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RRSPSTRATEGY

Tax losses &…

YOUR INVESTMENTS

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The beginning of 2016 was a rough start for investors as the markets tumbled in part due to China and now the low oil prices aren't helping matters. So chances are that your portfolio might be reflecting some losses. But as the ever optimist that I am, I can't help but point out the silver lining: this is a good opportunity for tax loss selling. Triggering losses does not necessarily mean that your pocketbook is lighter since any losses that you realize can help offset your 2016 tax bill. Below are some key rules you should know in order to embrace the art of tax loss selling:

1. Current-year capital losses offset current-year (i.e., 2016) capital gains, if any. To the extent that you have capital gains in 2016, this claim is mandatory: you cannot pass up claiming 2016 losses against 2016 gains.

2. If, after applying your 2016 capital losses against 2016 gains, there is an excess loss and you had taxable capital gains between 2013 and 2015, you can file for a tax refund. This offset is optional and you can choose the year to apply the losses.

3. If, after applying the above two rules, you still have excess capital losses after the carryback, you can carry them forward forever. This means that, if you don't have gains this year or back to 2013, there is no rush to go out and claim a tax loss.

When it comes to these rules, consider the following:

• To claim a tax loss in 2013 in respect of your investments, the trade must actually "settle" by December 31. The settlement delay on Canadian stock exchanges is three trading days after the date of the sell order.

To be sure that you don't miss the last possible "settlement date", you should consider December 24 as the last trading day since it is likely that the Canadian stock exchanges will be closed on the 25th and 26th. (Different rules may apply in the U.S.; and if the transaction is a "cash sale" - payment made and security documents delivered on the trade date – you may have until later in the month.)

• You may have been thinking of realigning your investment portfolio by taking your profits.

If paying capital gains tax on your winners has deterred you, sheltering these by letting go of your losers could be a tax-smart strategy.

• Make sure that there isn't a surprise gain this year, for example, if you hold a mutual fund outside your RRSP and it sells off some winners.

If you have potential tax losses, you may want to place a call to the mutual fund's manager to see if there'll be some capital gains in store this year.

• One example of when you may wish to pass up claiming a loss carry back is if you were in a lower tax bracket in earlier years than you expect to be in the near future and you expect to have capital gains.

Although, capital losses can be carried forward indefinitely – i.e., to be applied against future capital gains, the farther into the future your capital gain is,

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the lower the "present value" of your capital loss carryforward.

So if capital gains are a long way off, it might be better to apply for a carryback and get the benefit of a tax refund now – even if you were in a relatively low tax bracket.

If you intend to sell off an investment for a capital gain around year end, you may want to defer the gain to 2017, because you can postpone the capital gains tax for a year.

Note: you don't have to actually wait until the new year to do this, as long as you sell after the year end settlement deadline (see discussion above). One exception to this strategy is if you expect to move into a higher tax bracket next year.

Finding your Losses

When hunting losses, another thing you should do is check to see whether you incurred capital losses in a previous year which you have never used.

This is quite possible because deductions for capital losses can only be claimed against capital gains and unclaimed capital losses can be carried forward indefinitely.

If you don't have back records, another idea is to contact the CanRev to request your personal "carryforward balances".

Other possibilities for tax losses include bad loans (including such items as bad mortgage investments, junk bonds, a no-good advance to your company, bad loans to a business associate, and so on).

Finally, check your 1994 return to see if you have made the "last chance" election to take advantage of the now-defunct $100,000 capital gains exemption. For most investments, this will result in an increase to the cost base of the particular item.

If your gain is on a mutual fund and you made the election on it, you may have a special tax account - known as an "exempt capital gains balance" - which can be used to shelter capital gains from the fund until the end of this year, after which it must be added to the cost base of the particular investment.

Other Strategies

Here are some other things you should know about tax-loss selling:

• Hanging in. One complication when it comes to tax-loss selling occurs if you want to hold on to the investment. But if you're thinking of selling and buying back in again, watch out for the superficial loss rules.

These rules can knock out a tax loss if you're selling to take a loss, you buy an identical investment in the period within 30 days before or after the sale and you continue to hold it at the end of the period.

Either wait until after the 30-day period or have another family member (other than a spouse) buy back the investment - if you want in again.

These rules apply only if you buy an identical investment within the 30-day period. So if you sell, say, Royal Bank and buy, say, Bank of Montreal, you're okay, tax-wise at least.

• Mutual funds. If your mutual fund is down, one way to trigger a tax loss is to convert to another fund within the family e.g., from a Canadian equity to a U.S. equity or money market fund (as always, tax losses can't be claimed if the investment is in your RRSP).

However, some funds, such as the C.I. Sector Funds, have been set up so that, when this conversion takes place, there is no gain or loss recognized for tax purposes (of course, the idea behind this type of structure is to defer capital gains). This should be checked out before you make the conversion.

• ABILs. Losses from investments in "private" corporations devoted to Canadian business may qualify as "allowable business losses," a fancy term which means that your tax loss can be deducted against all sources of income, not just capital gains. (Tax drones use the acronym "ABIL" - as is the case with capital gains/losses 50% of the actual loss can be deducted.) In many cases, Canadian "over-the-counter-traded" shares may qualify. Warning: ABIL claims are closely-monitored by CanRev, so you should be in a position to back up your claim.

Basically, the corporation's assets must be devoted to Canadian active business activities. Also, to the extent that you've claimed the capital gains exemption in prior years, the "ABIL" will turn back into a garden-variety capital loss.

Business or Pleasure? In some cases, you could be treated as being "in the business" of trading investments. If so, 100% of your losses are deductible against all sources of income, not just capital gains. In fact, it may often be possible to claim a loss by "writing down" the investment to their value, if this is less than its original cost (the investments must be "written back up" if they recover in value).

But before you file on this basis, you'd better make sure you can back up your claim that you're in the "investment business". ❒