

# Our Insights



## Tax loss harvesting: How to make the most of unrealized losses

*Small routine actions can quietly invalidate a carefully planned tax harvesting strategy*

### FINANCIAL POST

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The growing popularity of artificial intelligence and robo-advisers makes it tempting to believe that most financial decisions can be automated, but certain strategies, such as tax loss harvesting, are notable exceptions.

Indeed, investors only benefit from tax loss harvesting if they thoughtfully navigate its strict rules, coordinate across accounts, avoid behavioural traps and integrate it into their broader financial plan.

Tax loss harvesting involves selling an investment in a taxable account that is trading below its adjusted cost base. The resulting capital losses can then be applied against taxable capital gains from the current year, carried back to any of the previous three years or carried forward indefinitely.

An important rule to keep in mind is the superficial loss rule. A capital loss is considered invalid if you buy back the same or an identical security within 30 days of the settlement date of the sale. This rule applies across all your

accounts, including corporate investment accounts, trusts and other entities that you or your spouse or common-law partner control.

This is why tracking activity across every account isn't just helpful; it's essential. In practice, many investors underestimate how easy it is to unintentionally breach the superficial loss rule, whether through a dividend reinvestment plan, recurring contribution or trade in a spouse's account.

Small routine actions can quietly invalidate a carefully planned tax harvesting strategy. Those working with an adviser should ensure all accounts and positions are fully disclosed so the adviser can coordinate decisions across the entire household.

One of the most common mistakes investors make is selling a position to harvest a loss and then sitting on the cash for 30 days to avoid triggering the superficial loss rule. Unless the goal is to exit an investment entirely, it is important

to stay invested and maintain exposure since prices can materially move over a 30-day period, and any missed upside can outweigh the tax benefits of the strategy.

Staying invested is particularly important in December. Since 1928, the S&P 500 has generated positive returns in December 72 per cent of the time, the highest rate of any month of the year.

Fortunately, investors do not need to stay in cash to comply with the superficial loss rule. For example, they can sell an exchange-traded fund (ETF) and immediately buy another ETF that tracks a similar market. Likewise, those who sell an individual stock can buy a broad-based ETF in the same sector to maintain their exposure.

For investors holding alternative investments, it is generally best to avoid tax loss harvesting unless they plan to allocate to a different strategy altogether. Most alternative strategies do not offer daily liquidity, and losses are recognized when the fund updates its valuations rather than when you choose to sell. This makes the timing and execution of tax loss harvesting harder to control.

Even if a loss is realized, suitable replacement options may be limited since strategies, vintages and structures can significantly vary between funds. Switching from one private fund to another is not the same as replacing one ETF with a similar ETF and can meaningfully change your portfolio's risk and return profile.

Even for experienced investors, psychological biases can add another layer of difficulty to an already nuanced strategy. Loss aversion and anchoring bias can lead some

investors to hold losing positions in the hope that they will get back to break-even.

A useful exercise is to imagine having cash instead of the losing position and asking whether you would buy that same investment today. If the answer is no, it may be best to realize the loss, save on taxes and redeploy capital toward better opportunities.

Tax loss harvesting can also become more complex for those with corporate accounts or concentrated positions from employee stock options, and these situations often benefit from more tailored wealth planning.

For example, business owners must consider how capital losses interact with the small business deduction, passive income rules and their capital dividend account to maximize overall tax efficiency. For example, a capital loss can reduce the capital dividend account and change how cash should be withdrawn from the corporation.

For individuals with large unrealized gains from employee stock options, advisers can employ in-kind rollover strategies that diversify concentrated positions without triggering immediate capital gains. In many cases, this can be a more effective strategy than tax loss harvesting alone.

No matter the complexity of your financial situation, tax loss harvesting works best when decisions are coordinated across accounts and grounded in a clear understanding of how each step supports your broader financial plan. With the right guidance, even a losing position can pave the way for building long-term wealth.

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