CI GLOBAL ASSET MANAGEMENT | Tax, Retirement and Estate Planning

SUPERFICIAL LOSSES AND HOW TO PLAN AROUND THEM

When contemplating a potential disposition or in-kind transaction, one should be watchful of the superficial, suspended and denied loss provisions of Canada's Income Tax Act (ITA). In brief, the superficial, suspended and denied loss rules were implemented to prevent the recognition of artificial capital losses by structuring transactions involving "affiliated persons" (see definition below) or within a group of related economic entities.

To assist in identifying potential superficial, suspended and denied loss traps, we have outlined the relevant concepts and have provided examples below.

WHAT IS A SUPERFICIAL LOSS?

A "superficial loss" is defined as a loss from the disposition of a "particular property" where:

a) During the period that begins 30 days before and ends 30 days after the disposition, the taxpayer or a person affiliated with the taxpayer acquires a property ("substituted property") that is, or is an "identical property" (see the definition below) to, the particular property, and;

b) At the end of that period, the taxpayer or a person affiliated with the taxpayer owns or has a right to acquire the substituted property.

Where a superficial loss is identified, the loss is deemed nil and is deferred by adding the loss to the adjusted cost base (ACB) of the substituted property acquired by the taxpayer or the person affiliated with the taxpayer. At such time the substituted property is ultimately disposed of, the loss is recognized by the taxpayer or the person affiliated with the taxpayer.

Situation to consider: Mr. Smith would like to redeem all 500 units of Fund A in his open, non-registered account. His wife, Mrs. Smith, purchased 50 units of Fund A in her open, non-registered account 27 days ago. If Mr. Smith were to redeem his units today, 1/10th (50/500) of his capital loss would be superficial, deemed nil and deferred for tax purposes. As well, the deferred loss portion would be added to the ACB of Mrs. Smith's Fund A units.

Proposed solution: As Mrs. Smith purchased her Fund A units 27 days ago, a suggestion would be for Mr. Smith to wait an additional four days to dispose of his Fund A units and for him and his wife not to acquire further units for 30 days following.

WHAT IS AN AFFILIATED PERSON?

The term "affiliated person" is more specific than the term "related party." In brief, an affiliated person may be an individual, trust, partnership or corporation.

An individual is affiliated with themselves and with a spouse or common-law partner, but NOT with a child, parent or sibling.

An individual is affiliated with a trust where he or she is a majority interest beneficiary of the trust, or is affiliated with a majority interest beneficiary, such as a spouse or common-law partner.

An individual is affiliated with a corporation by virtue of control (control is > 50%). Where control over a corporation is held by an individual or an affiliated group of persons, then the individual (and his or her spouse or common-law partner) is affiliated with the corporation.

WHAT IS AN IDENTICAL PROPERTY?

"Identical properties" are capital assets that are the same in all material respects, namely interests, rights, underlying assets, benefits and privileges. A potential buyer would have no preference as to which asset to acquire.

Situation to consider: Mr. Black purchased 10 units of Fund B. The collective 10 units are identical properties as there is no distinction between the first unit and the ninth unit in terms of rights, underlying assets, benefits, etc.

Instead, if he had purchased five units of Fund B and five units of Fund C, the Fund B and Fund C units would not be identical properties as the rights, underlying assets, and benefits between the two positions are different.

WHAT IS A SUSPENDED LOSS?

A "suspended loss" occurs where a corporation, trust or partnership disposes of a particular property and during the period 30 days prior, or 30 days following the disposition, an affiliated person acquires substituted property that is, or is identical to, the particular property. In addition, at the end of that period, the taxpayer or a person affiliated with the taxpayer still owns or has a right to acquire the substituted property.

A suspended loss is fundamentally the same as a superficial loss other than who reports and tracks the deferred loss. For a suspended loss, the deferred loss is deemed nil, is "suspended" and tracked by the original corporation, trust or partnership. At such time the substituted property is disposed of by the affiliated person, the loss may be reported and claimed by the original corporation, trust or partnership.

WHAT IS A DENIED LOSS?

A "denied loss" occurs as a result of the disposition of property to:

c) A trust governed by a DPSP, EPSP, RDSP, RRIF or TFSA under which the taxpayer is a beneficiary or immediately after becomes a beneficiary, or

d) A trust governed by an RRSP under which the taxpayer or the taxpayer's spouse or common-law partner is an annuitant or becomes, within 60 days after the end of the taxation year, an annuitant.

Where a denied loss occurs as a result of transferring assets in kind to an RRSP or TFSA, the loss is deemed nil and permanently denied. A denied loss also occurs if substituted property is acquired within the RRSP or TFSA 30 days before or 30 days after, and again the loss is permanently denied.

Situation to consider: Mrs. Allen requested that $21,000 worth of the Fund D units held in her open, non-registered account be transferred over to her RRSP in kind. The ACB of the units is $22,500 and they have a fair market value (FMV) of $21,000. If this transfer is carried out, there will be a deemed disposition of the units in the open account upon being transferred to the registered account. The capital loss of $1,500 ($21,000 - $22,500) is denied permanently and any potential tax saving is lost as the loss occurred as a result of a disposition of property to an RRSP.

Proposed solution: Mrs. Allen should be made aware of what she would report for tax purposes and what her alternatives are. Alternatives include contributing new funds or disposing of the Fund D units in her open, non-registered account, contributing the funds to her RRSP and ensuring that Fund D units were not purchased 30 days prior and are not purchased in the 30 days subsequent. If one of the alternative routes is taken, Mrs. Allen's capital loss on her Fund D units is preserved and can be applied to current year capital gains, or in the instance she has overall capital losses in the year, carried back against capital gains reported in the last three years or carried forward indefinitely and applied to future capital gains.

OTHER CONSIDERATIONS:

- The reporting of superficial, suspended and denied losses is the responsibility of the taxpayer.
- Financial institutions cannot identify with certainty superficial, suspended and denied losses as they may not know the identity of affiliated persons, nor the acquisitions/dispositions of substituted property.
- Prevention of superficial, suspended or denied losses is the best strategy.

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