Making lemonade out of tax losses

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Many of us started the year by looking ahead with bright hopes that 2020 would be a successful year for investors. Who would have thought that quarantine was going to be the most popular word of the first quarter?

The coronavirus has forced us to look at most of our day to-day actions with a new, flexible and wider perspective, requiring us to practice patience. Moreover, as regards our industry, investors have been caught by unexpected and substantial reactions to COVID-19, thereby creating mixed feelings towards investment decisions. These circumstances brought back a topic that is more relevant than ever: tax loss harvesting.

The various fluctuating movements in the markets have brought capital losses to many investors. While being in a loss position is not a desirable situation for anyone, when forced to realize capital losses, investors should take advantage of this unfortunate situation to create a favourable tax position whenever possible.

When a taxpayer realizes a capital loss, 50% of the realized loss will be considered, for tax purposes, as an allowable capital loss to offset any taxable capital gain (being 50% of any realized capital gain). While the utilization of allowable capital losses is limited to taxable capital gains, the Income Tax Act (ITA) allows a taxpayer to carry back unused capital loss balances for a period of three years or carry them forward indefinitely. These rules apply to individuals and corporate taxpayers.

For investors who have already realized tax losses, or those contemplating the option to sell their current investments held in non-registered accounts, the following tax strategies will allow them to convert capital losses into tax advantages.

Investors' gain and loss positions

The core objective of risk diversification is to maximize the potential gain one can realize by holding different investments in a portfolio. Distinct investments also imply that while one investment may be in a gain position for an investor, another asset may be in a loss position. When the investor faces this dual reality, tax loss utilization should be a key factor when deciding to sell a specific investment. If the investor has already realized capital gains for the year and has the opportunity to sell or redeem another investment with a pending capital loss, when realized, the allowable capital loss will result in the partial or total offset of taxable capital gains that would otherwise be included in the taxpayer's taxable income for the given year. The net effect of this offset will either reduce any tax payable or increase any tax refund due.

Furthermore, for investors holding investments with pending capital gains, where selling such investments in the short term was a potential option, the sale of these investments to crystalize pending capital gains is also a tax-efficient strategy, where the investor has realized capital losses. Again, considering the two offsetting positions, this will create a tax advantage for the taxpayer. Any taxpayer using such a strategy could repurchase the same investment, or a similar one, following the transaction. Investors considering this should be mindful of the superficial loss rules.

Superficial loss rules

The ITA provides a set of rules that prevent a taxpayer from deducting a capital loss where, before or after the sale of a property, the same property or an identical property (referred to as a "substituted property") is purchased, either by the taxpayer or an affiliated person. While the concept of affiliated persons is not the core subject of this article, one should note that an individual is deemed to be affiliated to her/himself, and spouses are affiliated to each other.

There is a period of time in which an investor (or affiliated person) cannot buy a substituted property. This period is 60 days, consisting of the 30 days preceding the sale, the day of the sale and the 30 days following the sale. Capital losses of investors who purchase substituted properties during this period will be denied and added to the adjusted cost base of the substituted property. This denied loss is referred to as a superficial loss. The Canada Revenue Agency's definition of substituted properties is, "properties which are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to another".

Investors tempted to buy back the same or identical property through a controlled corporation (commonly referred to as a holding company), should be aware that a corporation controlled by a taxpayer or her/his spouse is considered an affiliated person. As such, if a taxpayer's holding company purchases a substituted property within the 61-day period, the capital loss realized by the individual will be denied and added to the adjusted cost base of the substituted property purchased by the company.

While the superficial loss rules are carefully kept as part of an efficient tax planning strategy, the negative consequences can be avoided or limited.

Finally, some investors may want to force the application of superficial loss rules in cases where their spouse has realized capital gains for a given year. If the spouse purchases a substituted property, while the capital loss realized by the investor will be denied, it will be added to the adjusted cost base of the spouse's newly purchased substituted property. Following this transaction, the spouse can sell the substituted property 30 days after the date of the initial sale by the investor and realize a capital loss that will be used to offset any realized capital gain. This is another strategy that can create a tax advantage in a household.

Mutual fund switches

Where an investor wants to benefit from unrealized capital losses on investments held in a mutual fund trust, mutual fund corporation, or exchange-traded fund (ETF), in order to avoid the superficial loss rules, an effective tax strategy involves selling the investment held in the mutual fund trust and purchasing the equivalent fund in the mutual fund corporation or ETF version (or vice versa). Trusts, corporations and ETFs are not structured in the same manner, so these three investments won't be considered identical properties, and therefore not subject to the superficial loss rules.

Exchanged-traded funds

For investors holding ETFs with unrealized capital losses, the superficial tax loss rules should also be a potential issue of concern. In order to benefit from unrealized capital losses, while benefiting from decreasing markets, investors can avoid the superficial loss rules by selling their ETFs and repurchasing other ETFs tracking a different but similar index. For example, if a taxpayer sells an index-based security, such as an ETF, which tracks 300 companies within a specific industry, then purchases (within the 61- day superficial loss period), another index-based security that tracks 150 companies in the same industry, the two properties would not generally be considered identical.

Finally, switching from one ETF provider to another one that offers similar risk exposure, while using different strategies and structures, could be an effective tax strategy to avoid the superficial loss rules. Be cautious here, because whether the two investments are considered identical or not is a question of fact and depends on the characteristics of each investment.

As the preceding tax strategies show, while many investors are facing the reality of capital losses in the midst of the coronavirus crisis, they can convert them to tax efficient tools that could put them in a tax gain position.

When life gives you tax losses… make lemonade.

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