



Taking Advantage of Tax-Loss Harvesting

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The fall is a good time of year to review your financial plan before the year end and it's too late to improve your results for the year. Your review could include an assessment of whether or not your portfolio needs to be rebalanced so that it continues to reflect your preferred asset mix, geographic positions and sector weightings. Another thing to consider when reviewing your portfolio's progress and rate of return is the tax you are paying on your investment income. While you cannot control the markets, you do have some influence over taxes.

Twenty-eleven has been a very volatile year and, as of the time of writing, world equity markets are in a negative position on a year-to-date basis. If some of your investments have accrued losses you may want to consider triggering some losses to offset the taxes you would otherwise owe on capital gains that you realized during 2011. This type of action is referred to as tax-loss selling or harvesting.

How it Works

An investor may have sold some investments during the year at a profit and also have some investments that have decreased in value since they were purchased. He or she would decide to sell some or all of these investments at a loss in order to reduce his or her capital gains and/or to weed out the investments expected to continue to underperform. It's important to note that investment fundamentals should still play the most important role in determining which stocks to sell. Harvesting the tax loss is a secondary consideration.

For example, an investor who bought 1,000 shares of company ABC at \$10 per share sees that it is currently trading at \$5 per share. He or she decides to sell the shares and incurs a \$5,000 capital loss. Fifty percent of this loss (\$2,500) is the allowable capital loss that can be applied against a taxable capital gain. For an investor

in the highest Ontario tax bracket (46.41% in 2011), sheltering a \$2,500 taxable capital gain from taxation by applying an allowable capital loss results in a tax savings of approximately \$1,160. (Note that capital losses can be applied against capital gains only and not against other sources of income.)

If the investments with accrued losses are still considered good investments an investor may sell with the intention of repurchasing it. In these situations investors need to be aware of the superficial loss rules.

Superficial Loss Rules

In order to reduce taxable capital gains, investors must wait at least 30 days after selling a stock before repurchasing it, even if the transactions occur in different accounts. Otherwise, Canada Revenue Agency will consider the sale to be a "superficial loss", which can't be used to offset capital gains. Transferring in kind to registered accounts, such as RRSPs or Tax-Free Savings Accounts during the 30-day period, will not work either.

Selling and re-purchasing that involves someone or a corporation affiliated with the investor is not a way around the 30-day rule either. Examples of affiliated persons include a spouse or common-law partner, and a corporation that is controlled by the investor and his or her spouse.

The restriction also applies to any purchase in the 30 days before the security is sold, so purchasing the same shares before the sale won't help with the 30-day rule. Dividend reinvestment plans and systematic monthly deposits that have occurred in the previous or following 30-day period may also impact whether or not a capital loss is allowed.

To avoid holding cash for the 30-day period, an investor might buy a stock within the same sector or a mutual fund or exchange-traded fund with similar objectives to the ones sold.

For example, if an investor in the top tax bracket sells investments for \$40,000 with a cost base of \$50,000 and triggers a \$10,000 capital loss, it can be applied to realized capital gains to save about \$2,300 in taxes. However, the \$40,000 sitting in cash for 30 days could result in a missed opportunity if the market rises. For instance, if the market or sector was on an upswing during the 30 days and increased by 6%, then the investor would have missed out on a \$2,400 increase in his/her portfolio, wiping out the tax savings. On the other hand, if the market declines, it would be a win-win situation. With the current volatility in the markets creating significant day-to-day and week-to-week fluctuations, either of these scenarios is possible.

Unfortunately, a temporary position cannot be perfectly correlated to the one sold. For example, an investor looking to retain a position in the financial sector who sold TD Bank common stock and bought RBC common at the beginning of 2011 would have earned different returns on a year-to-date basis.

After the 30-day period, the investor could dispose of the temporary position and re-purchase the investment he or she originally sold. If the investment is still valued at \$5, the new adjusted cost base of the shares would be \$5 per share. If the price eventually recovers to \$10 and the shares are sold, tax will become due on the capital gain. In this instance, tax-loss selling works as a tax deferral strategy, i.e. saving taxes now and paying them later.

Other Considerations

Capital losses are only available on investments in non-registered or corporate accounts. You cannot use a loss triggered in an RRSP or TFSA. This is another good reason for placing dividend and capital gain/loss-producing investments in your non-registered and corporate accounts.

It's possible to have an investment in a loss position solely because of the foreign exchange loss. For example, an investor holds a U.S. investment that is not hedged to the Canadian dollar. If the Canadian dollar increases in value against the U.S. dollar, your investment would be in a loss position.

Keep in mind that capital losses can accrue on assets other than common stocks, such as bonds, preferred shares, trust units and real estate.

You may carry back capital losses three years and forward indefinitely. This is important if you anticipate a change in tax brackets moving forward or if your tax bracket was higher in one of the previous three years. You may, for example, have a RRIF starting next year that pushes you into a higher tax bracket. Is the sale of

property anticipated? Can you preserve the OAS clawback in a certain year by carrying forward the loss? Tax-loss tactics are part of an overall financial plan.

Because of the 3-day settlement requirement, investors need to sell personally held investments before December 28th and corporate held investments 3 days before your company's year end.

Holding individual securities in a portfolio allows for more selective selling and customization.

Triggering losses in conjunction with your periodic portfolio rebalancing makes sense. You might see a need to increase one sector at the expense of another and will sell loss positions to carry this out. You can fulfill two objectives at the same time.

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