Share your losses with the taxman

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IF you still have contribution room in your registered retirement savings plan, here is a creative way to use it — and let the government share part of the burden if you are losing on stocks or mutual funds.

Thousands of Canadians have large amounts of unused contribution room in their RRSPs. This is the total you are allowed to invest in your plan, including eligible amounts not contributed in previous years. (The latest federal budget allows you to carry forward RRSP room indefinitely.)

At the same time, you may have some RRSP investments that are not doing well. Capital losses are deductible from capital gains on investments outside an RRSP, which offsets the total tax owing. This is not the case inside an RRSP.

Before trying to use the following system, make sure your situation meets these three requirements:

- You must have a self-directed RRSP.
- You must have a reasonable amount of RRSP contribution room that you can't use in the near future.
- You must expect to hold the securities for the long term. This means that if you have capital losses on a particular mutual fund or stock, you must think they will eventually be recovered.

Suppose you bought the Volatile Equity Fund at $10 a unit three years ago inside your RRSP. The fund's unit value has slipped to $5, and your investment of $10,000 is worth only $5,000.

You have two options. You can do nothing and hope the unit value will return to $10 or perhaps higher — buy-and-hold investors choose this method.

Or, if you have, say, $20,000 of unused RRSP contribution room and find it impossible to use this in the near future, here's how to let the government participate in your losses.

First, arrange a swap. Put $5,000 into your RRSP and take the mutual fund out, holding it in a non-RRSP account. This does not change your RRSP contribution limit, since you only made a swap.

Hang on to the fund. When and if the unit value goes up, say back to $10, contribute all the units — now worth $10,000 — to your self-directed RRSP.

Take out the $5,000 in cash you used to replace the mutual fund. You have now used $5,000 of your total $20,000 contribution room.

Tax Planning

Because the fund's value has gone up, you have a $5,000 capital gain outside your RRSP. Three-quarters of this gain — that is, $3,750 — is subject to income tax. However, the full $5,000 can be deducted from your income because it is an RRSP contribution.

Your capital gains tax, assuming you are in a 40-per-cent tax bracket, is $1,500 — that is, 40 per cent of $3,750.

Your tax-deferred savings on the RRSP contribution is $2,000, or 40 per cent of $5,000.

The net gain is $500 — $2,000 minus $1,500.

If you borrow money to contribute to your RRSP, the interest is not tax-deductible. But an asset swap is not a contribution.

In the first swap, your non-RRSP account is using the $5,000 to buy the fund from your RRSP with the objective of making an actual capital gain, and therefore would be subject to capital gains tax. This may deem the interest on money borrowed for the swap tax-deductible. Check with your tax accountant.

In addition, while the Volatile Equity Fund is growing outside your RRSP, eventually saving you money when you swap the second time, your $5,000 within the RRSP is growing on a tax-deferred basis.

What if the fund's unit value doesn't go up? Don't worry. Keep the fund in your non-RRSP account. If it goes down further, you may be able to deduct a capital loss from your other capital gains. You don't really lose anything by holding the fund outside your RRSP.

There are two caveats. One, if Revenue Canada decides you are a professional trader, it may consider 100 per cent of your capital gains as income, which makes this exercise pointless.

Two, if the fund in your cash account loses more of its value, and you later decide to contribute it to your RRSP, you cannot deduct your capital loss.

The problem with holding a lot of unused RRSP contribution room is that you may eventually lose it to the cash-addicted government in another round of budget changes. Why not make use of it while you can?

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