Turn a loss into a Gain

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An earlier version of this article appeared in National Post November 1, 2008. Updated to January 2018.

The strategic ability to use capital losses becomes the number one tax topic in years with tumultuous markets.

Under the tax rules, capital losses may only be applied against capital gains. If you have no capital gains in the current year, the capital loss may be carried back and applied against any capital gains in the prior three years or may be carried forward indefinitely to offset future gains.

While there are a number of tax strategies available to minimize losses, you always need to be mindful of the superficial-loss rule that can throw a wrench into your tax planning.

Generally, a superficial loss will occur if you dispose of an investment at a loss and the investment is then reacquired either by you or an affiliated person within 30 days before or after the disposition date. The tax law defines an affiliated person to include, among others, your spouse or common-law partner as well as a corporation controlled by either of you, or a trust of which either of you are a majority beneficiary (such as your RRSP or TFSA).

The consequence of having a superficial loss means that the capital loss cannot be realized immediately. Instead, it must be added to the adjusted cost base (ACB) or tax cost of the investment, to be recognized upon ultimate disposition or sale of the investment.

So, can you ever use the superficial loss rules to your benefit?

Consider the following scenario: Maureen inherited some ABC Company shares years ago which now have an accrued capital gain of $10,000. She has no capital losses to shelter those gains should she sell the shares.

Her husband, Victor, has a portfolio that has been decimated by market events and he finds himself sitting on $10,000 of losses on his shares of XYZ Corporation, which he originally acquired for $50,000 and are now worth $40,000.

Unfortunately, Victor has no other gains this year nor did he have any gains in the prior three years which could be offset by this $10,000 loss.

Suppose that Victor sells the shares on the open market and receives proceeds of $40,000. The same day, his wife, Maureen, buys $40,000 of XYZ shares. Victor's loss will be deemed to be superficial since Maureen acquired the shares within 30 days of his disposition. That means that the superficial loss of $10,000 is added to the ACB of Maureen's shares, bringing her new tax cost up to $50,000 ($40,000 + the $10,000 superficial loss). If Maureen now waits at least 30 days before selling (assuming no further market declines in the value of the XYZ stock) she will realize a capital loss of $10,000 (proceeds of $40,000 minus her ACB of $50,000), which can then be used to offset the accrued gain of $10,000 when the ABC Company shares are sold. Sound fishy? This strategy has actually been blessed by the Canada Revenue Agency in several technical interpretations.

Investors should speak to a qualified tax advisor before implementing the strategy. In addition, transaction fees and market fluctuations will need to be taken into consideration.

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Disclaimer:

As with all planning strategies, you should seek the advice of a qualified tax advisor.

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