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TAXSTRATEGY

Tax Losses

Understand Before You Claim

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The last year and a half was a rough year for investors and businesses alike, as the markets and economy were on a downward spiral due to the pandemic and other global factors. So, chances are that your portfolio or financial statements might be reflecting some losses. But triggering losses does not necessarily mean that your pocketbook is lighter since any losses that you realize can help offset your 2021 tax bill.

Capital Losses

You have a capital loss when you sell, or are considered to have sold, a capital property for less than its adjusted cost base plus the outlays and expenses involved in selling the property. For tax purposes, a capital loss can only be used to offset against a capital gain (when you sell a capital property for more than its adjusted cost base plus outlays and expenses). But there are some key rules to keep in mind:

1. Current-year capital losses offset current-year (i.e., 2021) capital gains, if any. To the extent that you have capital gains in 2021, this claim is mandatory: You cannot pass up claiming 2021 losses against 2021 gains.

2. If, after applying your 2021 capital losses against 2021 gains, there is an excess loss and you had taxable capital gains between 2018 and 2020, 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 carry back, you can carry them forward forever. This means that, if you don't have gains this year or back to 2017, 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 2021 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

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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, the lower the "present value" of your capital loss carry forward. So if capital gains are a long way off, it might be better to apply for a carry back 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 2022, 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 can occur 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 Can-Rev to request your personal "carry forward 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.

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, when 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 OK 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.

☛ **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 investments must be "written back up" if it recovers in value). But before you file on this basis, you'd better make sure that you can back up your claim that you're in the "investment business."

☛ **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. 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 (i.e. the "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 shares of Xco at $40. Suppose that you also 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.

☛ **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.

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 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 the Canada Revenue Agency, 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.

Non-Capital Losses

If you happen to be carrying on a business (whether personally or through a corporation), it's possible that you may be generating "**non-capital losses**". Generally, a non-capital loss for a particular year includes any loss incurred from employment, property or a business. So, if your business didn't generate more income than your expenses in the year, you may have a business loss (i.e. non-capital loss), or if your rental stood empty for a few months last year despite your best efforts to find tenants, you may have a rental loss (i.e. non-capital loss).

If at the end of your taxation year you are in the red, the resulting non-capital loss can be carried back 3 years against previous year's income (and claim a tax refund), or carried forward to be applied to the income from your other sources such as employment, RRSP income, interest amounts, etc. The number of years to carry the loss forward will depend on when the loss was incurred:

☛ For taxation years ended March 22, 2004 or earlier, you can carry forward such losses for 7 years

☛ For taxation years ended after March 22, 2004 you can carry forward such losses for 10 years

☛ For taxation years ended after 2005, you can carry forward such losses for 20 years, except ABILs. Instead, a non-capital loss resulting from an ABIL arising in tax years ending after March 22, 2004, that has not been used within 10 tax years will continue to become a net capital loss in the eleventh year. Furthermore, a non-capital loss resulting from an ABIL arising in tax years ending prior to March 23, 2004, that was not used within seven tax years became a net capital loss in the eighth year (which means they can only be used offset capital gains).

But be careful when calculating that 20 year period if the business is being carried on by a corporation. ❑