Invesco

Tax & Estate

Capital loss planning

Market downturns can provide planning opportunities to take advantage of losses and offset other capital gains. This *InfoPage* explains some of the pitfalls to avoid and offers tax strategies you can use to decrease your losses. After all, financial planning is essential when the markets go down, as well as up.

SPECIAL NOTICE:

As per the 2016 Federal Budget, the government announced an end to tax-deferred switches among fund classes within a mutual fund corporation. Nonetheless, the structure continues to offer other tax efficiencies for non-registered accounts. Please refer to our *Tax & Estate special advisory* titled *Mutual fund corporation tax changes* for more information.

Planning for net capital losses

A capital loss must first be applied against any capital gains (including capital gains distributions) of the current year. However, once these capital gains have been used, the balance of the loss may either be carried back to offset capital gains in any of the three prior years or carried forward indefinitely to offset capital gains of future years.

If you have realized significant capital losses this year, there's a temptation to try to realize gains later in the year to offset some of these losses immediately. However, if you have net capital gains in any of the three previous years, you can also consider applying the net capital losses realized this year against the net capital gains realized in any one or more of those years. This way, you can receive a partial or full refund of the capital gains taxes you previously paid. If you have net gains in more than one of those years, there is no requirement that you must apply the loss against the earliest year first. For example, if you realized a net capital loss in 2013, and net capital gains in 2011 and 2009, you may choose to offset the loss this year against the gains in 2011 first, as opposed to 2009. You may want to do this if your personal tax rate was higher in 2011 than in 2009 and you would like to maximize the amount of refund you receive or reduce the amount you owe.

Alternate strategies

There are a number of strategies you may consider if you have accrued losses in investment portfolios. With proper planning you can realize and use them on a tax-effective basis. The following strategies generally assume that the investment will continue to be held in some form even though the accrued loss will be realized and used.

Beware the superficial loss rule

Canada's tax rules require you to wait at least 30 days before repurchasing the same property if you want to be able to claim the full amount of the capital loss. This is known as the superficial loss rule. In addition, if you or your spouse/common-law partner purchase property identical to that sold within the period that begins 30 days before and ends 30 days after the disposition, and still hold it on the 31st day after the disposition, then the loss on the original sale will be superficial.

A superficial loss is deemed nil, and will be denied and cannot be claimed. The denied loss is added to the adjusted cost base of the acquired property.

The superficial loss rule also applies if the property is acquired by a company controlled by you and/or your spouse/common-law partner during the period outlined above. Finally, the superficial loss rule also applies to trusts on which you or your spouse/common-law partner is a majority interest beneficiary. As a result, the strategy of selling property held in a non-registered account and reacquiring the property inside an RRSP, RRIF, RESP or TFSA is no longer available.

In-kind transfers to registered plans

Often you may consider funding your registered plan via an in-kind transfer of securities from your non-registered account. In-kind transfers from your non-registered account to your registered plan (e.g., RRSP or TFSA) will result in a disposition for tax purposes. Any capital gains triggered as a result of the disposition is taxable. A capital loss triggered from the in-kind transfer will be denied and unusable under Canada's "deemed to be nil" rules. It is therefore more advantageous to realize the capital loss on the security within the non-registered environment first, and then transfer the proceeds into the registered plan.

Example 1

Georgia holds a mutual fund trust within her non-registered portfolio that is currently in an unrealized loss position. She wishes to continue owning the fund but would also like to contribute her entire position to her RRSP. If Georgia transfers the fund in-kind to her RRSP, the disposition would trigger the capital loss; however, the loss would be denied under the "deemed to be nil" rules. Alternatively, Georgia could first switch into a different mutual fund investment within her non-registered environment and then transfer the new investment in-kind into her RRSP. The new fund could be the corporate version of the fund, a money market fund or another trust with a similar investment mandate. The switch would be considered a disposition triggering the capital loss, which would not be denied. Once the new investment is transferred into her RRSP, she would need to be wary of the superficial loss rules.

Transfer the mutual fund units to a child or parent

The superficial loss rule does not apply in the case of an immediate acquisition of the same units by a child or a parent. Therefore, it may be possible to realize a loss by transferring the mutual fund units to a child or parent.

Transfer from trust to corporate version of same mutual fund

Mutual funds can be set up legally as trusts or corporations. Many corporate funds have different classes of shares. Each class represents a different portfolio of securities, with a different investment mandate (e.g., technology, Europe, etc.). An investor may switch between the fund's different classes of shares without triggering a taxable event. If you have an accrued loss on the trust version of a particular mutual fund, you could switch to the corporate version of that fund and crystallize the loss. A switch either way between the trust and the corporate class is considered to be a disposition. When the other version of the fund is purchased, there is no superficial loss. This is because you are buying back a different legal structure, and not an identical property.

Purchase another mutual fund trust in the same category

As an alternative to switching from a mutual fund trust to a mutual fund corporation, it may also be possible to realize a loss by switching from one mutual fund trust to another mutual fund trust in the same category. For example, it may be possible to realize the loss incurred from one Canadian equity fund trust by switching to another Canadian equity fund trust within the same family. The ability to claim the loss in this case will hinge on whether the two Canadian equity fund trusts are considered to be "identical."

"Identical" property

Properties are generally considered identical where they are the same in all material respects and an individual would not have a preference for one over the other. Common examples of identical property include the same class of capital stock of a corporation or units of a mutual fund. The determination of whether properties are considered identical would require a comparison of the inherent qualities or elements of each property and, therefore, professional advice should be sought in this regard.

Spousal (common-law partner) transfer of losses

This is a strategy that can be used if you have a loss but cannot use it. If your spouse can use it, you can transfer the loss without having an attribution problem.

Example 2

Adam and Joanne are married. Joanne has a capital gain this year (or in the past three years), and Adam has a capital loss this year he cannot use.

Adam has an accrued loss on Company A shares:	$11,000
Fair market value (FMV) of Company A	$ 1,000
Accrued loss ($10,000)	($10,000)

Step 1: Adam sells shares to Joanne for $1,000

Adam may sell the shares to Joanne by using a promissory note bearing the Canada Revenue Agency's (CRA) prescribed interest rate. The interest must be paid in respect of each taxation year, not later than 30 days after the end of the year. The loss is denied because Adam sold the shares to his wife, Joanne, and, therefore, the loss is a superficial loss.

FMV of Company A	$ 1,000
ACB of Company A	($11,000)
Capital loss – superficial loss	($10,000)

The superficial loss is then added to Joanne's ACB as follows:

Denied loss added to ACB:

Amount paid	$ 1,000
Denied loss	$ 10,000
New ACB	$ 11,000

Step 2: Joanne sells shares on open market after 30 days

In order for Joanne to add the denied loss to her ACB, the loss must be superficial. The final criteria to establish a superficial loss requires the spouse to own the property 30 days after the original disposition. As a result, Joanne waits more than 30 days to sell the shares.

FMV of Company A	$ 1,000
ACB of Company A	($11,000)
Capital loss	($10,000)

Step 3: Elect out of automatic rollover – Subsection 73(1)

Since Joanne paid FMV for the shares, there is no attribution of the capital loss back to Adam as long as Joanne elects out of the automatic rollover. Under subsection 73(1) of the *Income Tax Act* (Canada), any property transferred to a spouse (common-law partner) is transferred automatically at ACB. An election out of subsection 73(1) will allow the transaction to occur at FMV, and the attribution rules will not apply as Joanne paid Adam FMV consideration for the shares.

Procedure to carry back a loss

The procedure to carry back a loss from the current year to any of the three preceding years is quite simple – you just need to complete CRA Form T1A "Request for Loss Carryback." It's available on the CRA website and included in most tax preparation software packages. On this form you select the year(s) in which you wish to apply the capital loss. The CRA will reassess your return for that year and mail you a refund cheque.

The best option

While the topic of losses is not something that most individuals wish to discuss, considering one or two of the above strategies may go a long way toward mitigating some of the pain associated with these losses. Nevertheless, every family and individual is unique, so it is important that you talk with your advisor, lawyer and/or tax advisor to find out the best available options in your situation. Once you have your plan in place, don't forget to review it from time to time, or as your circumstances change.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invesco.ca.

The information provided is general in nature and may not be relied upon nor considered to be the rendering of tax, legal, accounting or professional advice. Readers should consult with their own accountants, lawyers and/or other professionals for advice on their specific circumstances before taking any action. The information contained herein is from sources believed to be reliable, but accuracy cannot be guaranteed. Commissions, trailing commissions, management fees and expenses may all be associated with mutual fund investments. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Please read the simplified prospectus before investing. Copies are available from your advisor or from Invesco Canada Ltd.

Invesco is a registered business name of Invesco Canada Ltd.

* Invesco® and all associated trademarks are trademarks of Invesco Holding Company Limited, used under licence.
© Invesco Canada Ltd., 2016

TECALPE (04/16)