UNDERSTANDING CAPITAL LOSSES

Each year fluctuations in the stock markets leave investors with plenty to think about. Which stocks to keep in their portfolio and which to dispose of?

Although that's never an easy question to answer, 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. When losses exceed gains in a given year, there is no further reduction to your current taxable income. However, a capital loss can be used to reduce your capital gains in any three prior tax years, or can be carried forward indefinitely to reduce future gains.

This article will discuss capital losses, superficial losses and summarize amendments to Canada Revenue Agency's (CRA) Interpretation Bulletin IT-387R2 that deals with identical properties. For specific income tax advice regarding your personal situation, consult with your tax professional prior to implementation of a 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, and the investment is disposed of (i.e. sold), it doesn't yet exist.

As mentioned above, 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 will 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 23% depending on the province of residence.

Tax Loss Selling

The strategy involving selling an investment to create a capital loss is commonly referred to as "tax loss selling". Tax loss selling can be an effective way to reduce your total income tax liability.

If you are selling a property near the end of the calendar 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 31st.

Superficial Loss

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. 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 below) 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 (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, you have 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 property within 30 calendar days of the sale, let's say for $5,200, the superficial loss rule is triggered. 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 RRSP and RRIF and their spouse's RRSP and RRIF.

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). CRA has defined "identical properties" in its 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 and so it is necessary to examine all of the inherent qualities or elements that give each property its identity. Some examples that CRA has provided[1] are:

- gold bullion and gold certificates are considered identical properties,
- a TSE 300 Index-based mutual fund (currently the S&P/TSX Composite Index) *would generally not* be considered to be identical to a TSX 60 Index-based mutual fund (currently the S&P/TSX 60 Index),
- a TSE 300 Index-based mutual fund (currently the S&P/TSX Composite Index) of one financial institution *would* be considered identical to a TSE 300 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. Stripped bonds are identical to other stripped 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.

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 above 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 CRA has specifically addressed in its bulletin. In our example, if an individual disposes of Class A shares and realizes a loss on the sale and subsequently acquires

[1] *CRA document # 2001-0080385*

Class B shares within 30 days, 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, CRA has outlined[2] its administrative position on how to calculate the superficial loss. CRA accepts 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 (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), and
- L is the capital loss on the disposition as otherwise determined.

For example, where a taxpayer disposes of all of his or her 100 class A common shares of X 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 and add that superficial loss to the adjusted cost base of the 5 shares subsequently acquired. Using the formula,

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.
2. An unrealized capital loss can be transferred to a spouse 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 to treat the sale/transfer of the loss securities at fair market value (the Income Tax Act otherwise treats transactions between spouses as having been done at cost) and avoidance of potential attribution rules. The superficial loss rules are triggered since the spouse 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 (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 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 their spouse's) RRSP within the 30-day period. As before, the capital loss is also denied if a security is transferred "in-kind" to the RRSP.

Security No Longer Publicly Traded

If your portfolio contains securities for which there is no market, you may still be able to take advantage of the tax loss 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,
- 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 claim a capital loss equal to the adjusted cost base of the

[2] *CRA document # 2005-0150811E5*

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. One final note, 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.

Conclusion

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.

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