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Capital Losses and Tax Loss Selling

A summary of the tax rules and opportunities surrounding capital losses

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If you have investments in your securities portfolio that are in a loss position, you may face the possibility of realizing capital losses when you dispose of these investments. This article describes how you can maximize the opportunities associated with tax loss selling to help reduce your tax liability or obtain refunds of taxes paid in previous years.

Capital losses on individual securities

When you sell a security at a loss, you can use 50% of this capital loss (called an “allowable capital loss”) to offset taxable capital gains that you realize in the same year. This may reduce your tax liability for that year. Unfortunately, losses realized in your investment portfolio may be used against capital gains only — they cannot be used to reduce your other income for the year such as employment income.

Net capital losses

Capital losses realized in a given year must first be used to offset capital gains realized in the same year to reduce the current year’s tax liability. When you have no capital gains in the current year or your capital losses in the year exceed your capital gains, the remaining capital loss is known as a “net capital loss.”

You can carry a net capital loss back and apply it against taxable capital gains realized in any of the previous three years, which could result in a refund of capital gains tax paid in those years. For example, losses realized in 2008 could be applied against net capital gains realized in 2005, 2006 or 2007.

You can also carry net capital losses forward indefinitely to use against taxable capital gains in future years.

Why use capital losses?

There are a number of reasons why you may wish to trigger capital losses. For example:

- A particular security no longer meets your investment criteria
- You wish to reduce your tax liability for the current year by offsetting your capital gains realized in the year
- You wish to recoup taxes paid on capital gains realized in 2005, 2006 and 2007 by carrying back net capital losses realized this year
- You have triggered gains by making gifts of securities to your beneficiaries during your lifetime as part of your estate plan and wish to offset these gains to minimize the tax impact of such transfers
- You have sold your business and have realized a sizable gain on the disposition of your shares
- You have realized a capital gain on the sale of real estate that is not your principal residence
- You reported sizable capital gains on your 2005 tax return, and therefore, 2008 is the last year you can realize excess capital losses to carry back to your 2005 tax return

Other ways to realize capital losses

According to our tax rules, there are certain situations where you could realize a capital loss if a security declined in value even if you did not sell it on the market. These include:

- Deemed dispositions such as:
    - Transferring a security to an individual other than your spouse
    - Transferring assets to any person other than your spouse or a spousal trust upon your death
    - Transferring assets to a family trust if you or your spouse is not a majority-interest beneficiary
- Deemed dividends received from a corporation in certain circumstances
- Deemed dispositions of worthless securities disposed of in certain ways

How to carry back a capital loss

Carrying back a capital loss is a relatively easy process. Use CRA form T1A to request that the net capital loss realized in 2008 be applied to any of the three previous tax years and attach the completed form to your income tax return. The CRA will use this form to reassess your prior year's tax return to apply your net capital loss and issue a refund.

Be aware of superficial loss transactions

In order to be able to claim a capital loss on the sale of a security, it's important to ensure that the transaction is not a superficial loss. A superficial loss is triggered when both the following events occur:

- 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 acquires the identical property that was sold at a loss; and

- At the end of that period (i.e. 30 days after the settlement date of the disposition), you or a person affiliated with you owns or has a right to acquire the identical property.

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