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TAXSTRATEGY

Triggering tax losses: tips and traps

Tax losses

Samantha Prasad, LL.B

As we begin to approach the end of the calendar year, a common tax tip is to think about "tax-loss selling." This refers to the strategy of triggering losses before December 31 in order to offset capital gains you may be facing for 2014.

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 cost to you). By selling such investments in a loss position, you can trigger a loss.

Why trigger a loss?

Yes, this means you aren't making any money off these sales. However, it also means the loss that results can be used to offset the gains; at the end of the day, this translates into lowering your tax bill.

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

Do you need a tax loss?

If you don't have any capital gains as far back as 2011, there's no need to run out and sell a loser just for its tax loss. (Capital losses can be carried back only three years.)

That's because capital gains can be claimed only against capital losses. For most investors, the result will be a capital loss.

Keep in mind that 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, 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 it's likely you are sitting on at least a couple of losses. However, don't assume this is the case.

So 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.

Calculating your tax cost on a weighted average basis

Let's say that you bought 2,000 shares of Xco at $20 per share and another block of 1,000 at $40. Supposed too that you decided to take your lumps on the second purchase and you sold the block of 1,000 at $30. Your loss would be $10 a share, right? Wrong!

Instead, you have to calculate your cost on a 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.

The math behind this is

Samantha Prasad, LL.B., is a tax partner with the Toronto-based law firm Minden Gross LLP, a member of Meritas Law Firms Worldwide, and a Contributing Editor of The TaxLetter, published by MPL Communications.
sprasad@mindengross.com

straight forward: (2,000 x $20 + 1,000 X 40)/3,000.

Crunch these numbers and you get $80,000/3,000, which works out to $3.33.

So that apparent $10 loss is in fact a $3.33 gain per 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 members make the initial purchases, in order to "isolate" cost base in each person.

In the previous example, if your spouse had purchased the second block at $40 and later sold it, your spouse's adjusted cost base would have been based on the $40 amount.

Advanced tax loss strategies

Here are some more advanced tax loss 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 as they would likely be in the lowest (or at least a lower) tax bracket.

In other words, you get to claim the tax loss and, when the investment recovers in value, the capital gain - in your child's hands - 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 $11,138 of income (for 2014). And, with the 50 per cent capital gains inclusion rate now in effect, this means that 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).

Meet your legal responsibilities

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 the transfer be made to a so-called "in-trust account," which is registered in the name of an adult. This 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, you might sell, then change your mind and buy in again, perhaps after the stock has dropped further. The superficial loss rule would apply here, vetoing your capital loss.

The rules will also apply if your spouse buys back an investment (or a controlled company) within the 30-day period; however, they don't apply if a child or parent reinvests.

These rules apply not only to stocks, but to exchange-traded funds and mutual funds as well. However, they only apply if you repurchase an identical asset. So if you sell Bank A and buy Bank B, you're okay.

Mutual satisfaction

If your mutual fund is down, one way to trigger a tax loss is to convert to another fund within the fund 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).

That said, 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. Check this out before you make the conversion.

Settlement dates are crucial

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 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 in which the investment is held, there is a greater chance that there will be losses.

Defer your loss to 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 further into the future your capital gain is, the lower the “present value” of your capital loss carryforward.

So if anticipated 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 2015, 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 is if you expect to move into a higher tax bracket next year. ❐