Tax & Estate

Loss carryforward Q&A
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Mutual funds, like other taxpayers, may realize capital losses in excess of capital gains. The following questions and answers provide more important information on capital losses realized by mutual funds and the implications for investors.

Q: What are capital loss carryforwards and how do fund unitholders benefit from them?

A: If a fund sells a holding and realizes a capital loss, the loss is first applied against any current year's capital gains to reduce potential capital gains distributions to unitholders at year-end. Remaining capital losses may be carried forward indefinitely to reduce capital gains inside the fund in future years. The benefit to unitholders is that the fund can realize capital gains in the future while reducing potential future capital gains distributions by the amount of loss carryforwards available.

Q: What are non-capital loss carryforwards and how do fund unitholders benefit from them?

A: Non-capital losses are the result of expenses of a fund, such as the management expense ratio, exceeding income in a particular year. They can be carried forward for up to 20 years and deducted against the fund's future income. As a result, they may reduce distributions in future years.

Q: What is the difference between an unrealized capital loss and a realized capital loss?

A: An unrealized capital loss is a paper loss that has not yet been realized by the selling of a security. As the value of an underlying security goes up or down, it is reflected in the net asset value (NAV) of a fund on a daily basis. If the value of the security has gone down relative to its original cost, the fund has an unrealized loss. This loss cannot be used to offset other capital gains until the security is actually disposed of and becomes a realized capital loss. When the fund ultimately sells the security, it will realize a capital gain or loss.

Q: What is the difference between a capital loss and a non-capital loss?

A: A capital loss arises when capital property (e.g., a stock or bond) is sold for proceeds valued at less than its adjusted cost base or tax cost. A capital loss can only be applied against a capital gain.

A noncapital loss arises when expenses exceed income. A non-capital loss can be applied against all sources of income. Both capital losses and non-capital losses can be carried back up to three years, but it is impractical for mutual funds to do so. As a result, a capital loss can be carried forward indefinitely to offset a future capital gain, whereas a non-capital loss can only be carried forward to offset income for up to 20 years.

Q: How are distributions determined?

A: At the end of the year, the net income of a fund is determined by adding up all the sources of income in the fund (interest, foreign non-business income, dividends) along with any net capital gains (less capital losses). This net income is then reduced by expenses of the fund. Expenses are applied against the least tax-preferred forms of income (e.g., interest and foreign income) first and capital gains last.

The Capital Gains Refund Mechanism is used to reduce the capital gains required to be distributed by the fund at year-end to take into account that unitholders/ shareholders in the fund may have also paid tax on capital gains when they redeemed. The formula attempts to prevent the double taxation of capital gains.

Q: What is the Capital Gains Refund Mechanism (CGRM) and how does it work?

A: The CGRM is a provision in the *Income Tax Act* (Canada) that attempts to avoid the double taxation of capital gains by reducing capital gains distributions a fund is required to make at year-end based on an estimate of capital gains realized throughout the year by redeeming investors.

Q: Do loss carryforwards affect the fund's performance?

A: Performance is based on the NAV of a fund at any point in time. When the fund sells a particular position and realizes a loss, this loss has already been reflected in the NAV on a daily basis. The act of disposing of the security does not affect the NAV or the fund's performance. What the disposition does is realize the loss. This loss can be used by the fund to offset other capital gains of the current year from the disposition of other securities, or it may be carried forward to reduce the capital gains of future years.

Q: As the market picks up, what effect will loss carryforwards have on funds?

A: As the market picks up, the NAV will increase as the value of the underlying assets increases. A fund may realize capital gains on dispositions within the fund. Loss carryforwards can be used to reduce ultimate capital gain distributions to investors.

Q: Investors can carry capital losses back three years and carry them forward indefinitely. Is the same true for mutual funds?

A: Yes. However, it is not practical for mutual funds to carry losses back, as prior years' tax returns for the funds have already been filed and distributions have been made to unitholders/ shareholders who filed their tax returns in previous years. As a result, these losses are carried forward.

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

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