

Turn Your Paper Losses Into Dollar Bills

“Everything has its beauty but not everyone sees it.” - Confucius

With recent declines in the stock markets many people are looking at portfolios that are worth a lot less than they once were (so-called “paper losses”). By turning the “paper losses” into real losses there is an opportunity to recover capital gains taxes paid in prior years.

It should be noted that, first and foremost, any decision to sell a stock must be made primarily from the investment perspective and not be driven solely by income tax planning. However, if it is determined that certain stocks no longer meet investment objectives, the tax implications of selling should be considered. In addition, there may be an opportunity to repurchase the stock after a certain waiting period and still achieve the desired tax savings.

For tax purposes, other than deemed dispositions required in certain circumstances, only realized capital gains are subject to tax. Similarly, only realized capital losses are reported on your tax return.

A capital gain is realized when you dispose of an investment for proceeds greater than your adjusted cost base (“ACB”) of the investment. A capital loss occurs when you dispose of an investment for proceeds less than your ACB of the investment. Capital gains and losses are subject to a 50% inclusion rate for tax purposes. That is to say, if you realize a gain of \$100 on the sale of your investment only \$50 would be subject to tax.

The ACB of an investment (ie. shares of a particular company) is equal to the weighted average cost of all of the shares of that particular company. In the case of publicly traded shares, generally, the cost is equal to the amount you paid for the shares plus any broker fees or transaction fees associated with the purchase. For example if you bought 100 common shares of Vandelay Industries for \$10 per share and broker fees of \$50 your ACB would be \$1,050 or \$10.50 per share. If you subsequently acquired an additional 50 shares for \$12.50



per share plus broker fees of \$25, the ACB for your 150 shares would be \$1,700 or \$11.33 per share. If those were your only transactions prior to selling 50 of the shares for \$15 per share, your capital gain would equal \$750 (50 shares X \$15) – \$566.50 (50 shares x ACB of \$11.33/share) = \$183.50. Your taxable capital gain would be \$91.75 (50% of \$183.50).

If a loss is realized on the sale of an investment, unfortunately, other than on death, that capital loss is only deductible against a capital gain. If you incurred a \$100 loss on the sale of an investment, that loss can only be applied to offset income from capital gains in the year or in any of the three preceding years or any future year. The capital loss cannot be used to reduce other sources of income (ie. your income from employment).

If a stock is sold at a loss in 2009, it can serve to reduce 2009 taxes if capital gains have been realized earlier in the year. If losses exceed gains for the year, the net loss balance can be applied to offset capital gains reported in years 2006, 2007 and/or 2008 and there is a recovery of capital gains taxes from those years. Any remaining loss balance can be applied in future years to reduce capital gains taxes.

The tax savings arising from the loss selling depends on your marginal tax rate. In Ontario, the savings can be as high as 46.4% of the taxable capital gain (23.2% of the actual gain). In Quebec, the savings can be as high as 48.2% of the taxable capital gain (24.1% of the actual gain).

For example, assume Alex Keaton, an Ontario resident, earns an annual salary of \$125,000. In addition, on his

2006 personal income tax return he reported taxable capital gains of \$10,000. In 2007, he reported taxable capital gains of \$5,000. With the market in decline in 2008 he decided not to sell any investments. In 2009, after hearing about the benefits of loss selling, he decides to realize some of his “paper losses”. He sells enough investments to trigger allowable capital losses of \$15,000 (\$30,000 in actual losses). By carrying the losses back to the 2006 and 2007 taxation years, Mr. Keaton would be refunded \$4,640 of taxes paid in 2006 and \$2,320 of taxes paid in 2007.

The claim for a capital loss carry-back is made by completing form T1A “Request for Loss Carry-back”. The amount of losses carried back is limited to the taxable capital gains reported in the year you are carrying the loss back to; net of any capital losses realized from other years and claimed in that year. It is also worth noting that you should only carry losses back to the extent that you have taxes payable. You do not want to waste your non-refundable tax credits by claiming a loss carry-back.

With peak RRSP season fast approaching it should be noted that transfers of shares to your RRSP either as an investment swap or as a RRSP contribution is an option. The transfer is deemed to take place at fair market value and any capital gains arising on the transfer are subject to tax. However, as there is no change in the beneficial ownership of the shares, any loss is denied and cannot be claimed to offset other capital gains.

When looking at realizing capital losses, you must be mindful of the “superficial loss” rules. A “superficial loss” is defined as the taxpayer’s loss from the disposition of a particular property where:

- During the period that begins 30 days before and ends 30 days after the disposition, the taxpayer or a person affiliated with the taxpayer (including a spouse or common-law partner) acquires a property that is identical to the particular property, and
- At the end of the 30 day period, the taxpayer (or a person affiliated with the taxpayer) owns or had a right to own the property.

The rule is designed to deny a loss where within 30 days of the disposition you (or your spouse) are in the same position as you were prior to the disposition. For example, if you were to sell 50 shares of a company at a loss and within 30 days of the sale had reacquired 50 shares of the same company, you have not really incurred a loss. You still have the 50 shares. You must wait 31 days to repurchase the shares otherwise the loss will be denied. The denied loss is added to the ACB of the repurchased shares, thereby deferring the loss claim until the shares are sold again and not repurchased within 30 days.

Although it is too late for the 2009 taxation year, given the 30 day holding period required, the superficial loss rules do provide the possibility to “shift” losses between

spouses to maximize the recovery of prior year capital gains taxes.

Returning to Mr. Keaton, assume instead that he owns stock with an accrued loss but has no gains in the current year to apply the loss to and has not had any capital gains in the last 3 years. However, his spouse has reported capital gains in the last 3 years. Mr. Keaton could sell his shares to his spouse and elect under s.73(1) of the Income Tax Act to have the transaction take place at the current fair market value. Because Mr. Keaton is affiliated with his spouse, the capital loss would be denied to Mr. Keaton and the loss would be added to the ACB of his spouse’s shares. This essentially gives her an ACB equal to Mr. Keaton’s ACB. As long as his spouse waits more than 30 days to sell the shares, she can realize the capital loss and carry-back the loss to a prior year to apply against the capital gains reported in those years. Note that if she does not wait more than 30 days, the superficial loss rules do not apply and the loss will have to be claimed by Mr. Keaton.

It is important to note that in order to apply to the 2009 taxation year, any tax loss selling transactions must take place no later than December 24, 2009. This is due to the Canada Revenue Agency’s view that it is the settlement date and not the transaction date that determines the timing of the transaction.

For more information about loss selling please contact a professional at Welch LLP or visit us at: www.welchllp.com

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