Wealth Management

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Claiming losses on worthless securities

This article explores the requirements to recognize a loss on a share or debt instrument ("security") for tax purposes when that security becomes 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.

The content in this article is for information purposes only and does not constitute tax or legal advice. It is imperative that you obtain professional advice from a qualified tax advisor before acting on any of the information in this article. This will ensure that your own circumstances are properly considered and that action is taken based on the most current legislation.

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) The worthless security can be disposed of permanently to a financial institution.

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 for proceeds equal to nil at the end of the year that the security becomes worthless. These rules also deem you to reacquire the same worthless security immediately after the year-end at a cost equal to nil. This means the tax loss realized would be equal to the adjusted cost base (ACB) of the worthless security.

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.

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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 this 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 nil; **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 of. For tax purposes, once the loss is realized, the ACB of the worthless security is nil.

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 exempt when this election is made.**

To determine 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. Also note that a cease trading order does not necessarily mean the company is insolvent or worthless for the purposes of this election.

There is no prescribed form for making this election; instead you should make this election in a letter stating that you request that subsection 50(1) of the Income Tax Act (the "Act") to apply to the security in question. This election should be signed by you and attached to your tax return. For returns filed electronically, the election along with supporting documentation must be submitted in writing.

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 a long-term cease trading order.

In these circumstances it is not possible to use the 50(1) election. As well, if the security is not trading it is almost impossible to reregister a security in another person's name or obtain a certificate from

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 who can be related or unrelated to you. You will need to ensure that the person is not your spouse or minor child.

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 who can be related or unrelated to you. If you gift the worthless security to a family member, you will need to ensure that the person is not your spouse or minor child. Gifting the worthless security is very similar to selling the security to that other person for its fair market value, which, in this case, is often nil. For example, you may wish to gift the worthless security to your brother. The worthless security would end up in your brother's account, and you would have succeeded in disposing of the worthless security and claiming the loss for tax purposes.

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 rules. These rules would apply to any disposition for tax purposes unless specifically exempt as in the first method discussed above.

These superficial loss 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 that 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 you, your spouse, your corporation, or your trust. This means that the ACB of the security now held would have the same ACB as the security that was previously 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.

In the scenario discussed above, where the worthless security is gifted to another person, 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 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 occurred. It could be argued that at the time of the disposition there may have been a plan in place to eventually return the worthless security to you.

Method 3 – Disposing of the worthless security permanently to a financial institution

If it is not possible to dispose of the worthless security in any of the ways described earlier, you can consider disposing of the worthless security to a financial institution. Generally, you will not receive any consideration for a worthless security that is removed from your account using this procedure.

In order to be able to claim the loss for tax purposes, 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 income, you will not be able to reacquire the security or receive the distribution of income from the financial institution that acquired the worthless security because the original disposition was permanent. Therefore, if there is any possibility that the security will ever recover in the future, you may want

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to choose an alternative method to claim the tax loss.

To remove a worthless security from a non-registered account, you will need to contact a financial institution to determine the procedure you will need to follow. You should get a confirmation letter or receipt that the security was removed from your account. As well, the removal of the security will be reported to you in your tax package and reported to the Canada Revenue Agency and Revenu Quebec where applicable.

It is possible to remove a worthless security from a registered plan such as an RRSP or RRIF. Again, you will need to follow the financial institution's procedure for removing the security.

The superficial loss rules must be considered if there is any possibility of acquiring the same worthless securities in the future as there is no exemption from the superficial loss rules where you choose to dispose of a worthless security in this manner.

Conclusion

If you currently own a worthless security, you may want to claim the loss to offset capital gains you have realized. If you would like to do so, speak with your qualified tax advisor to determine which method of claiming the loss makes sense to use in your circumstances.