

Capital loss planning

Market downturns can provide planning opportunities to take advantage of losses and offset other capital gains. This *InfoPage* explains some of the pitfalls to avoid and offers tax strategies you can use to decrease your losses. After all, financial planning is essential when the markets go down, as well as up.

Planning for net capital losses

A capital loss must first be applied against any capital gains (including capital gains distributions) of the current year. However, once these capital gains have been used, the balance of the loss may either be carried back to offset capital gains in any of the three prior years or carried forward indefinitely to offset capital gains of future years.

If you have realized significant capital losses this year, there's a temptation to try to realize gains later in the year to offset some of these losses immediately. However, if you have net capital gains in any of the three previous years, you can also consider applying the net capital losses realized this year against the net capital gains realized in any one or more of those years. This way, you can receive a partial or full refund of the capital gains taxes you previously paid. If you have net gains in more than one of those years, there is no requirement that you must apply the loss against the earliest year first. For example, if you realized a net capital loss in 2008, and net capital gains in 2007 and 2005, you may choose to offset the loss this year against the gains in 2007 first as opposed to 2005. You may want to do this if your personal tax rate was higher in 2007 than in 2005 and you would like to maximize the amount of refund you receive or reduce the amount you owe.

Alternate strategies

There are a number of strategies you may consider if you have accrued losses in investment portfolios. With proper planning you can realize and use them on a tax-effective basis. The following strategies generally assume that the investment will continue to be held in some form even though the accrued loss will be realized and used.

Beware the superficial loss rule

Canada's tax rules require you to wait at least 30 days before repurchasing the same property if you want to be able to claim the full amount of the capital loss. This is known as the superficial loss rule. In addition, if you or your spouse/common-law partner purchase property identical to that sold within the period that begins 30 days before and ends 30 days after the disposition, and still hold it on the 30th day after the disposition, then the loss on the original sale will be superficial. A superficial loss is denied and cannot be claimed. The denied loss is added to the adjusted cost base of the acquired property.

The superficial loss rule also applies if the property is acquired by a company controlled by you and/or your spouse/common-law partner during the period outlined above. Finally, recent changes to the superficial loss rule also apply to trusts on which you or your spouse/common-law partner is a majority interest beneficiary. As a result, the strategy of selling property held in a non-registered account and reacquiring the property inside an RRSP or RRIF is no longer available.

If you want to realize a capital loss, but you are concerned about being out of the market for 30 days, then the following approaches may be considered.

Transfer the mutual fund units to a child or parent

The superficial loss rule, however, does not apply in the case of an immediate acquisition of the same units by a child or a parent. Therefore, it may be possible to realize a loss by transferring the mutual fund units to a child or parent.

Transfer from trust to corporate version of same mutual fund

Mutual funds can be set up legally as trusts or corporations. Many corporate funds have different classes of shares. Each class represents a different portfolio of securities, with a different investment mandate (e.g., technology, Europe, etc.) An investor may switch between the fund's different classes of shares without triggering a taxable event. If you have an accrued loss on the trust version of a particular mutual fund you could switch to the corporate version of that fund and crystallize the loss. A switch either way between the trust and the corporate class is considered to be a disposition. When the other version of the fund is purchased, there is no superficial loss. This is because you are buying back a different legal structure, and not an identical property.

Purchase another mutual fund trust in the same category

As an alternative to switching from a mutual fund trust to a mutual fund corporation, it may also be possible to realize a loss by switching from one mutual fund trust to another mutual fund trust in the same category. For example, it may be possible to realize the loss incurred from one Canadian equity fund trust by switching to another Canadian equity fund trust within the same family. The ability to claim the loss in this case will hinge on whether the two Canadian equity fund trusts are considered to be "identical," and professional advice should be sought in this regard.

Spousal (common-law partner) transfer of losses

This is a strategy that can be used if you have a loss but cannot use it. If your spouse can use it, you can transfer the loss without having an attribution problem.

Example:

Adam and Eve are married. Eve has a capital gain this year (or in the past three years) and Adam has a capital loss this year he cannot use.

Adam has an accrued loss on Company A shares:

Adjusted cost base (ACB) of Company A	\$11,000
Fair market value (FMV) of Company A	\$1,000
Accrued loss	(\$10,000)

Step 1: Adam sells shares to Eve for \$1,000

Adam may sell the shares to Eve by using a promissory note bearing the Canada Revenue Agency's (CRA) prescribed interest rate. The interest must be paid in respect of each taxation year not later than 30 days after the end of the year. The loss is denied because Adam sold the shares to his wife, Eve, and therefore the loss is a superficial loss.

FMV of Company A	\$ 1,000
ACB of Company A	(\$11,000)
Capital loss - superficial loss	(\$10,000)

The superficial loss is then added to Eve's ACB as follows:

Denied loss added to ACB:	\$ 1,000
Amount paid	\$10,000
Denied loss	\$11,000
New ACB	

Step 2: Eve sells shares on open market after 30 days

In order for Eve to add the denied loss to her ACB, the loss must be superficial. The final criteria to establish a superficial loss requires the spouse to own the property 30 days after the original disposition. As a result, Eve waits more than 30 days to sell the shares.

FMV of Company A	\$ 1,000
ACB of Company A	(\$11,000)
Capital loss	(\$10,000)

Step 3: Elect out of automatic rollover - Subsection 73(1)

Since Eve paid FMV for the shares, there is no attribution of the capital loss back to Adam as long as Eve elects out of the automatic rollover. Under subsection 73(1) of the *Income Tax Act* (Canada), any property transferred to a spouse (common-law partner) is transferred at ACB. An election out of subsection 73(1) will allow the transaction to occur at FMV, and the attribution rules will not apply as Eve paid Adam FMV for the shares.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invescotrimark.com.

Procedure to carry back a loss

The procedure to carry back a loss from the current year to any of the three preceding years is quite simple - you just need to complete CRA Form T1A "Request for Loss Carryback." It's available on the CRA website and included in most tax preparation software packages. On this form you select the year(s) in which you wish to apply the capital loss. The CRA will reassess your return for that year and mail you a refund cheque.

The best option

While the topic of losses is not something that most individuals wish to discuss, considering one or two of the above strategies may go a long way towards mitigating some of the pain associated with these losses. Nevertheless, every family and individual is unique, so it is important that you talk with your advisor, lawyer and/or tax advisor to find out the options that are best in your situation. Once you have your plan in place, don't forget to review it from time to time, or as your circumstances change.

The information provided is general in nature and is provided with the understanding that it may not be relied upon as, nor considered to be, the rendering of tax, legal, accounting or professional advice. Readers should consult with their own accountants and/or lawyers for advice on the specific circumstances before taking any action. Commissions, trailing commissions, management fees and expenses may all be associated with mutual fund investments. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Please read the simplified prospectus before investing. Copies are available from your advisor or from Invesco Trimark.

* Invesco and all associated trademarks are trademarks of Invesco Holding Company Limited, used under licence. Trimark and all associated trademarks are trademarks of Invesco Trimark Ltd.

© Invesco Trimark Ltd., 2008

TECALPE(10/08)

