Investors should be aware of this quirk in the superficial loss rule

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If you're an investor who buys and sells stocks, mutual funds or other securities with some regularity in your non-registered trading or brokerage account, one of the things you need to pay attention to is whether you have triggered the superficial loss rule, which could restrict you from claiming the resultant capital loss at the time of a partial disposition.

Let's review how the superficial loss rule works and then show you how the technical rules as drafted in the *Income Tax Act* could work to deny you the capital loss on a disposition of a portion of your holdings in a specific security or fund, and how a little-known Canada Revenue Agency (CRA) administrative policy may help you claim some of an otherwise superficial loss, depending on the circumstances.

The superficial loss rule

The superficial loss rule, sometimes known in the investing world as the "30-day rule," typically applies when you sell property for a loss and buy back the property (or an identical property) within 30 days of the sale date. The rules also apply if property is repurchased within 30 days by an "affiliated person," including your spouse or partner, a corporation controlled by you or your spouse or partner, or a trust of which you or your spouse or partner are a majority interest beneficiary (such as your RRSP or TFSA). Technically, the "30 days" is really 61 days because the *Income Tax Act* defines the purchase period as one "that begins 30 days before and ends 30 days after the disposition." We'll come back to this quirk a bit later when we discuss what happens when you dispose of only some of the shares you hold.

Under the superficial loss rule, your capital loss will be denied and added to the adjusted cost base (ACB) or tax cost of the repurchased security. That means the benefit of the capital loss can only be obtained when the repurchased security is ultimately sold.

To illustrate a basic application of the rule, let's say Brooke sold 100 shares of XYZ Corp. in early December and realized a capital loss of $4,000, which she hoped to use against other capital gains she realized in the year. But because Brooke is actually optimistic about the future prospects of XYZ Corp., she decided to repurchase 100 shares towards the end of December. Her repurchase of shares would trigger the superficial loss rule, preventing Brooke from claiming the $4,000 capital loss in the year. Instead, this $4,000 superficial loss will be added to the ACB of her newly reacquired XYZ shares.

But what many investors may not realize is that the superficial loss can also be triggered on a partial disposition, even when identical securities are not repurchased within 30 days.

Partial disposition of property

To illustrate, say Chad purchased 100 common shares of XYZ Co. on Nov. 20 and then sold 25 of the shares on Dec. 1, incurring a capital loss of $1,000 on the sale. Chad had no other purchases or dispositions of the XYZ shares in the year.

Under a strict technical reading of the superficial loss rule, the entire capital loss of $1,000 would be disallowed since, during the period that begins 30 days before (Nov. 1) and ends 30 days after (Dec. 31) the disposition date of Dec. 1, Chad acquired the property and, at the end of the period, Chad continued to own that property, or identical property.

This rule seems to make little sense as no shares of XYZ were repurchased after the date of disposition, so where's the offence? The only possible rationale I can see for this rule is that legislators didn't want taxpayers to be able to claim a loss on recently acquired property unless they have truly divested themselves of any interest in the property.

The CRA has acknowledged that this technical reading of the law is, indeed, correct and confirmed that it applies. That being said, it has adopted an administrative policy to allow some of the otherwise superficial loss on a partial disposition of property, based on an algebraic formula. (If you hated grade 9 math, you can stop reading here.)

Under the CRA's administrative formula, the denied superficial loss is equal to:

$$(\text{the least of } S, P \text{ and } B) \div S \times L,$$

where S is the number of items disposed of; P is the number of items acquired in the 61-day period; B is the number of items still left at the end of the period; and L is the total loss on the disposition, as determined ignoring the superficial loss rules.

The logic behind this formula seems to be to deny part of the loss to the extent that you still own some of the shares.

In the example above, applying the formula to Chad's partial sale of shares, we would take the least of S (25), P (100), and B (75), which is 25, and divide that by S (25), which is 100%, meaning that the entire capital loss of $1,000 is a superficial loss and is denied and added to the ACB of the remaining 75 shares.

Now, let’s assume that instead of selling only 25 shares, Chad sold 75 shares. Applying the CRA formula, we would take the least of S (75), P (100), and B (25), which is 25, and divide by S (75), which is 33 per cent. This means that only one third of the $1,000 capital loss or $333 is a superficial loss, which is denied and added to the ACB of the remaining 25 shares. A capital loss of $667 could be claimed and used against other capital gains realized in the year. Any unused net capital loss could be carried back 3 years or carried forward indefinitely and applied against future years’ taxable capital gains.

While it may seem unlikely that you could be affected by the above rule, it does come into play with some frequency in the context of employee share purchase plans, where employees are regularly buying shares throughout the year. If an employee should sell some shares at a loss, yet continue to buy shares in future pay periods via payroll deduction, the superficial loss rule for partial dispositions may come into play.

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