Capital Losses in your RRSP: Can You Harvest Them?

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So you gambled away some money in your RRSP (Registered Retirement Savings Plan) and bought dot-com stocks last year. Now you can't write-off your capital losses. Or can you?

RRSP's are tax-sheltered income deferral instruments. All the gains within the RRSP, including capital gains, are tax-exempt, as long as they stay inside the plan. By the same token, no capital losses within a registered plan can be claimed.

For example: You bought $10,000 worth of "XYZ.com" fund within your self-directed RRSP in February of 2000. It is now worth only $5,000.

Your first option is to do nothing about it. You hope that eventually the fund will do better. You hold on to it.

You may want to consider another option. To make use of it, you need to meet all these three requirements:

- You need to have a self-directed RRSP in place.
- You need to have unused RRSP contribution room that you don't think you can use in the near future.
- You expect that the value of your "XYZ.com" investment will go up eventually.

If all these conditions apply, here is how you can let the taxman participate in your losses:

Step 1: Write a cheque for $5,000 to your self-directed RRSP trustee, and take the now-$5,000-worth "XYZ.com" fund "in-kind" from your RRSP into your open investment account. This does not affect your contribution room. This called a "swap".

Step 2: Hang on to your "XYZ.com" fund in your open investment account.

Step 3: When and if the value of "XYZ.com" fund goes up to $10,000, you now have $5,000 in capital gains. Contribute half of your units ($5,000) as "in-kind" contribution to your self-directed RRSP. Swap the other half of your units "in-kind" with the $5,000 cash in your RRSP that you put in "Step 1". You may want to do it a few days apart to avoid confusion.

Your net contribution to your RRSP is now $5,000 and the other $5,000 is simply a swap. Your RRSP contribution room is now reduced by $5,000.

Because your "XYZ.com" fund was outside your RRSP, in the year it is placed into your RRSP, you must report a capital gain of $5,000. 50% of capital gains must be included in your income, in this case, i.e. $2,500.

Assuming you are in a 45% tax bracket, your *total cost* (ignoring the swap fee) is the capital gains tax of $1,125, calculated as 45% of $2,500.

Your *total gain* (deduction from income) is 45% of your $5,000 in-kind RRSP contribution in "Step 3", i.e. $2,250.

Your *net gain* is *total gain* minus *total cost*, $1,125, calculated as $2,250 minus $1,125.

In effect, in an indirect way, you permitted the taxman to share your loss by $1,125 on an investment that was originally inside your RRSP. By the way, this is exactly the amount you would be eligible to write-off as capital-loss (against other capital gains), if the same loss had occurred in an open investment account.

And what if the unit value of "XYZ.com" fund does not go up? Nothing, keep the fund in your cash account. If its value goes down more, you may be eligible for a capital loss deduction from other capital gains. You don't really lose any more for holding it outside your RRSP. We left behind a bad year for equities. Barring unforeseen calamity, markets may do better in year 2001.

Make sure to get professional advice before attempting this interesting tax-loss harvesting technique.