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Transferring Capital Losses to your Spouse

Transferring your capital losses to your spouse may reduce your family's tax bill

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This article explains how you can transfer capital losses to your spouse using the superficial loss rules to help lower your overall family tax bill.

Are you interested in transferring your unrealized capital losses to your spouse? You might be if you have unrealized capital losses that you would not be able to use personally and your spouse has taxable capital gains that would otherwise be subject to tax. Even if you can use the losses yourself, you may want to transfer your capital losses to your spouse if your spouse is in a higher marginal tax bracket and has taxable capital gains that would otherwise be subject to tax at a higher rate.

Capital losses can be used to offset capital gains — but only if the gains and losses are reported by the same person. Generally, spouses may use only their own losses against their own gains. However, by using the superficial loss rules to your advantage, the following legitimate income tax strategy may assist you in transferring your unrealized capital losses to your spouse so that they may be used to offset your spouse's capital gains and reduce your overall family tax burden.

A simple share transfer does not work

If you simply transfer your securities to your spouse, the income attribution rules will prevent the loss from being realized in your spouse's hands, and you will not achieve your goal. This is because when assets are transferred from you to your spouse without your spouse paying fair market value (FMV) consideration, capital gains or losses and future income are attributed back to you.

Note that the income attribution rules do not apply between spouses if both of the following occur:

- The transferee spouse pays the transferor spouse fair market value for the securities (i.e. your spouse receives the securities from you and pays you for them); **and**

- The transferor spouse (you) reports the disposition for tax purposes at fair market value.

A strategy that may work

In order to successfully transfer a portion of your unrealized capital losses to your spouse, you and your spouse could implement the following strategy:

STEP 1: You sell the “loss” securities to your spouse at fair market value.

STEP 2: Your spouse holds the securities for at least 30 days.

STEP 3: Your spouse sells all the securities on the market.

STEP 4: You file a tax election with your tax return to have the transfer take place at fair market value.

The mechanics of the strategy

The key to this strategy is to use the superficial loss rules to your advantage. A superficial loss transaction is triggered when both of the following events occur:

a) During the period that begins 30 days before and ends 30 days after the settlement date of the disposition, you or a person affiliated with you (e.g. your spouse) acquires the identical property that was sold at a loss **— this is achieved in Step 1;**

AND

b) At the end of that period (e.g. 30 days after the settlement date of the disposition), you or a person affiliated with you (e.g. your spouse) owns the identical property **— this is achieved in Step 2**.

Once the superficial loss is triggered, you are not allowed to claim the capital loss. The amount of the capital loss is not lost forever, but rather added to the adjusted cost base (ACB) of the substituted property, which now belongs to your spouse. Once your spouse sells the position on the market, he or she triggers the capital loss, which must then be reported for tax purposes on his or her tax return.

Example #1: One spouse has capital losses and the other spouse has capital gains

In this example, one spouse has an unrealized capital loss and the other spouse has a capital gain and both are in the same tax bracket. The couple uses this strategy to transfer the losses from one to the other in order to make use of the losses and reduce their income tax.

Paul currently owns securities with an ACB of $100,000 and an FMV of $10,000; thus, he has an unrealized capital loss of $90,000. He wants to sell the security; however, he cannot use the capital loss. Unfortunately he has had a spell of losses in the last three years and has no prospect of a capital gain any time soon — therefore he does not foresee using the losses himself. Paul's spouse, Louise, is a sharp investor and has accrued capital gains almost every year. This year alone she already has more than $90,000 in capital gains. Paul and Louise are wondering if there's a way they can take advantage of Paul's losses to ease the tax bite for Louise as a result of her capital gains.

STEP 1: PAUL SELLS THE SECURITIES TO LOUISE AT FAIR MARKET VALUE

It is imperative that Louise purchases the securities from Paul **at fair market value with her own money** so that the income attribution rules do not apply. If Louise does not have the available funds to pay Paul the $10,000, there may be an opportunity to implement a spousal loan strategy. Please ask your advisor for details about spousal loans.

At this point, Louise's ACB is $10,000, which is the amount she paid for the securities. However, an adjustment to the ACB will take place after Step 2. See below for details.

STEP 2: LOUISE HOLDS THE SECURITIES FOR AT LEAST 30 DAYS

Louise must hold the securities for at least 30 days after purchasing them from Paul. This is an important point because if she sells sooner, there will be no superficial loss, and thus the objective of this strategy will be missed entirely.

After holding the securities for 30 days, the superficial loss rules are triggered and Paul is denied the loss. The $90,000 loss is added to the ACB of the securities. Thus after completing Step 2, Louise now owns all of the securities and her total ACB is $100,000 ($10,000 from Step 1 plus Paul's $90,000 denied loss from Step 2 = $100,000).

STEP 3: LOUISE SELLS ALL OF THE SECURITIES ON THE MARKET

Louise sells all of the securities on the market. Assuming the value of the securities has not changed, her proceeds of disposition are $10,000. Since her total ACB for all the securities is $100,000, her capital loss is $90,000. As a result of this step, Louise has triggered a $90,000 capital loss, which she can use to offset her gains.

STEP 4: PAUL FILES AN INCOME TAX ELECTION WITH HIS INCOME TAX RETURN

Paul must file an election with his income tax return stating that he “elects not to have the provisions of subsection 73(1) of the Income Tax Act apply” on the transfer of the securities to Louise. This election basically allows transfers between spouses to take place at fair market value rather than at cost, which is the norm.

The following tables summarize the overall tax implications of this example:

Summary of the tax implications to Louise	
Proceeds of disposition upon final sale in the market	$10,000
Less her ACB ($10,000 as per Step 1 + $90,000 as per Step 2)	($100,000)
Capital loss to be reported by Louise	**$90,000**

Summary of the tax implications to Paul	
Capital loss on the securities sold to Louise (transferred at FMV)	($90,000)
Capital loss denied because of the superficial loss rules	$90,000
Capital loss to be reported by Paul	**$0**

Tax savings for the couple

The following calculation shows the approximate tax savings assuming Louise is taxed at the top marginal tax rate of 46%1 and Paul cannot make use of the capital losses on his own:

Increase in Paul’s taxes as a result of the transfer (since he could not make use of the capital loss on his own)	$0
Decrease in Louise’s taxes as a result of the transfer ($90,000 x 50% inclusion rate x 46%[1] tax rate)	($20,700)
Total tax savings relating to Louise’s use of the capital loss	**$20,700**

Example #2: Transferring unrealized capital losses to a higher income spouse

In this example, the lower income spouse has unrealized capital losses and could use them to offset her own capital gains but chooses to transfer them to her higher income spouse who also has capital gains in order to take advantage of the losses at his higher marginal income tax rate and reduce their overall family tax burden.

Patricia currently owns securities with an ACB of $95,000 and an FMV of $15,000. Therefore, she has an unrealized capital loss of $80,000. She wants to sell the security. Patricia has enough capital gains to use the losses herself against current year gains and by carrying some of the losses back to the past three years. However, since her spouse, Richard, is in a higher tax bracket, they decide to transfer her losses to Richard, who can use them this year to offset his capital gains, which would be taxed at a higher marginal tax rate. Here are the steps involved in this strategy:

STEP 1: PATRICIA SELLS THE SECURITIES TO RICHARD AT FAIR MARKET VALUE

It is imperative that Richard purchases the securities from Patricia at fair market value with his own money so that the income attribution rules do not apply. If Richard does not have the available funds to pay Patricia the $15,000, there may be an opportunity to implement a spousal loan strategy or another lending strategy in order to facilitate this transaction. Please ask your advisor for more details.

At this point, Richard's ACB is $15,000, which is the amount he paid for the securities. (However, an adjustment to the ACB will take place after Step 2. See below for details.)

STEP 2: RICHARD HOLDS THE SECURITIES FOR AT LEAST 30 DAYS

Richard must hold the securities for at least 30 days after purchasing them from Patricia. This is an important point because if he sells sooner, there will be no superficial loss, and thus the objective of this strategy will be missed entirely.

After holding the securities for 30 days, the superficial loss rules are triggered and Patricia is denied the loss. Patricia's $80,000 loss is added to the ACB of the securities. Thus after completing Step 2, Richard now owns all of the securities and his total ACB is $95,000 ($15,000 from Step 1 plus Patricia's $80,000 denied loss from Step 2 = $95,000).

STEP 3: RICHARD SELLS ALL OF THE SECURITIES ON THE MARKET.

Richard sells all of the securities on the market. Assuming the value of the securities has not changed, his proceeds of the disposition are $15,000. Since his total ACB for all the securities is $95,000, his capital loss is $80,000. As a result of this step, Richard has triggered an $80,000 capital loss, which he can use to offset his gains.

STEP 4: PATRICIA FILES AN INCOME TAX ELECTION WITH HER INCOME TAX RETURN

Patricia must file an election with her income tax return stating that she "elects not to have the provisions of subsection 73(1) of the Income Tax Act apply" on the transfer of the securities to Richard. This election basically allows transfers between spouses to take place at fair market value rather than at cost, which is the norm.

The following tables summarize the overall tax implications of this example:

Summary of the tax implications to Richard	
Proceeds of disposition upon final sale in the market	$15,000
Less his ACB ($15,000 as per Step 1 + $80,000 as per Step 2)	($95,000)
Capital loss to be reported by Richard	**$80,000**

Summary of the tax implications to Patricia	
Capital loss on the securities sold to Richard	($80,000)
Capital loss denied because of the superficial loss rules	80,000
Capital loss to be reported by Patricia	**$0**

TAX SAVINGS FOR THE COUPLE

The following calculation shows the approximate tax savings assuming Richard is taxed at the top marginal tax rate of 46%1 before considering his capital gains or losses and Patricia is in a lower tax bracket and would save approximately 20%1 in tax from the capital losses if she used them for herself:

Increase in Patricia's taxes as a result of the transfer (she forfeits the tax savings on the capital loss, which is approximately $80,000 x 50% inclusion rate x 20%[1] tax rate)	$8,000
Decrease in Richard's taxes as a result of the transfer ($80,000 x 50% inclusion rate x 46%[1] tax rate)	($18,400)
Total estimated tax savings relating to the transfer of the capital losses	**$10,400**

We recommend you consult with your tax advisor prior to implementing this strategy to determine if you could benefit from it. As a result, the financial benefit of implementing this strategy may be partially reduced by any professional fees incurred.

Conclusion

In summary, you may transfer your unrealized capital losses to your spouse by following these steps:

- You sell the securities to your spouse at fair market value.
- Your spouse holds the securities at least 30 days.
- Your spouse sells all the securities on the market.
- You elect on your tax return that you wish to sell your securities to your spouse at fair market value rather than at cost.

This strategy may help you lower your family's overall income tax liability if you will not be able to use your capital losses or your spouse will be taxed at a higher marginal income tax rate.

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