Be Greedy (In Tax) When Others Are Fearful: Triggering Losses and Estate (re)Freezes

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These days, it's hard to miss the scary stock market headlines: "*The Dow has crashed into a bear market", "Historical market freefall!*", "*Covid-19 shuts down market!*" and so on. On top of these market troubles, our local Alberta economy has suffered a prolonged downturn since 2014. The human costs of these difficulties are profound, and we see them all around us. Warren Buffet's famous advice of "*be greedy when others are fearful*" offers optimism in these challenging times, but it also rings true in tax planning.

The premise of our income tax system is that the Government is a stakeholder with you in all of your interests: your ability to profit from employment, business, or investment is partly due to the Government's investment in you through education, health care, security and other goodies. As part of this contract, you pay a portion of your earnings to the Government as income tax. On the flip side, if you lose money, you incur losses that shelter your other earnings. By enabling a tax deduction for your losses, the Government is effectively sharing the economic cost of your loss with you. Of course, as in all things tax-related, it is never this straightforward. In this article, we will explore how you could crystallize and maximize tax benefits from this low valuation environment.

Triggering Tax Losses

Unless you had the foresight to liquidate your portfolio into cash a few weeks earlier, your portfolio statement is likely a tsunami of red. Should you do something now to trigger tax losses on your portfolio? Well, it depends. Theoretically speaking, you should be indifferent between triggering the loss and simply holding on. To illustrate, assume you previously bought XYZ stock at $10. Today it sits at $2, but you believe it will return to $10 in a year – should you trigger loss or hold?

XYZ Stock – Sell Today, Buy it Back, and Sell One Year Later at $10

	Today	Next year
Proceeds	$2	$10
Cost	$10	$2
Capital Loss	($8)	$8

Capital loss of $8 shelters $8 of gain. Net taxable gain $0. Note that this ignores the superficial loss rules that will be discussed below.

XYZ Stock – Hold and Sell One Year Later at $10

	Today	Next year
Proceeds		$10
Cost		$10

Capital Loss	N/A	$0

Net taxable gain also $0

Over time and assuming the value of XYZ stock recovers to $10, you are in the same position either way. If you trigger the $8 loss and invest the $2 proceeds today, the cost of your investment resets to $2. This means you will have a $8 gain when you sell at $10 next year. The initial $8 loss offsets the $8 subsequent gain, netting you a $0 net gain, the exact same position as if you just held the XYZ stock.

There are however situations you would be better off triggering a loss. Assume you realized a $20 gain three years ago. By triggering that $8 loss today, you can carry that $8 back three years to partially shelter that $20 gain and collect a tax refund on that $8 loss. But aren't you just breaking even over time – your cost base in your new investment is reset to $2, and you will eventually end up with a $8 gain that cancels the benefit of the $8 loss carry-back? You are correct, but you would have earned the time-value of collecting that tax refund now. Also, triggering losses now may make sense if you expect valuations to stay low for a long period of time.

In addition, there may be many investment and emotional reasons to sell that loss stock so as to lock in that tax loss for current or future use.

How do you actually trigger that loss and how do you use it?

To address this question, you must first determine the nature of your holdings. Are the stocks held as capital property? In that case, the loss would be a capital loss. On the other hand, if the stocks are held as inventory in the business of trading, the loss would be a business loss. Capital losses can only be claimed against capital gains and may be carried back three years and carried forward indefinitely. In contrast, business losses can be claimed against any income (yes, even against your employment income), and may be carried back three years and carried forward 20 years. (Note that if you previously made a proper tax election under subsection 39(4) of the Income Tax Act, losses on Canadian securities may be deemed a capital loss).

Whether stocks are held as capital property or inventory is a complicated subject deserving of its own treatise, and it depends on many factors such as frequency of trading, length of holding period, time spent and knowledge of trading, amongst others. CRA's archived Interpretation Bulletin IT-479R provides more content on this subject. If you are like the vast majority of the Canadian population, you are likely holding stocks as capital property and any loss triggered from selling them is a capital loss.

When triggering capital losses, it is very important to be aware of the "superficial loss" rules. Your capital loss on the sale of a property would be denied if you or an "affiliated person" acquire an identical property within the period that is 30 days before and 30 days after the sale. Generally speaking, an affiliated person is your spouse or a corporation you or your spouse control. To illustrate, if you sell XYZ stock at a loss on March 13, 2020 and your spouse purchases XYZ stock on March 31, 2020, the loss on your sale is denied and that loss is added to your spouse's cost base in XYZ stock.

If you are a trader and your holdings actually qualify as inventory in your trading business, then these superficial loss rules do not apply, and you may even write off paper losses without a sale. We use the word "may" because this is only possible if your trading business is not "an adventure or concern in the nature of trade". CRA has an archived explanation of what is an adventure or concern in the nature of trade here.

Estate "Freeze" and "Refreeze"

An estate freeze is a set of reorganization transactions that "freezes" the current wealth of an individual (the freezer), and passes on the future growth to the freezer's next generation. There are many estate and succession planning reasons for a freeze, but the primary tax reason is to set an upper limit and provide certainty to the amount of future tax upon the ultimate death of the freezer. Freezes are usually done for family businesses, but it could also be used for significant passive assets – although corporate attribution issues would need to be managed for the latter. To learn more about estate freezes, check out our recent article on the subject.

Since the typical tax motivation behind an estate freeze is the minimization of wealth in the hands of an individual, today's combination of low valuation and challenging business conditions provides a perfect storm of conditions for estate freezes that it may actually merit the tired expression of an "*once in a lifetime opportunity*". The below example will illustrate our point.

A successful entrepreneur, Mr. Apple, spent his career building a business that used to be worth $10 million in 2015. Due to the economic downturn, the business is worth only $2 million today, but Mr. Apple believes that its value will bounce back to at least $7 million once economic conditions improve. Mr. Apple would like his daughter, Ms. Juice, to take over the business in the future.

Mr. Apple may be interested in an estate freeze to take advantage of the low valuation of his business today. By undertaking a freeze, Mr. Apple will fix the wealth in his hands to $2 million, so that the future growth of $5 million and beyond will accrue entirely to Ms. Juice's hands. Upon the death of Mr. Apple, the value subject to tax will be limited to the $2 million (in contrast, if the freeze has not been done, Mr. Apple could die with $7 million or more of value subject to taxation). Furthermore, Mr. Apple is likely going to have a much lower taxable value on death than the $2 million because part or all of it would have gone to fund his lifestyle post-freeze. If Mr. Apple is unsure about Ms. Juice's succession or whether he wants to be passing wealth to her at all, a family trust could be established to provide flexibility in the future wealth and business transfers.

Even families who already froze in the past can take advantage of today's low valuation environment by executing a "thaw and refreeze". Generally speaking, a thaw and refreeze is done if the aggregate valuation of a business falls below the frozen value in a freezer's hands. A proper refreeze will reset the value subject to tax at death to the lower valuation, allowing more future growth to flow to the next generation.

Investments Held by Private Corporations

Counterintuitively, a capital gain may sometimes be a good thing to have inside a private corporation! Earning capital gains increases a private corporation's capital dividend account (CDA), which in turn allows tax-free capital dividends to be paid to the shareholder. This may be the case even if the capital gain is sheltered by business and non-capital losses. An important consideration for private corporations before triggering any capital loss is to ensure the capital loss does not drain any existing CDA, and careful planning is done to crystallize that CDA beforehand. Also, for cash-rich private corporations, perhaps it may not be a bad idea to consider buying investments now for potential future capital gains and CDA.*

This is a challenging and hurtful time. However, opportunities rise from ashes, and tax refund or deferral rise from losses. So be greedy (in tax) when others are fearful!

* *Special thanks to Balaji Katlai PhD, CPA, CGA for his suggestions on CDA planning.*