Tax-loss selling could save you money

Do you have investments in a non-registered account that have dropped in value? It might make sense to remove some of the sting by using a strategy called tax-loss selling.

Tax-loss selling involves selling securities with accrued capital losses before the end of the year. The capital losses would be first applied against any realized capital gains in 2020, thus reducing your 2020 tax bill, and to the extent the capital losses exceed capital gains in 2020, they could be carried back to a previous year to trigger a refund.

Is tax-loss selling appropriate for you? Here are seven key points to consider:

1. Any decision to sell a security should be driven by investment considerations, not merely the desire to eliminate or reduce taxes.

Just because an asset has declined in value doesn't mean it is no longer an appropriate investment for your needs. Consider how long it may be before the investment might rebound and, if you plan to repurchase it, keep in mind transaction costs and the risk that it will rebound before you repurchase it.

2. Determine whether you can actually benefit from the tax-loss selling strategy.

Tax-loss selling only provides tax savings if you otherwise expect to have overall capital gains for 2020, or have reported capital gains overall on your 2017, 2018 or 2019 tax returns. If you did not report capital gains in any of the three prior tax years, net capital losses for 2020 can be carried forward indefinitely to offset future capital gains.

3. Keep the superficial loss rules in mind.

You should consider the superficial and denied loss provisions of Canada's Income Tax Act, which were implemented to prevent the recognition of artificial capital losses. If you sell an investment, you or an affiliated entity (such as your your spouse, common-law partner (CLP) or your RRSP or TFSA) cannot purchase the identical investment 30 days prior, or 30 days following your disposition if your desire is to make use of your capital loss.

4. Can your spouse benefit from your loss?

If you have unrealized capital losses, but no capital gains against which to apply the capital losses, you may be able to transfer the losses to your spouse or CLP. You would trigger a capital loss by selling a security that has dropped in value, and your spouse would then acquire the identical security on the open market – within 30 days of your sale. This would cause your capital loss to be deferred because of the superficial loss rules. The deferred loss, however, would be added to the adjusted cost base of your spouse's purchase which, after waiting 31 days to clear the superficial loss period, he or she would be able to claim on the future sale of the security. This is an effective strategy where one spouse has realized capital gains and the other has unrealized capital losses.

5. Corporate class shares may allow you to generate a tax benefit while remaining fully invested.

Switching from a CI mutual fund trust to an equivalent CI corporate class fund may create a capital loss that you can use to offset capital gains.

6. December 29, 2020 is the last day to execute a trade on a Canadian stock exchange that would settle in 2020.

If you make a trade after this date, it would settle in 2021 – too late to be used for tax-loss selling for the 2020 tax year.

7. Proceeds from tax-loss selling can be rolled into your tax-free savings account.

The TFSA is available to Canadians aged 18 and older. TFSAs are an ideal home for proceeds generated from tax-loss selling because investments within these accounts grow tax-free and no tax is payable when securities are withdrawn. TFSA-eligible investments include stocks, mutual fund units, corporate class shares, segregated fund interests and bonds. To avoid having capital losses denied, you must comply with the superficial loss rules which means, triggering the loss in the non-registered environment (perhaps by switching to cash or a different security) and waiting 31 days before reacquiring the original security within the TFSA. Also, be mindful of denied loss rules that prevent the use of capital losses when a security with an unrealized loss is transferred directly to a registered plan. For more information, see our whitepaper, "In-kind transfers to registered plans: Dealing with superficial and denied loss rules".

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