The Navigator

Capital Losses and Tax Loss Selling

A summary of the tax rules and opportunities surrounding capital losses

If you have investments in your securities portfolio that are in a loss position, you may realize 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 for taxes paid in previous years.

Prior to implementing any tax planning strategies, a qualified tax advisor should be consulted about the tax implications specific to your situation.

Capital Losses on Individual Securities

When you sell a security at a loss, 50% of this capital loss (called an "allowable capital loss") will 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 only be used against capital gains — they cannot be used to reduce other income you have earned in the year such as your 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 allowable capital losses in the year exceed your taxable capital gains, the remaining allowable 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 taxes paid in those years. For example, net capital losses realized in the current tax year (Year 4) could be applied against taxable capital gains realized in the previous three tax years (Year 1, Year 2 or Year 3).

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

Why Trigger Capital Losses?

There are a number of reasons why you may wish to trigger capital losses, including the following:

- A particular security no longer meets your investment criteria;
- You wish to reduce your tax liability for the current year by offsetting your taxable capital gains realized in your investment portfolio in the year;
- You wish to recoup taxes paid on net capital gains realized in the previous three years by carrying back net capital losses realized in the current year;
- You have triggered capital gains by making gifts of securities to your beneficiaries during your lifetime as part of your estate plan and wish to offset these capital gains to minimize the tax impact of such transfers;
- You have sold your business and have realized a sizable capital gain on the disposition of your shares;

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- You have realized a capital gain on the sale of real estate that is not your principal residence; and
- You reported sizable capital gains three years ago on your tax return, and therefore, the current year is the last year you can realize excess capital losses to carry back to that prior year.

Other Ways to Realize Capital Losses

There are certain situations where you may realize a capital loss even if you did not sell the security 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; and
  - Transferring assets to a family trust if you or your spouse is not a majority-interest beneficiary.
- Deemed dispositions following a redemption of shares by a corporation in certain circumstances
- Deemed dispositions of worthless securities by way of an election

How to Carry Back a Capital Loss

Carrying back a capital loss is a relatively easy process. Use Canada Revenue Agency (CRA) form T1A to request that the net capital loss realized in the current year 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, where applicable. However, note that your net income for the previous years, which is used to calculate certain credits and benefits, will not change.

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 transaction. A superficial loss is triggered when both of 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.

If a superficial loss is triggered, you will not be allowed to claim the capital loss and therefore will not be able to offset this amount against any taxable capital gains. The amount of the capital loss will be added to the adjusted cost base of the identical property acquired.

Please contact us for more information.

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