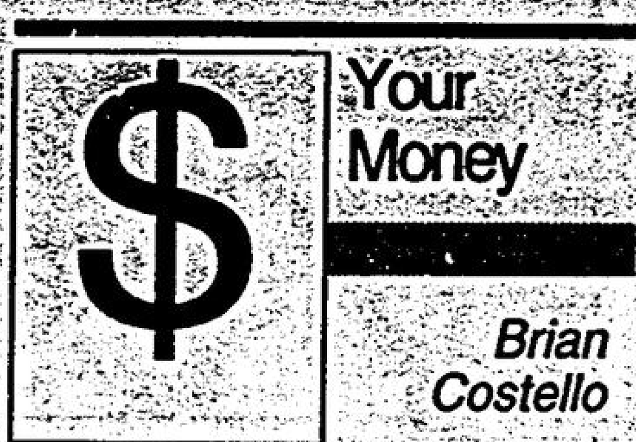
Cumulative net investment losses could cause tax troubles



While millions of Canadians are bugging their financial advisors about how to crystallize up to $100,000 in tax free capital gains before the exemption disappears, many will be bitterly disappointed.

They will be hit with CNIL or cumulative net investment losses that have been growing since 1987.

Back then Ottawa introduced a rule that effectively says any investment expenses we claim as deductions against income earned through non investment sources must be deducted from our capital gains before we can use the $100,000 tax free capital gains deduction.

CNIL may not be a big problem in the future when capital gains are taxable anyway. But right now, when we want to squeeze the last dollar out of this deduction we can, indeed, feel the pain.

In the simplest of terms, if you borrowed $100,000 to buy an investment one year ago and claimed $10,000 interest expense as a tax deduction against your salary, you must earn $10,000 in taxable capital gains or other investment income before you can claim any tax free capital gains.

The sad part is that Canadians who voluntarily claim capital gains this last time without considering CNIL may trigger a big tax problem rather than creating tax free gains. They may have been better off hanging onto the cottage property or other investments for years or decades and paying the tax in the future.

So what type of investment expenses must be included in your calculations? The obvious one is all your investment carrying charges and interest. Interest expenses incurred when you borrow to operate a business are not included though. In fact, it was often advisable to borrow for business purposes while paying cash for investments.

However, many Canadians borrowed to buy investments that produced little or no yield. It looked good at the time in that the tax deductions wiped out tax on other forms of income while giving them the ability to own large investments that might have paid off in the future. Losses incurred when you were involved in the rental or leasing of real estate and 50 per cent of resource flow through deductions and losses incurred when investing in limited partnership type investments are others that must be included.

However, there are types of income that will reduce your CNIL account. For example, if you earn dividends or interest income it will reduce your CNIL even though they don't come from the same investments that produced the losses in the first place.

While investing in limited partnerships often creates a CNIL problem, income earned by owning LPs, as they are called, will reduce your CNIL balance. The same can happen when you invest in flow through shares. You are allowed to claim flow through deductions. However, if the investment pays off you can earn substantial profits. They should be added to your CNIL account to reduce its balance.

If you own rental real estate that produces positive cash flow those amounts should also be added to your CNIL balance.

Many investors have already triggered some capital gains in the past. Don't forget that the non eligible portion of those capital gains can also be used to reduce your account.

If you are considering using the capital gains deduction there are a few things you might want to do to eliminate your CNIL account in advance.

Some investors buy high yielding shares or mutual funds just before they do "X dividend". You are now guaranteed the dividend. Usually the share prices are knocked down the next day as they no longer include the dividend. The dividend will count towards your CNIL account and you can sell the shares at a loss. That loss will also allow you to sell other investments at a capital gain. One will wipe out the other.

If you own a small business corporation you may want to pay yourself dividends rather than salary. The dividends wil be useful in reducing your CNIL account but they may reduce the amount of money you can contribute to your RRSP or your Canada Pension Plan benefits for this year.

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