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Superficial Loss Rules and Planning Strategies

An overview of the rules and strategies surrounding superficial losses

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If you are faced with a capital loss and would like to benefit from the tax advantage associated with the loss, ensure that you understand the superficial loss rules and the planning opportunities surrounding them.

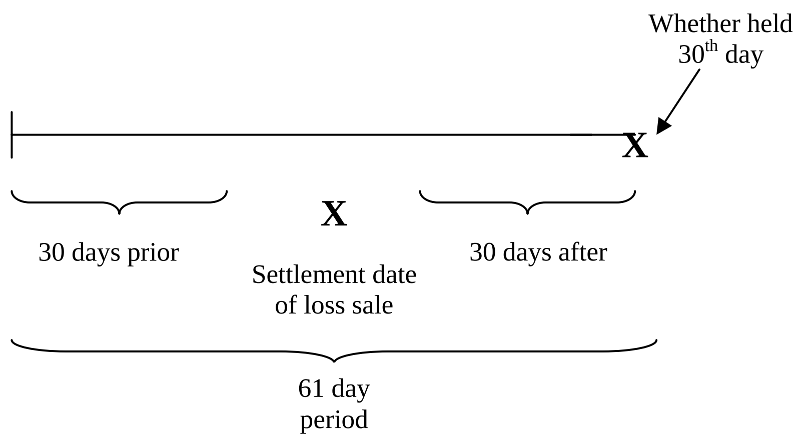
In order for you to claim a capital loss on the sale of a security, you must ensure that the transaction is not considered a superficial loss transaction. Generally this means that you cannot repurchase the same security within a certain period of time if you wish to claim the capital loss on the sale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

What Is a Superficial Loss Transaction?

A superficial loss transaction is triggered when **both** of the following events occur:

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 are a majority interest beneficiary) acquire the identical property that was sold at a loss; **AND**

b) at the end of that period (i.e. on the 30th day after the settlement date of the disposition), you or a person affiliated with you own or had a right to acquire the identical property.



If a superficial loss is triggered, you will not be allowed to claim the capital loss. The amount of the capital loss is not lost forever, but is added to the adjusted cost base of the substituted property. For example, assume Bob sold a security today for $100 and realized a capital loss of $10. If Bob repurchases the identical security for $103 in the same quantity a week later, and held 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 adjusted cost base of the substituted property so that the adjusted cost base on the new security will be $113 ($103 + $10).

Two-Part Test

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

PART A

A common misconception among investors about the superficial loss rule is that it only applies if the identical security is repurchased within the **30 days** after the settlement date of the sale of the original investment. Though this is true, it is not complete. The superficial loss rules can also be triggered if you acquire the identical security on the **same day** as the sale or at any time within the 30 days prior to selling the original investment. **There is a 61-day period which need 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

Another common misconception among investors regarding the application of the superficial loss rules is that as soon as the identical security is acquired at anytime within the 61 day period the superficial loss rules are automatically triggered. However, since this is a two-part test, the second part must also be met. The second part of the test is only met if identical security is owned on the 30th day after the settlement date of the loss sale. **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 may be able to avoid the superficial loss rule by ensuring you do not own the security on the 30th day.

For example, let's say you sold a security at a loss on the first of the month and then repurchased it the following week because you didn't want to be out of the position. The rules suggests that as long as you (or a person affiliated with you) do not own the security on the 30th day after the settlement date of the loss sale (the 31st of the month in our example) you will not be caught by the superficial loss rules. So in our example, if you sold the security and it settles on the 29th of the month you would be able to claim the loss you incurred on the 1st of the month and even reacquire the position again a few days later. (Of course if the second sale settling on the 29th of the month was also at a loss now you have to pay close attention to whether the superficial loss rules will apply to that loss.) Please note that this strategy is more aggressive than simply waiting until the 30th days have passed to require the position therefore please ensure you discuss this strategy with your tax advisor if you are considering implementing it.

Settlement Date

It is important to point out that for purposes of the superficial loss rule; the 61-day period is from settlement date to settlement date and not the transaction date. For example, assume Bob sells 100 shares of XYZ with a trade date of October 21, 2008. This trade will settle on October 24, 2008. To avoid a superficial loss transaction, Bob must not acquire any new XYZ shares, which settle on or after September 24, 2008 or before November 23, 2008 (inclusive). Because of the settlement dates, this means that Bob can acquire new XYZ shares with a trade date before September 19, 2008, or on or after November 19, 2008 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, 2008 (see above for details regarding 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 respects so that a prospective buyer would not have a preference for one over the other (Interpretation Bulletin 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 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 CRA has also stated that two classes of shares of a company may be considered identical for purposes of superficial loss rules, if one class of shares can be converted to the other class of shares. Consider for example, XYZ Ltd. with 2 classes of shares. Shares of class B have a conversion right that 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 as a superficial loss transaction by the CRA.

Superficial Loss Strategies – That May Work

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

ALL SECURITIES

- Sell and repurchase the same security after 30 days from the settlement date of the sale.
- Purchase an identical security at least 31 days prior to selling the original security. This could work quite well since you will not 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.
- Ensure 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 above under Two-Part Test for details.
- Transfer the security to a child or a parent.
- Purchase only a portion of the identical security back within the 61-day superficial loss period. For example, if you sold 100 shares of XYZ Inc. for a loss of $100 and repurchased 50 shares back within the 61-day period and continue to hold it on the 30th day after the loss sale settlement date, you can still claim 50% of the loss or $50 (50/100 * $100).

SHARES

- Sell shares of one company and purchase shares of a different company that provides similar exposure to the markets.
- Sell an exchangeable share and purchase the common share of the same company (but not the other way around).
- Sell the shares and purchase 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

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

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:

- An in-kind transfer of the security from your non-registered account to your RSP/RIF account or selling the security in your non-registered account and repurchase the identical security in your RSP/RIF. In either case your loss would be denied since you are affiliated with your RSP and since the security will end up in the registered account, the loss can never be claimed.
- Sell the security in a non-registered account and immediately repurchase the same security in a managed non-registered account or vice versa.
- Sell shares of a HOLDRs and repurchase any of the underlying securities held in the HOLDRS.
- Sell a security held by one company and repurchase the same security in a different company if both companies are controlled by the same individual or group of individuals.

Using Superficial Losses to Transfer Capital Losses between Spouses

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

This may be particularly desirable in situations where one spouse has significant taxable capital gains in the current or any of the three prior years. The spouse with little or no taxable capital gains can transfer their unrealized capital losses to the other spouse to offset those gains. Alternatively, it may also be beneficial to transfer capital losses of a lower income spouse to a higher income spouse to minimize the amount of total taxes paid by both spouses.

Conclusion

By considering some of the strategies outlined above, 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.

Please be aware that while the strategies presented in this article may not trigger the application of the superficial loss rules, there may be other provisions in the Income Tax Act that may apply to prevent you from claiming the tax benefits associated with tax-loss selling. Furthermore, 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 above information 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.