The Navigator

RBC WEALTH MANAGEMENT SERVICES

Superficial Loss Rules and Planning Strategies

An overview of the rules and strategies surrounding superficial losses

In order for you to claim a capital loss on the sale of a security, you must ensure that the transaction is not considered a superficial loss transaction. Generally this means that you cannot repurchase the identical security within a certain period of time if you wish to claim the capital loss on the sale of the security. This restriction may be a concern for you if you have a loss position on an investment that you would like to continue owning, but would also like to sell for tax loss purposes.

If a superficial loss is triggered, you will not be allowed to claim the capital loss. The amount of the capital loss will be added to the Adjusted Cost Base (ACB) of the substituted property.

What is a superficial loss transaction?

The definition of a superficial loss is a two-part test — this means both of the following conditions must be met in order for the loss to be considered a superficial loss.

Part A

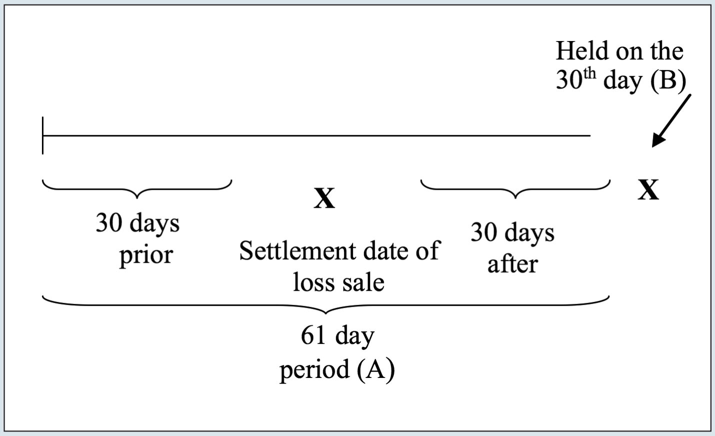
During the period that begins 30 days before and ends 30 days after the settlement date of the disposition, you or a person affiliated with you (i.e. your spouse, a company controlled by you and/or your spouse, or a trust in which you and/or your spouse are a majority interest beneficiary) acquires the identical property that was sold at a loss.

There is a 61-day period that needs to be considered — it includes the 30 days before, the day of and the 30 days after the settlement date of the loss sale.

Part B

The second part of the test is only met if, at the end of that period (i.e. on the 30th day after the settlement date of the loss disposition), you or a person affiliated with you owns or has a right to acquire the identical property.

The identical security can be purchased at any time during the 61-day period without triggering the superficial loss rules as long as you or someone affiliated with you does not own that identical security on the 30th day following the settlement date of the sale of the original investment.



Therefore if you sold a security at a loss and then you (or a person affiliated with you) repurchased the identical security at some time during the 61-day period, you might be able to avoid the superficial loss rule by ensuring you did not own the security on the 30th day.

> For example, assume Bob sells a security today for $100 and realizes a capital loss of $10. If Bob decides that he doesn't want to be out of the position and repurchases the same quantity of the identical security for $103 a week later, and holds that security for longer than 30 days from the settlement date of the original disposition, then Bob will be denied from claiming the $10 capital loss on the initial sale. The $10 loss will be added to the ACB of the substituted property so that the ACB of the new security will be $113 ($103 + $10).
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> If Bob had sold the new security so that it settled on the 29th day after the settlement date of the original disposition, he would be able to claim the $10 loss he incurred. He could even acquire the position again a few days later. Of course if the second sale settling 29 days after the original disposition was also at a loss, Bob would then have to pay close attention to whether the superficial loss rules would apply to that loss too. Please note that the above strategy is more aggressive than simply waiting until the 30 days have passed to re-acquire the position; therefore, please ensure you discuss this strategy with your tax advisor if you are considering implementing it.

You might be able to avoid the superficial loss rule by ensuring you did not own the security on the 30th day.

Settlement date

It is important to point out that for the purposes of the superficial loss rules, the 61-day period is from settlement date to settlement date and not from the transaction date.

> For example, assume Bob sells 100 shares of XYZ with a trade date of October 19, 2012. This trade will settle on October 24, 2012. To avoid a superficial loss transaction, Bob must not acquire any new XYZ shares that settle on or after September 24, 2012 or before November 23, 2012 (inclusive). Because of the settlement dates, this means that Bob can acquire new XYZ shares with a trade date on or before September 18, 2012 or on or after November 21, 2012 if he wishes to avoid triggering the superficial loss rules. Alternatively, since it is a two-part test, he can simply ensure he does not own any XYZ shares on November 23, 2012 (see previous section for details on the two-part test).

Identical property

Another aspect of the superficial loss rules is that it only applies if "identical property" is acquired. Therefore a similar but not identical property can be acquired at any time without triggering the superficial loss rules. But what is an identical property? The Canada Revenue Agency (CRA) has expressed that it considers identical properties to be properties that are the same in all material aspects so that a prospective buyer would not have a preference for one over the other (IT-387R2). You will need to seek the assistance of a qualified tax professional if you are trying to determine whether two investments are identical or not. It can be quite tricky.

> For example, the CRA stated that a TSX 300 index-based mutual fund from one financial institution would generally be considered identical to a TSX 300 index-based mutual fund of another financial institution. However, in the same document, the CRA also stated that it would generally not consider a TSX 300 Index Fund to be identical to a TSX 60 Index Fund.

The 61-day period is from settlement date to settlement date and not from the transaction date.

The CRA has also stated that two classes of shares of a company may be considered identical for purposes of the superficial loss rules if one class of shares can be converted to the other class of shares. Consider, XYZ Ltd. with two classes of shares. Shares of class B have a conversion right whereby they can be converted to shares of class A. In this case if the individual sells XYZ A shares and buys XYZ B shares within a period of 30 days, the transaction will likely be considered a superficial loss transaction by the CRA.

Proportionate superficial loss formula

If a superficial loss is triggered, some of the capital loss may still be claimed in the year of sale, if you own fewer identical shares at the end of the 61-day period than the number of shares you recently sold at a loss. Based on a 1992 CRA Technical Interpretation, the amount of the denied loss can be calculated using the following formula:

Denied loss = capital loss otherwise determined x (least of S, P and B) ÷ S

Where:
S = the number of shares disposed of
P = the number of shares bought in the 61-day period referred to in Part A of the two-part test
B = the number of shares left at the end of the 61-day period

For example, Assume Anika purchased 1,000 shares of XYZ Inc. in 2011 for a total ACB of $10,000. On August 3, 2012, she sold the 1,000 shares of XYZ Inc. for total proceeds of $4,000, resulting in a capital loss of $6,000. However, Anika decided to buy back 300 shares of XYZ Inc. on August 17, 2012 for a total ACB of $1,500 and continues to hold these 300 shares after September 10, 2012. How much of her $6,000 capital loss is denied? Based on the formula, her denied loss is calculated as follows:

Denied loss = $6,000 x (least of 1,000, 300 and 300) ÷ 1,000
= $6,000 x 300 ÷ 1,000
= $1,800

As a result, Anika can still claim a capital loss of $4,200 ($6,000 – $1,800); however, $1,800 of the capital loss is denied due to the superficial loss rule formula. This denied loss of $1,800 is added to the total ACB of her remaining 300 XYZ Inc. shares, giving her a new total ACB of $3,300 ($1,500 + $1,800).

If you own fewer identical shares at the end of the 61-day period than the number of shares you recently sold at a loss, then the denied loss formula should be used.

Basically, if you own fewer identical shares at the end of the 61-day period than the number of shares you recently sold at a loss, then the denied loss formula should be used to determine if some of the capital loss can still be claimed in the year of sale.

However, due to the way the CRA has set the formula, you may find the following scenario surprising:

Assume Sarina bought 1,000 ABC Inc. shares on July 16, 2012 for a total ACB of $10,000 ($10 per share). On August 3, 2012, she sold 500 of these shares for total proceeds of $4,000, resulting in a $1,000 capital loss [$4,000 – (500 x $10)]. She continues to hold the remaining 500 ABC Inc. shares after September 10, 2012. How much of her $1,000 capital loss is denied according to the CRA formula?

Denied loss = $1,000 x (least of 500, 1,000 and 500) ÷ 500
= $1,000 x 500 ÷ 500
= $1,000

In this example, the full capital loss of $1,000 is denied and added to the total ACB of the remaining 500 shares (i.e. 500 x $10 = $5,000), resulting in a new total ACB of $6,000 ($5,000 + $1,000). It is surprising to note that if Sarina had sold all her shares on August 3, 2012 and then repurchased 500 shares a few days later and continued to hold them on September 10, 2012, she would be able to report a $500 capital loss on her tax return.

Superficial loss strategies that may work

The following are some transactions that may enable you to sell your investment that is in a loss position and realize the capital loss while possibly avoiding the application of the superficial loss rules:

All securities

- Selling and repurchasing the same security after 30 days from the settlement date of the sale.
- Purchasing an identical security at least 31 days prior to selling the original security. This could work quite well since you don't have to be out of the market at any time. Keep in mind the weighted average cost rules will impact the size of the loss that can be claimed in this situation.
- Ensuring you do not own the security on the 30th day following the settlement date. This relates directly to the second part of the two-part test. (See the Two-Part Test section for details).
- Transferring the security to a child, parent or sibling (i.e. anyone unaffiliated).
- Purchasing only a portion of the identical security back within the 61-day superficial loss period (see Sarina's example above).

Shares

- Selling shares of one company and purchasing shares of a different company that provides similar exposure to the markets.
- Selling an exchangeable share and purchasing the common share of the same company (but not the other way around).
- Selling the shares and purchasing a call option as long as you or someone you are affiliated with does not own that call option on the 30th day following the settlement date of the sale of the shares.

Mutual funds

- Switching from one mutual fund trust to a different mutual fund trust in a similar asset class.
- Switching from one mutual fund trust to a similar mutual fund corporation in a similar asset class or vice versa.

It is possible to take advantage of the superficial loss rule to transfer your unrealized capital losses to your spouse.

Superficial loss strategies that may not work

The following transactions involving investments in loss positions may result in the application of the superficial loss rules:

- Making an in-kind transfer of the security from your non-registered account to your RRSP/RRIF/TFSA/RESP of which you are the subscriber, or selling the security in your non-registered account and repurchasing the identical security in your RRSP/RRIF/TFSA/RESP. Although not considered a superficial loss, these losses would be permanently denied under another section of the Tax Act and can never be claimed.
- Selling the security in a non-registered account and immediately repurchasing the same security in a managed non-registered account or vice versa.
- Selling shares of a HOLDR and repurchasing any of the underlying securities held in the HOLDR.
- Selling a security held by one company and repurchasing the same security in a different company if both companies are controlled by the same individual or group of individuals.

Using superficial loss to transfer capital loss to a spouse

It is possible to take advantage of the superficial loss rule to transfer your unrealized capital losses to your spouse. You may be interested in this strategy if you have unrealized capital losses that you can't use personally and your spouse has taxable capital gains that would otherwise be subject to tax (or vice versa). Even if you or your spouse can use the losses personally, you may still want to transfer capital losses to the spouse in the higher tax bracket if that spouse has taxable capital gains that would be subject to tax at a higher rate.

By selling your loss securities to your spouse at their fair market value, and purposefully triggering the superficial loss rules, your spouse will end up with the securities at your ACB which will be higher than the fair market value they paid for them. In turn, your spouse will sell the securities and get to use the loss against any capital gains they may have. Because your spouse bought the security from you, there will not be any attribution of the loss back to them.

Call option strategy

To avoid being out of a position and risk having the price of the security appreciate significantly in the 30 day period that you must be out of that stock in order to claim the loss, a call option can be acquired at or near the money within this 30-day period. The call option enables the investor to be out of the underlying stock, but reap the potential benefits if the price of the stock should appreciate during the intervening period.

To avoid the superficial loss rule, you cannot own the call option on the 30th day after settlement of the disposition of the shares. Since call options are settled on the next business day, this means that you must sell the call option by the 29th calendar day after the settlement date of the disposition of the shares. The net result is that you will be covered for the upside potential during the 30 day period that you own the option and the superficial loss rules will not be triggered since neither the stock nor the call option was owned on the 30th day after the settlement of the disposition of the shares.

To avoid the superficial loss rule, you cannot own the call option on the 30th day after settlement of the disposition of the shares.

If the call option was held beyond the 30-day period, then the superficial loss rule will apply to deem the amount of loss from the sale of the underlying stock to be nil. That denied loss will be added to the ACB of the call option and may only be recognized upon the subsequent sale or expiration of the call option. If the call option is subsequently exercised, the denied loss forms part of the ACB of the newly acquired shares and gets recognized when those shares are sold.

Conclusion

By considering some of the strategies outlined in this article, you will be in a better position to avoid the negative consequences associated with superficial loss transactions, thereby enabling you to maximize your tax loss selling opportunities. The decision to dispose of assets should be based on the investment merits and not strictly tax motivated.

The information contained in this article is intended to provide general information only and should not in any way be construed as providing legal or tax advice. The article is based on the current and proposed tax law in effect as of the date of this article. You should consult your own professional legal or tax advisors before acting on any of the strategies presented herein.

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