Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Claiming losses on worthless securities

Sometimes, a security you hold (e.g. a share of a company or debt instrument) becomes worthless. In such a case, you may want to claim a capital loss, which can be used to offset your capital gains and reduce your taxes payable. This article discusses some strategies that may allow you to recognize a capital loss on a security when that security becomes worthless in a non-registered account.

Ways to be able to claim a loss

It may be possible to dispose of a worthless security in order to be able to recognize the loss for Canadian tax purposes. Three methods of doing so are:

1. The worthless security can be deemed to be disposed of under Canadian tax rules.
2. The worthless security can be gifted or sold to another party or into the market.
3. The worthless security can be disposed of permanently to a financial institution.

Method 1 – Deemed disposition under Canadian tax rules

Under Canadian tax rules, you may be able to trigger a deemed disposition of a worthless security at the end of the year in which the security becomes worthless. To do so, you will need to file an election with your income tax return. If you make this election, you are deemed to have disposed of the security for nil proceeds at the end of the year and reacquire the same security immediately after the year-end at nil. This allows you to realize a capital loss that's equal to the adjusted cost base (ACB) of the worthless security. Although you are deemed to have immediately reacquired the worthless security after triggering the loss for tax purposes, the superficial loss rules (discussed in more detail later in the article) will not apply when this election is made.

If you hold a debt instrument that was acquired for investment purposes, you will need to establish that the debt became a bad debt during the course of the year in order to make this election. To be considered a bad debt, you must:

- Establish that all legal means to collect the debt have been exhausted, or
- Establish that the debtor has become insolvent and has no means of paying the debt

In the case of shares, this special election is available if any one of the following conditions occur:

- The corporation whose shares are at issue has, during the calendar year, become bankrupt as defined by the *Bankruptcy and Insolvency Act*
- The corporation whose shares are at issue has, during the calendar year, become insolvent as defined in the *Winding-up and Restructuring Act*, and a wind-up order has been issued pursuant to this act, or
- The corporation whose shares are at issue at the end of the year meets all of the following conditions:
  - The corporation is insolvent
  - The corporation is no longer carrying on any business
  - The fair market value of the corporation's shares is nil, **and**
  - It's reasonable to expect the corporation will be dissolved or wound up and that it will not commence to carry on any business in the future

It's important to note that a cease trading order does not necessarily mean the company is insolvent or worthless for the purposes of this election.

The primary advantage of this method of recognizing the tax loss is that the security is not actually disposed of — in other words, you continue to own the security.

To determine the status of a specific worthless security for purposes of this election, you could consult publications such as the "*Financial Post Survey – Predecessor & Defunct*." Although not as authoritative, there are also public websites listing defunct companies.

Method 2 – Actual disposition of the worthless security

Other than the issues of bankruptcy and insolvency raised previously, there are several events that can cause a security to become worthless. A few of the possible causes are:

- The security has become delisted or no longer trades on an exchange
- The company whose securities are at issue has just ceased operations
- The derivative securities are so far out of the money, there is no value or market for them, or
- The security is under a long-term cease trading order

The primary advantage of this method of recognizing the tax loss is that the security is not actually disposed of — in other words, you continue to own the security.

In these circumstances, it may not be possible for you to file the election to claim a deemed disposition. Instead, you may need to dispose of the security in order to claim the capital loss. If the security cannot be sold in the market, it may be possible to dispose of the worthless security by gifting it to another person. The recipient can be related or unrelated to you, subject to the superficial loss rules discussed later in the article.

In order to complete the gift of public company shares, there will generally need to be a transfer agent that can help you re-register the security in the recipient's name and provide a certificate. You will need to contact the transfer agent that the company deals with for information regarding the gifting procedure.

Superficial loss rules

In order to be able to claim a capital loss on the sale or gift of a security, it's important to ensure that the loss is not considered a superficial loss. Otherwise, you will not be able to use the capital loss to offset capital gains.

A capital loss is considered a superficial loss where:

- During the period that begins 30 days before and ends 30 days after the settlement date of the transaction, you or a person affiliated with you acquires the same security or identical property that was sold at a loss, and
- At the end of that period (i.e. 30 days after the settlement date of the disposition), you or a person affiliated with you owns or has a right to acquire the security or identical property.

The denied capital loss is added to the ACB of the security or identical property acquired. This effectively preserves the capital loss on the worthless security.

The affiliated person definition is complex. It includes you, your spouse, a corporation controlled by you and/or your spouse, and a trust where you and/or your spouse are majority interest beneficiaries. It also extends to partnerships and combinations of all of these, so care must be taken when choosing who you will gift or sell the worthless security to.

For more information on the superficial loss rules, please ask your RBC advisor for an article on this topic.

Method 3 – Disposing of the worthless security permanently to a financial institution

Another method of realizing the capital loss on a worthless security is disposing of the worthless security to a financial institution by having the financial institution remove the security from your account. Generally, you will not receive any consideration for a worthless security that's removed from your account using this procedure.

In order to be able to claim the loss for tax purposes, the removal of a worthless security from your account must be permanent. In the rare event that the worthless security is ever valued in the market, or the security makes a distribution to the security holders, you will not be able to reacquire the security or receive the distribution from the financial institution that acquired the worthless security because the original disposition was permanent. Therefore, if there is any possibility that the security will ever recover in the future, you may want to choose an alternative method to claim the tax loss.

To remove a worthless security from a non-registered account, you will need to contact a financial institution to determine the procedure you will need to follow. You should get a confirmation letter or receipt that the security was removed from your account. As well, the removal of the security will be reported to you in your tax package and reported to the Canada Revenue Agency and Revenu Québec where applicable.

To remove a worthless security from a non-registered account, you will need to contact a financial institution to determine the procedure you will need to follow.

Please note that the superficial loss rules must be considered, as there is no exemption from the superficial loss rules where you choose to dispose of a worthless security in this manner.

Conclusion

If you currently own a worthless security, you may want to claim a capital loss to offset capital gains you have realized. Speak with a qualified tax advisor to determine whether it's possible for you to use one of the methods discussed in this article to realize the capital loss.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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