Wealth Management

RBC Wealth Management Services

Superficial loss rules and planning strategies

Tax rules to remember when triggering capital losses

You may realize a capital gain or loss when you sell a non-registered security for more (gain) or less (loss) than the cost base of the security. Income tax is payable on the net capital gains you realize in a year. While this sounds pretty straightforward, some capital losses are considered "superficial" and cannot be used to offset capital gains. This article discusses the superficial loss rules and how they are applied.

All references to a "spouse" in this article also includes a common-law partner.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

Please contact us for more information about the topics discussed in this article.

What is a superficial loss?

When you sell your investment at a loss and reacquire the identical property, in some cases, the loss may be a superficial loss. When you realize a superficial loss, you cannot claim the loss and therefore, you cannot use it to offset capital gains. Instead, the loss is added to the adjusted cost base (ACB) of the identical property reacquired.

Both of the following conditions must be met for the superficial loss rules to apply:

Condition 1

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 acquires the identical property that was sold at a loss. Although the rules may be complex, affiliated persons include you, your spouse, a corporation controlled by you and/or your spouse, and a trust where you and/or your spouse are majority interest beneficiaries.

Therefore, when you sell your

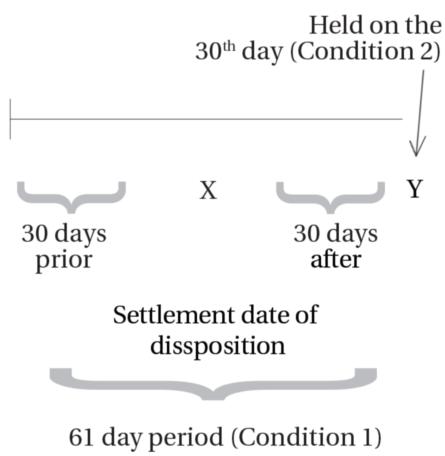
The identical property can be purchased at any time during the 61-day period without triggering the superficial loss rules as long as you or someone affiliated with you does not own that identical property on the 30th day following the settlement date of the disposition of the original investment.

investment at a loss, you need to consider the 61 days that includes the 30 days before, the day of and the 30 days after the settlement date of the disposition.

Condition 2

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 owns or has a right to acquire the identical property.

The identical property 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 property on the 30th day following the settlement date of the disposition 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 could avoid the superficial loss rules by ensuring you (and any person affiliated with you) do not own the security on the 30th day.

For example, you own 1 share of XYZ with an ACB of $100. You sell the share of XYZ today for $90 and realize a capital loss of $10. You decide that you do not want to be out of the position and repurchase a share of XYZ for $103 a week later. You hold this share of XYZ for longer than 30 days from the settlement date of the original disposition. In this case, you will be denied from claiming the $10 capital loss on the initial sale. The $10 loss will be added to the ACB of the security you repurchased so that the ACB of the XYZ share you currently hold will be $113 ($103 + $10).

If you had sold the repurchased security so that it settled on the 29th day (or any time before the 29th day) after the settlement date of the original disposition, you would be able to claim the $10 loss you realized on the original sale of the security. You 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, you 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 discuss this strategy with a qualified tax advisor if you are considering implementing it.

The superficial loss rules only apply if you acquire “identical property”. A similar but not identical property may be acquired at any time without triggering the superficial loss rules.

Settlement date

For the purpose of the superficial loss rules, the 61-day period is from settlement date to settlement date and not from the transaction date. Therefore, it is important to know how long it will take a particular transaction to settle. In general, it takes 3 business days for a transaction involving a Canadian equity to settle. Mutual funds transactions take 1 business day to settle.

For example, assume you sell 100 shares of XYZ with a trade date of October 19, 2016. This trade will settle on October 24, 2016. To avoid triggering the superficial loss rules, you must not acquire any new XYZ shares that settle on or after September 24, 2016 and before November 23, 2016 (inclusive). Because of the settlement dates, this means that you can acquire new XYZ shares with a trade date on or before September 20, 2016 or on or after November 21, 2016 if you wish to avoid triggering the superficial loss rules. Alternatively, since you must meet both conditions to trigger the superficial loss rules, you can simply ensure you do not own any XYZ shares on November 23, 2016 (see previous section for details on the conditions).

Identical property

The superficial loss rules only apply if you acquire “identical property”. A similar but not identical property may be acquired at any time without triggering the superficial loss rules.

What is an identical property? The Canada Revenue Agency (CRA) has stated the following: “identical properties are properties that are the same in all material aspects, so that a prospective buyer would not have a preference for one as opposed to another. To determine whether properties are identical, it is necessary to compare the inherent qualities or elements which give each property its identity.[1]” If you are unsure of whether a property is an identical property you should seek advice from a qualified tax professional.

Generally, two different classes of shares of a corporation would not be considered identical if they do not have the same interests, rights and privileges. For example, if class A shares of XYZ has voting rights but class B shares do not, they would not be considered identical. However, the CRA takes the position that if one class of shares is convertible into another class of shares, the two classes of shares may be considered identical. This is because the right to convert from one class of shares (e.g. Class X) to another (e.g. Class Y) is considered a right to acquire property and that right attached to Class X is identical to the Class Y shares for the purposes of the superficial loss rules.

The CRA has also provided guidance on mutual funds. The CRA stated in a Technical Interpretation[2] 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 stated that it would generally not consider a TSX 300 Index Fund to be identical to a TSX 60 Index Fund.

1) CRA Interpretation Bulletin (IT) 387-R2
2) TI 2001-0080385 (November 22, 2001)

Mutual funds may allow pre-authorized contributions on a weekly, bi-weekly, monthly or annual basis. They are a form of regular savings that are quite popular; however, you may be affected by the superficial loss rules if you decide to sell some of the funds at a loss.

Proportionate superficial loss formula

When you have triggered a superficial loss, you may still be able to claim some of the capital loss 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 sold at a loss. You may calculate the amount of the denied loss 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 Condition 1 described above

B = the number of shares left at the end of the 61-day period

For example, you purchased 1,000 shares of XYZ Inc. in January 2015 for a total ACB of $10,000. On October 2, 2016, you sold the 1,000 shares of XYZ Inc. for total proceeds of $4,000, resulting in a capital loss of $6,000. However, you decided to buy back 300 shares of XYZ Inc. on October 16, 2016 for $1,500 and continue to hold these 300 shares with no plans to sell them. How much of your $6,000 capital loss is denied? Based on the formula, you 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, you 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 rules. This denied loss of $1,800 is added to the ACB of your remaining 300 XYZ Inc. shares, giving you a new ACB of $3,300 ($1,500 + $1,800).

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

Pre-Authorized Contribution (PAC) Plans

Mutual funds may allow pre-authorized contributions on a weekly, bi-weekly, monthly or annual basis. They are a form of regular savings that are quite popular; however, you may be affected by the superficial loss rules if you decide to sell some of the funds at a loss. For example, by selling some units in one month where the fund is in a loss position and then rebuying more in the same or the next month could trigger the superficial loss rules and the loss may be denied. To avoid the superficial loss rules, you may need to stop the PAC in the month following a sale.

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

- Repurchasing the same security after 30 days from the settlement date of the original 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.

Making an in-kind transfer of a security from your non-registered account to your RRSP/RRIF/TFSA/RESP of which you are the subscriber. Although not considered a superficial loss, these losses would be permanently denied under another section of the Income Tax Act and the loss can never be claimed.

- Ensuring you do not own the security on the 30th day following the settlement date.
- Transferring the security to an adult child, parent or sibling (i.e., anyone unaffiliated with you).
- Purchasing only a portion of the identical security back within the 61-day superficial loss period (see "proportionate superficial loss formula" example).

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 a non-exchangeable 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.

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 or similar rules where the capital loss is denied:

- Making an in-kind transfer of a security from your non-registered account to your RRSP/RRIF/TFSA/RESP of which you are the subscriber. Although not considered a superficial loss, these losses would be permanently denied under another section of the Income Tax Act and the loss can never be claimed.
- Selling a security in your non-registered account and immediately repurchasing the identical security in your RRSP/RRIF/TFSA/RESP.
- Selling a security in your non-registered account and immediately repurchasing the identical security in a managed non-registered account or vice versa.
- Selling a security in your non-registered account and repurchasing the security in a corporation controlled by you.
- Selling a security held by one of the corporations controlled by you and repurchasing the same security in a different corporation also controlled by you.

Exceptions to the superficial losses rules

In some cases, even if you meet the two conditions above, the superficial loss rules will not apply. Some of the more common situations include:

- You are deemed to have sold the capital property because you became or ceased to be a resident of Canada.
- You are considered to have sold the property because you changed its use.

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).

- The property is considered to have been sold because the owner died.
- The disposition results from the expiry of an option.
- You dispose of the property and within 30 calendar days after the disposition you became or ceased to be exempt from income tax.

Using superficial loss rules to transfer a capital loss to your 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. For more information on this strategy, ask your RBC advisor for our article "Transferring Capital Losses to Your Spouse".

Call option strategy

Call option strategies may entail significant risk and are not suitable for all investors. Please consult with an option licensed advisor prior to investing in any option strategy.

You may have purchased a call option on the security you just sold for a loss to allow you to be out of the position but take advantage of any price appreciation during the 30 days you need to stay out of the security. However, for purposes of the superficial loss rules, **a right to acquire a property** is generally deemed to be property that is identical to the property that was originally sold. Since the call option gives you the right to purchase the identical security, the superficial loss rules will be triggered if you hold the call option on the 30th day after the sale of the security.

To avoid the superficial loss rules, you cannot own the call option on the 30th day after settlement of the disposition of the shares. Since call option transactions are generally 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 security. The result is that you will be out of the position for one day (the 30th day) after the loss sale. The superficial loss rules will not apply since the security or the call option is not owned on the 30th day after the settlement of the disposition of the original security. You can repurchase the original security on the 31st day to remain in the position.

If the call option was held on the 30th day after settlement of the disposition of the security, then the superficial loss rules will apply to deem the amount of loss from the sale of the underlying security 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 security and is recognized when the security is sold.

By considering some of the strategies outlined in this article, you may be able to avoid the negative consequences associated with superficial loss transactions so that you can maximize your tax loss selling opportunities.

Conclusion

By considering some of the strategies outlined in this article, you may be able to avoid the negative consequences associated with superficial loss transactions so that you can maximize your tax loss selling opportunities. However, it is important to keep in mind that the decision to dispose and acquire investments should be based on the investment merits and not strictly tax motivated.

Please contact us for more information about the topics discussed in this article.