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TAXSTRATEGY

Triggering Losses

Tips & Traps

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Here we are in July, and the year is half over. As we start to enter the last half of 2018, it's never too early to think about end-of-year tax planning. Rather than leaving it to the 11th hour, consider how you might be able to lower your tax bill for the current year.

One common tax tip is tax-loss selling, which refers to the strategy of triggering losses before December 31 to offset capital gains that you may be facing for 2018. So, the real question is: How do you trigger a loss?" One easy way is to look at the stocks or other investments in your portfolio to see which are in a loss position (i.e. where the current market value is less than the original cost). By selling such investments in a loss position, you can trigger a loss. Yes, it means that you aren't making any money off these sales, but it also means that the loss that results can be used to offset the gains, which at the end of the day translates into lowering your tax bill.

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Caveat Venditor

Sounds easy doesn't it? But before you place your sell order, here are some things to watch for:

☛ Do you need a tax loss? If you don't have any capital gains as far back as 2015, there's no need to run out and sell a loser just for its tax loss. That's because capital gains can be claimed only against capital losses. For most investors, the result will be a capital loss. A capital loss cannot shelter income from your job, a business or even an employee stock option benefit. So, if you have no capital gains in the current year, or in the last three years (capital losses can be carried back three years, to 2015), then there's no point in tax loss selling. (A possible exception applies to losing investments in Canadian private corporations devoted to active-business endeavours - this could include over-the-counter traded stocks.)

☛ Do you have a tax loss? You probably are thinking that it's a good likelihood that you are sitting on at least a couple of losses. However, don't assume this is the case. The first question to ask yourself is whether you actually have a tax loss to begin with. This depends on the tax cost of your investment – or as we tax drones call it, your "adjusted cost base." One important thing to bear in mind is that you must calculate your tax cost on a weighted average basis for all identical investments.

Let's say that you bought 2000 shares of Xco at $20 per share and another block of 1000 at $40. Let's also suppose that you decided to take your lumps on the second purchase and you sold the block of 1000 at $30. Your loss would be $10 a share, right? Wrong! You have to calculate your cost on the weighted average basis. Since most of your shares were bought when the stock was below its selling price, the weighted average cost per share would be $36.67 - i.e., (2000 x $20 + 1000 X 40)/3000, so that apparent $10 loss would turn into a $3.33 gain a share.

You must use this approach even if you used a different broker for each purchase.

Happily, though, initial purchases by other family members will not figure in the weighted average calculation. For this reason, it may make sense to have other family member make the initial purchases, in order to "isolate" cost base in each person. In the previous example, if your spouse had purchase the second block at $40 and had sold it, your spouse's adjusted cost base would have been based on the $40 amount.

Advanced strategies:

☛ The kiddie double play. One way to trigger losses is to transfer shares to your kids. In fact, if you play your cards right, you could end up getting a tax-reducing "double play:" First, you get the tax loss itself from the flip. But in addition, once your kids own the investment, future capital gains can be taxable in the child's hands - often resulting in little or no tax since they would likely be in the lowest (or lower) tax bracket. In other words, you get to claim the tax loss, and when the investment recovers in value the capital gain could be tax free!

Here's how: Every Canadian individual – irrespective of age - is legally entitled to the basic personal exemption, which covers off the first $11,635 of income (for 2018). And with the 50 per cent capital-gains inclusion rate, kids can now earn over $22,000 of capital gains annually without paying a cent of tax. After your kids run out of personal exemptions and the like, they are taxed at the lowest tax bracket (assuming they have no other income). (Note - your loss can't be used to shelter your child's gain.)

In the case of minors, remember that the strategy applies only to capital gains. If dividends or interest is paid after the flip, the general rule is that you must pay tax on this income until the year in which the child turns 18 (due to the attribution rules). To make the transaction legal in the eyes of the tax department, make sure the investment is transferred to a separate account for the child. It's a good idea to have a written agreement to back up the flip - especially if your broker insists that the transfer be made to a so-called "in-trust account", which is registered in the name of an adult. The paper should document that there has been a transfer of ownership either by way of gift or sale.

☛ Beware of the superficial loss rules. The superficial loss rules can veto a capital loss if you're selling on the market to take a loss, and you buy back an identical investment within 30 days before or after the sale. Although these rules are designed to counter artificial losses, they could apply inadvertently - for example if you sell, then change your mind and buy in again, maybe after the stock has dropped further. The rules will also apply if your spouse buys back in within the 30-day period (or a controlled company), but not if a child or parent reinvests. The rules apply not only to stocks, but to mutual funds as well. But they only apply if you repurchase an identical asset. So, if you sell Bank A and buy Bank B, you're OK.

☛ Mutual satisfaction. 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 (NOTE: tax losses can't be claimed if the investment is in your RRSP). However, some 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.

☛ Settle in. Remember that for open-market trades, the date of the tax loss is the settlement date, not when you tell your broker to sell. On Canadian stock exchanges at least, this is three business days after the trade date. Therefore, in order to claim a tax loss in 2014, the trade must actually "settle" by December 31, 2014. To be sure that you don't miss the last possible "settlement date" (what with all the holidays at the end of December), you should check with your broker. (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.)

☛ Watch foreign currencies. When assessing whether you're in a loss position, don't forget that capital gains are calculated in Canadian dollars - so currency fluctuations can be a key consideration. If the Canadian dollar has appreciated against the currency, there will tend to be losses.

☛ Defer your loss until next 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, 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.

On the flip side, if you intend to sell off an investment for a capital gain around year end, you may want to defer the gain to 2019, 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 (again, check with your broker to ensure you have the correct settlement date). One exception to this strategy will occur if you expect to move into a higher tax bracket next year. ❏