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TAX-WISE INVESTOR

Get a head start on cutting your taxes

Triggering losses

Samantha Prasad LL.B.

Normally I write about triggering tax losses closer to the end of the year. That's when we all suddenly realize there's only a few months left to properly structure our taxes.

Ideally, however, you should be thinking about strategies to minimize the 2013 tax bill well before Dec. 31.

And now that we've all had a chance to recover from this year's April 30 filing deadline, there's no reason why we can't talk today about tax-loss selling in the context of your investments.

So, now that I have you in a relaxed state of mind, let's go over some key rules:

Current-year (2013) capital losses offset current-year capital gains, if any. If you have capital gains in 2013, this claim is mandatory: you cannot pass up claiming losses against gains for the year.

If, after applying those 2013 losses against your 2013 gains, there is an excess loss and you had taxable capital gains between 2010 and 2012, you can file for a tax refund. This offset is optional and you can choose the year to apply the losses to.

However, 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 2010, there's 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 to your investments, the trade must actually "settle" by Dec. 31. The settlement delay on Canadian stock exchanges is three trading days after the date of the sell order.

To ensure that you don't miss the last possible "settlement date," you should consider Dec. 24 as the last trading day, since Canadian stock exchanges often close on Dec. 25 and 26.

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, let's say you hold a mutual fund outside your RRSP and it has sold some winners. If you have potential tax losses, you could place a call to the fund's manager to see if there'll be some capital gains in store this year.

If you were in a lower tax bracket in earlier years and expect to be in a higher one in the near future (and you anticipate capital gains) then you might want to pass up claiming a loss carryback.

That being said, capital losses can be carried forward indefinitely to be applied against future capital gains. However, 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 –

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even if you were in a relatively low tax bracket.

If you intend to sell an investment for a capital gain around year end, you may want to defer the gain to 2014. Why? 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 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, check to see whether you sustained capital losses in a previous year that you have never used.

This is quite possible because deductions for capital losses can only be claimed against capital gains (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).

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").

This can be used to shelter capital gains from the fund until the end of this year. After that, 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 is 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 simply to take a loss. You buy an identical investment in the period within 30 days before or after the sale and continue to hold it at the end of the period.

Check to see whether you sustained capital losses in a previous year that you have never used

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, for example, if you sell, Royal Bank shares and buy Bank of Montreal shares, you're okay in the eyes of the taxman.

Mutual funds. If your mutual fund is down, one way to trigger a loss is to convert to another fund within the same family.

To illustrate this, I'll use Franklin Templeton as an example. Switching from Templeton's Canadian equity to their U.S. equity or money market fund if fine because they are both managed by the same fund company.

Remember, tax losses can only be claimed if the investment is outside of your RRSP.

However, some funds, have been set up and structured so that when this conversion takes place, there's no gain or loss recognized for tax purposes.

The idea behind this type of fund is to defer capital gains. This should be checked out before you make the conversion.

Allowable Investment Loss, or ABILs. Losses from investments in "private" corporations devoted to Canadian business may qualify as ABILs.

This fancy term means 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 per cent 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 per cent 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 its value, if this is less than its original cost.

The investment must be "written back up" if it recovers 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." ❐

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