Assante® PRIVATE CLIENT

Tax Loss Selling and Planning Around the Superficial and Suspended Loss Rules

What is tax-loss selling?

Tax-loss selling is the sale of a security at a loss in order to specifically reduce the capital gains realized on other investments.

Who would benefit from tax-loss selling?

Clients who realized significant capital gains during the current or any of the three previous taxation years may benefit from tax-loss selling. Capital losses realized in the current year are automatically applied against capital gains in the current year and optionally can be carried back up to three years to recover the tax paid on capital gains previously reported. Any unused capital losses can be carried forward indefinitely.

Potential traps

When contemplating a potential disposition, one should be mindful of the superficial and suspended loss provisions of Canada's Income Tax Act (ITA). Briefly, the superficial and suspended 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 and suspended loss traps, we have outlined the relevant concepts and have provided examples below.

Superficial or suspended loss – concept

In simple terms, a superficial or suspended loss may be triggered if an investment is disposed of at a loss and the same investment is purchased by an affiliated person 30 days before or 30 days after the loss is triggered AND an affiliated person holds the investment 30 days after the disposition triggering the loss.

What follows is a more robust look at these concepts.

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 settlement date of 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.

Consequence of a superficial loss

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. When the substituted property is ultimately disposed of, the loss is recognized by the individual or the person affiliated with the individual.

Situation to consider: In order to trigger capital losses, Mr. Smith would like to dispose of 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 dispose of his units today, one tenth (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 the settlement date of his disposition.

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 greater than 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.

In addition, if he had purchased five units of Fund B mutual fund trust pool and five shares of Fund B Corporate Class, even though the investments are similar, they are not considered identical properties because the underlying interests, rights, benefits and privileges 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 settlement date of 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. The key difference between the two types of losses is, a superficial loss is in relation to an individual, while a suspended loss is in relation to a corporation, partnership or trust.

Consequence of a Suspended Loss

For a suspended loss, the deferred loss is deemed nil, is "suspended" and tracked by the original corporation, trust or partnership. When the substituted property is disposed of by the affiliated person, the loss may be reported and claimed by the original corporation, trust or partnership.

Steps to consider when tax-loss selling

1. **Identify** which investments (identified investments) have accrued losses and should be considered for tax-loss selling. If contemplating this for our managed pools, run the Adjusted Cost Base Reconciliation Report to ensure you are working with an accurate ACB.

2. **Review if the identified investments are** currently held by any other affiliated person or in any other affiliated account. If the intention is to sell all the identified investments and no other affiliated person or accounts currently hold the identified investment, proceed to step 4 below, otherwise proceed to step 3.

3. **Review** the identified investments to determine if they have been purchased by an affiliated person or in an affiliated account in the prior 30 days. Printing a transaction summary for the investment policy group, and all other known persons affiliated with the client for which we have an account for the previous 30 days, will identify potential offending purchase transactions.

4. **Determine** if the superficial or suspended loss rules apply:

   a) If not, complete and submit the Tax-Loss Selling form.

   b) If yes, consider the magnitude of impact the superficial or suspended loss rules will have and discuss the implications with the client.

Turn off rebalancing for 30 days

When implementing tax loss selling for our managed solutions, we recommend turning off rebalancing for 30 days to prevent a potential repurchase of the pool within the client's investment policy group. Turning off rebalancing will reduce the likelihood that the same investment is purchased by an affiliated person (assuming their non-registered accounts are under the same investment policy group) 30 days after the loss is triggered, thereby resulting in a superficial or suspended loss. Turning off rebalancing will be done automatically when you submit the Tax-Loss Selling form.

For example, if a client's Corporate Class funds were disposed of in their open account, turning off rebalancing will prevent a repurchase on a rebalance or PAC of the same Corporate Class fund in the spouse's open account.

Other considerations:

- If markets increase in the 30 days while tax-loss selling is in process, gains may be triggered when the investments are switched back to their original position which could reduce or eliminate any intended tax savings or potentially increased taxes payable.
- Consider the investment implications of shutting off rebalancing for 30 days.
- Review the materiality of any benefits of tax-loss selling against the potential risks in the client circumstances. Consider whether there will be a permanent tax savings or just a timing difference of when the loss is claimed, by factoring in the tax rate of the client in the period the loss is planned to be claimed versus their future tax rate if you don't crystalize the loss.
- For corporate clients, consider whether it makes sense to pay out a capital dividend prior to crystalizing any losses.
- Consider the nature and potential amount payable of any taxable distributions that may be received on the alternate investment, compared to the identified investment in the 30-day window while tax-loss selling is in process.
- The reporting of superficial and suspended losses is the responsibility of the taxpayer.
- Financial institutions cannot identify with certainty superficial and suspended losses, as they may not know the identity of affiliated persons, all accounts owned by the client, nor the acquisitions/dispositions of substituted property.
- Prevention of superficial and suspended losses is the best strategy.

Can your spouse benefit from your loss?

If you have an unrealized capital loss but no capital gains against which to apply those capital losses, you might be able to transfer the unrealized capital loss to your spouse. You would trigger a capital loss by selling a security that has dropped in value, and your spouse would then acquire the identical security on the open market – within 30 days of your sale. This would cause your capital loss to be deferred because of the superficial loss rules. The deferred loss would be added to the adjusted cost base of the investment (after the 30th day from the date or your sale) and realize a capital loss that your spouse may be able to use. This is an effective tax-planning tool where one spouse has reported capital gains and the other has not.

The source for terminologies and concepts is the Income Tax Act (ITA).

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