Tax-loss selling could save you money

Investors have seen a significant decline in the value of stocks in 2008 because of the global financial crisis. If you have investments in a non-registered account that have dropped in value, it may make sense to take some of the sting out of the market downturn – 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 applied against any realized capital gains in 2008, thus reducing your 2008 tax bill, and to the extent the capital losses exceed capital gains in 2008, 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 increase in value before repurchase.

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 2008, or have reported taxable capital gains on your 2005, 2006 or 2007 tax returns. If you have no realized capital gains, any 2008 capital losses 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 RRSP, your spouse, and your spouse's RRSP) cannot purchase the identical investment 30 days prior, or 30 days following, your disposition.

4. Can your spouse benefit from your loss? If you have capital losses but no capital gains against which to apply those

capital losses, you might be able to transfer unrealized capital losses (losses still on paper) to your spouse. 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 would be added to the adjusted cost base of the investment acquired by your spouse. Your spouse can sell the same investment (after the 30th day from the date of your sale) and realize a capital loss that he or she may be able to use.

5. Corporate class shares may allow you to generate a tax benefit while remaining fully invested. Switching from a mutual fund trust at CI Investments to the equivalent CI Corporate Class fund may create a capital loss that you can use to offset capital gains. At the same time, you would continue to hold a similar investment.

6. Wednesday, December 24, 2008 is the last day to execute a trade on a Canadian stock exchange that would settle in 2008. If you make a trade after that, it would settle in 2009 – too late to be of use as tax-loss selling for the 2008 tax year.

7. Proceeds from tax-loss selling can be rolled into your tax-free savings account. Starting in January 2009, the new tax-free savings account (TFSA) allows Canadians aged 18 and older to contribute $5,000 annually. 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 the securities are withdrawn. TFSA-eligible investments include stocks, mutual fund units, corporate class shares, segregated funds and bonds. To avoid having the capital losses denied, you must follow the superficial loss rules.

Tax-loss selling is an established strategy that could reduce your taxes. Please consult with your financial advisor to determine whether you can benefit.

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CI Investments

2 Queen Street East, Twentieth Floor, Toronto, Ontario M5C 3G7 | **www.ci.com**

Head Office / Toronto
416-364-1145
1-800-268-9374

Calgary
403-205-4396
1-800-776-9027

Montreal
514-875-0090
1-800-268-1602

Vancouver
604-681-3346
1-800-665-6994

Client Services
English: 1-800-563-5181
French: 1-800-668-3528