



December 3, 2009

Valueless / Worthless Security Positions

How You Can Claim a Loss for Canadian Tax Purposes

This article explores the requirements to recognize a loss on a share or debt instrument ("security") for tax purposes when that security becomes valueless or worthless. To answer this question, you must examine the cause of the security becoming worthless. 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 a Loss

It may be possible to dispose of a worthless security in one of three ways in order to be able to recognize the loss for Canadian tax purposes. The three ways are:

- 1) The worthless security can be deemed to be disposed under Canadian tax rules.
- 2) The worthless security can be disposed of to another individual (or into the market, if possible).
- 3) Clients of RBC Dominion Securities may dispose of the worthless security permanently to RBC Dominion Securities.

METHOD 1 – DEEMED DISPOSITION UNDER THE CANADIAN TAX RULES

Under Canadian tax rules, you may elect on your tax return to have a deemed disposition of a worthless security at the end of the year that the security becomes worthless. These rules deem you to reacquire the same worthless security immediately after the year-end. The proceeds of this deemed disposition are zero. This means the amount of the tax loss would be equal to the Adjusted Cost Base (ACB) of the worthless security elected upon.

This election can also 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, you must:

- establish that all legal means to collect the debt have been exhausted; or
- establish 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 another method must be used to realize the accrued loss on the worthless security.

The primary advantage of this method of recognizing the tax loss is that the security is not actually disposed. For tax purposes, once the loss is realized, the ACB of the worthless security is zero, the same amount as the deemed proceeds of the disposition.

Note that although you are 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 are specifically exempted when these rules are elected.**

To find out the status of a specific worthless security for purposes of this election, you could consult 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.

No form is prescribed for this election; instead you should make this election in a letter stating that you request that subsection 50(1) of the Income Tax Act to apply to the shares in question. This election should be signed by you and attached to your return.

SUPERFICIAL LOSS RULES

With any type of disposition of a security that is in a loss position, you must be aware of the superficial loss or "tax loss selling" rules. These rules would apply to any disposition unless specifically exempted as above.

These rules state that in order not to lose the ability to claim the loss on the disposed worthless security, you must ensure that the security was not reacquired by yourself, your spouse, a corporation controlled by you and/or your spouse, or a trust in which either of you have a majority interest, in the period that began 30 calendar days before the disposition and ended 30 days after the disposition and the identical security is not held on the 30th day after the sale. This means that a 61-day period must be considered for this rule (30 days before the disposition, the day of the disposition, and 30 days after the disposition). The loss will be denied and the amount of the denied loss will be added back to the ACB of the security now held by your spouse or your corporation. This means that the ACB of the security now held would have the same ACB as the security that was sold.

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 these tax rules. 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, you may gift a worthless security to your brother. The worthless securities would end up in the account of your brother, and you would have succeeded in disposing of the worthless securities for tax purposes. You 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.

Gifting the worthless security to a child, parent or grandparent could also work. It should be noted that if the worthless security is returned to you 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 you.

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, you can consider disposing of the worthless security to RBC Dominion Securities. You will not receive any consideration for a 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 your account must be **permanent**. In the very rare event that the worthless security is ever valued in the market or the security distributes monies you will not be able to reacquire the security or the distribution of monies 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 you may want to choose an alternative method to claim the tax loss.

To remove a worthless security from a non-registered account, you can simply contact your advisor and request that the worthless security be removed from your account. A letter will be sent to you confirming the security that was removed. As well, the removal of the security will be shown on your monthly statement and the annual Summary of Security Dispositions statement. The disposition will also be reported to the Canada Revenue Agency and Revenue Quebec where applicable.

For a worthless security in a registered plan such as an RSP or RIF, you 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.

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.



This publication is not intended as nor does it constitute tax or legal advice. Readers should consult their own lawyer, accountant or other professional advisor when planning to implement a strategy. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. The examples provided in this article are for illustration purposes only and are not indicative of future returns; fees and commissions are not included in these calculations.

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information.

RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member CIPF. ©Registered trademark of Royal Bank of Canada. RBC Dominion Securities is a registered trademark of Royal Bank of Canada. Used under licence. ©Copyright 2009. All rights reserved.