the taxpayer's discretion. Accordingly, a further consideration exists for individuals exercising stock options in 2024.

³ High income individuals realizing significant capital gain income should also be aware of recent changes to the Alternative Minimum Tax (AMT) regime. The AMT is a parallel tax calculation for individuals (and many trusts) that calculates an alternate taxable income that allows fewer deductions, exemptions, and tax credits than under the ordinary income tax rules, and applies a flat tax rate on this adjusted taxable income (exceeding a standard exemption amount) instead of the usual progressive rate structure. A taxpayer ultimately pays the AMT or regular tax, whichever is highest. Notably, although only 50% (or 66.67%) of a capital gain realized is included in income for regular tax purposes, for AMT purposes, 100% of the capital gain will be included effective in 2024, and thereafter. Since the new AMT flat rate for 2024 of 20.5% exceeds the top Federal regular tax rate on capital gains subject to the 50% inclusion rate (i.e., 16.5% = 33% x 50%), individuals with large capital gains who claim offsetting deductions, exemptions or credits to substantially reduce their regular tax liability could be subject to the AMT in 2024. However, AMT is less of a concern for capital gains subject to the higher 2/3 rate (after June 24, 2024), since the top Federal regular tax rate on capital gains will increase to 22% (i.e., 33% x 2/3), which will exceed the new flat AMT rate of 20.5%. Notwithstanding these recent changes, the AMT may be relevant for some higher-income individuals (and family trusts), particularly those who crystallized large, accrued capital gains prior to June 25, 2024.

⁴ Individuals intending to claim their lifetime capital gains exemption in the year should be aware that a "tax-loss selling strategy" can impact this claim. Please consult with your tax advisor for assistance.

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