



Worthless Securities

How You Can Claim a Loss for Canadian Tax Purposes

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One of the most frequently asked questions that the Financial Planning Advisory Team receives is about the requirements to be able to use a loss on a share or debt instrument ("security") for tax purposes when that security becomes worthless. To answer this question, an examination of the cause of the security becoming worthless must be undertaken. Once the cause of the loss is understood, steps can be taken to ensure that the loss can be realized for Canadian tax purposes in the current taxation year.

THREE WAYS TO BE ABLE TO CLAIM THE LOSS

It is possible to dispose of a worthless security in any of three possible ways in order to be able to use the loss for Canadian tax purposes. These three ways are described in depth in the following sections of this article. It is possible to have a deemed disposition of the worthless security under the Income Tax Act (ITA). Alternatively the worthless security can be disposed of to another individual (or possibly into the market). As a third alternative, clients of RBC Dominion Securities can now again consider disposing of the worthless security permanently to RBC Dominion Securities.

METHOD 1 - "WORTHLESS" AS DEFINED BY THE INCOME TAX ACT

Subsection 50(1) of the ITA allows for a taxpayer to elect on their tax return to have a deemed disposition of a worthless security at the end of the year that the security becomes worthless. The ITA also says that the taxpayer is deemed to reacquire the same worthless security immediately after the year-end. The proceeds of this deemed disposition would be zero, which would mean the amount of the tax loss would be equal to the Adjusted Cost Base (ACB) of the worthless security elected upon.

This special election can be made for a debt instrument acquired for investment purposes if it can be established that the debt became a bad debt during the course of the year. To be considered a bad debt, an investor must establish that all legal means to collect the debt have been exhausted or that the debtor has become insolvent and has no means of paying the debt.

In the case of shares, this special election is only available if any one of the three following conditions has actually occurred:

- The corporation whose shares are at issue has during the same calendar year become bankrupt as defined by the *Bankruptcy and Insolvency Act*; **or**
- The corporation whose shares are at issue has during the same calendar year become insolvent as defined in the *Winding-up and Restructuring Act* and a wind-up order has been issued pursuant to that Act; **or**
- The corporation whose shares are at issue at the end of the year meets **all** of the following four conditions:
 - a) the corporation is insolvent,

- b) the corporation is no longer carrying on any business,
- c) the fair market value of the corporation's shares is zero, **and**
- d) it is reasonable to expect the corporation will be dissolved or wound up and that it will not commence to carry on any business in the future.

If any one of these three conditions has not occurred, then it is not possible to use this section of the ITA to realize the loss on the worthless security for tax purposes. Another method will have to be used to realize the accrued loss in this situation.

One of the advantages of this method of realizing the tax loss is that the security never has to be disposed. For tax purposes, once the loss is realized, the ACB of the worthless security is equal to zero, the same amount as the deemed proceeds of the disposition.

Note that although the taxpayer is immediately deemed to reacquire the worthless security after triggering the loss for tax purposes, the superficial loss rules will not apply. The superficial loss rules do not apply in this very special case because there is a specific exemption in the ITA when an election is made under subsection 50(1) as described above.

To find out the status of a specific worthless security for purposes of subsection 50(1) of the ITA, advisors should be consulting publications such as the Financial Post's Survey of Predecessor and Defunct Companies. This publication lists name changes, amalgamations and acquisitions affecting Canadian public corporations; including companies being wound up and/or dissolved. Alternatively, advisors could contact the Royal Bank Library for assistance in doing the research on specific worthless securities.

SUPERFICIAL LOSS RULES

With any type of disposition of a security that is in a loss position, the individual must be aware of the superficial loss or "tax loss selling" rules.

These rules state that in order not to lose the ability to claim the loss on the disposed worthless security, the individual must ensure that the security was not reacquired by the individual, the spouse, or a corporation controlled by the individual and/or the spouse in the period that began 30 calendar days before the disposition and ended 30 days after the disposition. This means that a 61-day period must be considered for this rule (30 days before the disposition plus the day of the disposition plus 30 days after the disposition). For this reason, disposing of the worthless security directly to a spouse or a corporation controlled by the individual and/or the spouse will not allow for the realization of the tax loss. The loss will be denied to the individual disposing of the worthless security and the amount of the denied loss will be added back to the ACB of the security now held by the spouse or the corporation.

Further, if the worthless security is reacquired during this 61-day period, even if the reacquisition occurred in the following calendar year, the tax loss would still be denied.

METHOD 2 - ACTUAL DISPOSITION OF THE WORTHLESS SECURITY

Other than the issues of bankruptcy and insolvency raised above, there are several events that can cause a security to become worthless. A few of the possible causes are:

- The security has become delisted or no longer trades on an exchange;
- The company whose securities are at issue has just ceased operations;
- The derivative securities are so far out of the money, there is no value or market for them; or
- The security is under some kind of long-term cease trading order.

In these circumstances it is not possible to use the special election contained in subsection 50(1) of the ITA. As well, if the security is not trading it is next to impossible to reregister a security in another person's name or obtain a certificate from the transfer agent.

It may instead be possible to actually dispose of the worthless security to be able to realize the loss for tax purposes. If the security cannot be sold in the market, it may be possible to dispose of the worthless security by gifting it to another person. This gift to another person is very similar to selling the worthless security to that other person for its fair market value, which is often zero. For example, an individual may gift a worthless security to a brother. The worthless securities would end up in the account of the brother, and the original individual would have succeeded in disposing of the worthless securities for tax purposes. The individual would thus be able to claim the tax loss. From an administrative point of view, this transaction would be handled in a very similar way to that in which an in-kind gift of securities from a grandparent to a grandchild would be done.

Gifts of the worthless security to a child, a parent or grandparent could also work. It should be noted that if the worthless security is returned to the original holder subsequent to the expiry of the 30-day superficial loss period, there still may be doubt as to whether the tax loss was realized. The reason for this doubt is the issue of whether in substance a real disposition actually occurred, when at the time of the disposition there may have been a plan in place to return the worthless security to the original holder.

METHOD 3 - DISPOSING OF THE WORTHLESS SECURITY PERMANENTLY TO RBC DOMINION SECURITIES

If it is not possible to dispose of the worthless securities in any of the ways described above, a client can consider disposing of the worthless security to RBC Dominion Securities. Clients will not receive any consideration for any worthless security that is removed using this procedure.

In order to ensure that all of the criteria required for a loss to be claimed for Canadian tax purposes are met, the removal of a worthless security from a client's account must be permanent. In the very rare event that the worthless security is ever valued in the market, the client will not be able to reacquire the security from RBC Dominion Securities because the original disposition was a permanent disposition. Thus, if there is any possibility that the security will ever have value in the future, then an alternative method should be considered to claim the tax loss.

To remove a worthless security from a non-registered account, a client can simply contact their Investment Advisor and request that the worthless security be removed from their account. A letter will be sent to the client describing the security that was removed. As well, the removal of the security will be shown on the client's monthly statement.

For a worthless security in a registered plan such as an RSP or RIF, the client must provide written authorization to remove the worthless security from the registered plan. As well, RBC Dominion Securities will only remove the worthless security from a registered plan if the security is from a company that has either gone bankrupt or has been delisted. The removal of a worthless security from a registered plan will impact the book value of the plan and therefore it will affect the foreign content limits. For this reason, the foreign content limits should be carefully examined prior to the removal of any worthless security from a registered plan.

Additional information on the steps to take to remove a worthless security from a client's account using this procedure are available to advisors on the AdvisorNet, under OperationsNet, under Client Accounting, under Account Administration, under the document called "How to Remove Valueless/Worthless Security Positions from a Client's Account".

All of the previous discussions related to the superficial loss rules must be considered if there is any possibility of acquiring the same worthless securities in the future.

Note: This article is for information purposes only and should not be construed as offering tax advice. Individuals should consult with a qualified tax advisor before taking any action based upon the information contained in this article. The issues and strategies discussed in the article are based on Canadian tax laws in effect as of the date of this article.

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