Tax Loss Selling

The information contained in this article is a high level overview of some of the aspects of tax loss selling from a Canadian tax perspective. It is intended for general information purposes only.

What is tax loss selling?

Tax loss selling is a tax strategy which involves selling unprofitable securities and using the realized losses to offset capital gains realized in the current year thereby reducing the amount of taxes owing. Tax loss selling is simply a tax strategy to minimize capital gains from other sources

If the amount of capital losses in a given year exceeds that of capital gains, the excess capital losses (known as net capital losses) can be carried back and applied against net capital gains realized in any of the previous three years (or carried forward indefinitely) for a tax refund.

The Canada Revenue Agency (CRA) form T1A – Request for Loss Carryback is used to carryback net capital losses to a prior year.

Generally speaking, losses are usually carried back and applied against gains in the earliest of the past three years first. However, if your marginal tax rate varied significantly in the past three years, you may wish to apply the loss carryback to the year with the highest marginal tax rate (assuming you had net capital gains in that year) if your goal is to receive the most tax refund per dollar of loss carryback.

While tax loss selling may be beneficial from a tax planning perspective, the decision to sell a particular security should also be based on its investment merits, and your long-term goals.

Superficial loss

In order to claim a capital loss on the disposition of a security, you should make sure that the loss is not a superficial loss. Generally this means you cannot buy the identical security during the period that begins 30 days before and ends 30 days after you have disposed of that security, and still own that security at the end of that period (i.e. 30 days after the disposition).

The superficial loss rules will also apply in the case where your spouse or common-law partner (hereinafter collectively referred to as the "Partner"), or a company controlled by you and/or your Partner purchases an identical security that you have sold during the 61-day period, and own the security at the end of that period.

The effect of the superficial loss rules is that you cannot claim the loss as a capital loss. Rather the amount of the loss is added to the adjusted cost base of the identical security purchased.

As an example, suppose you sold 100 shares of XYZ Ltd. today for a loss of $100 and you immediately buy back the same 100 shares at a cost of $1,000 and held onto those shares for more than 30 days. In this case you will not be able to claim the $100 loss as a capital loss. However, the $100 is added to the adjusted cost base of your reacquired shares which is now $1,100 ($1,000 + $100). This will effectively reduce any future capital gains from the subsequent disposition of these shares. In the preceding example if only 50 shares were repurchased and owned beyond the 30-day period, then 50% of the loss may be claimed as a capital loss, and the remaining 50% added to cost of the shares reacquired.

Settlement date

For superficial loss purposes, the 61-day period is from settlement date to settlement date. For example, if you sell your shares on the Toronto Stock Exchange on October 19, 2012 the transaction will settle on October 24, 2012. To avoid the application of the superficial loss rules, this means you cannot acquire these shares between September 24, 2012 and November 23, 2012 settlement dates. This in turn means you must purchase the shares on or before September 19, 2012, or on or after November 20, 2012 to avoid a superficial loss.

Identical property

Another aspect of the superficial loss rules is that an identical property must be acquired for these rules to apply. The CRA in an Interpretation Bulletin (IT-387R2) provided its view that identical properties are properties that are the same in all material respects so that a prospective buyer would not have a preference for one as opposed another.

The determination of what constitutes an identical property can be quite tricky. For example, the CRA has opined in one of its past documents that it considers an index fund that tracks the performance of the TSX Composite Index from one financial institution to be identical to that from another financial institution. Professional tax advice is strongly recommended to assist in the determination of identical properties.

Superficial loss transactions

The following are examples of transactions that may be considered as superficial loss transactions if they occurred within the 61-day period previously described:

1) Sell a security in a non-registered account, and repurchase the identical security in a RSP/RIF.
2) Sell a security in a non-registered account, and repurchase the identical security in a managed account or vice versa.
3) In-kind transfer of an unprofitable security to a RSP/RIF. In this case, the loss is permanently denied.
4) Switches to different versions (e.g. deferred sales charge to front-end) of the same mutual fund.
5) Sell shares and then purchase call options on those shares if the options are held beyond the 30-day period.

Examples of transactions that may not be considered as superficial loss transactions include:

1) Purchasing the identical security outside the 61-day window period. It should be noted that if the identical security is purchased ahead of the sale, it may affect the average cost of the security, and thereby the size of the loss in the subsequent sale.
2) Transfer the security to a child or parent.
3) Sell common shares and purchase preferred shares.
4) Sell shares of one company and purchase shares of a similar company.
5) Switch from one mutual fund trust to another mutual fund trust in the same asset category.
6) Switch from one mutual fund trust to a similar mutual fund corporation or vice versa.

Stop-loss rules

The superficial loss rules apply to individuals seeking to claim a loss. Where it is a company that is seeking to claim a loss, the stop-loss (and not superficial) loss rules will apply. If a company controlled by an individual and/or his/her Partner disposes of a security at a loss, and the identical security is repurchased by that individual or his/her Partner within the 61-day window period, the stop-loss rules will apply to suspend the claiming of the loss by the company until such time as the identical security is disposed of by that individual or his/her Partner.

Transferring unrealized losses to a Partner

It is possible to transfer capital losses from one Partner to another. This is something that may be worth considering where one Partner has realized capital gains and the other Partner has unrealized losses but no gains with which to offset.

In this case the Partner with the unrealized losses can sell that security on the open market, and the other Partner can repurchase that security immediately also on the open market. The resulting superficial loss transaction would cause the amount of the loss to be added to the cost of the security purchased.

After 30 days, and assuming the market value of the security has not changed appreciably, the security can be sold and the loss can be claimed by the Partner who purchased the security. A tax election may have to be filed by the Partner who disposes of the security to complete the transaction.

As with all tax planning, professional advice and assistance from a qualified tax advisor is strongly recommended. With some careful planning and professional advice, you can turn tax loss selling into tax loss winning.

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