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### Determining The Tax Treatment Under The Superficial Loss Rule

One of the most common traps associated with loss crystallization strategies is the superficial loss rule.

The Income Tax Act sets out the conditions by which a particular capital loss will be considered to be a superficial loss. Generally, a superficial loss will occur when a taxpayer disposes of capital property at a loss and either the taxpayer, or a person affiliated with the taxpayer, acquires the same or identical property within 30 days.

Technically, the "30 days" is really 61 days because the Act defines the period as one "that begins 30 days before and ends 30 days after the disposition". A superficial loss cannot be realized immediately but instead must be added to the adjusted cost base (ACB) of the property, only to be recognized upon ultimate disposition.

### Partial Disposition Of Property

A 2005 Canada Revenue Agency (CRA) technical interpretation (2005-0150811E5) discusses, in some detail, how the mechanics of the superficial loss rule work upon a partial disposition of property.

To illustrate the problem associated with a partial disposition, let's assume that on January 1, Donna bought 100 shares of XYZ Inc. for \$300. Then, on March 1, the price of an XYZ share having decreased substantially, she decided to purchase an additional 100 shares for \$100. As a result, on March 1, Donna owned a total of 200 shares of XYZ Inc. with an ACB of \$2 per share, based on the identical property averaging rule  $((\$300 + \$100)/200)$ .

Let's now assume that on the following day, March 2, she sold half her XYZ shares (100 shares) for proceeds of \$100 with a resulting capital loss of \$100. If we assume that no further transactions occur in the 30-day period following March 2, would Donna's loss be superficial?

### CRA's Formula

The CRA has, administratively, established a formula to determine the amount of a superficial loss upon a partial disposition. The formula is as follows:

$SL = (\text{Least of } S, P \text{ and } B) / S \times L$ , where SL is the superficial loss, 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 left at the end of the period and L is the loss on the disposition as otherwise determined without regards to the superficial loss rules.

Responding to the example above, the CRA stated that Donna's loss would indeed be superficial because during the 30 days prior to the disposition date of March 2 she acquired additional shares of XYZ Inc.

Following the formula above,  $SL = (\text{least of } S (100), P (100) \text{ and } B (100) / S (100) \times L (\$100) = \$100$ .

### Employee Share Purchase Plans

While all this math may at first seem highly theoretical, let's review a very real situation based on another CRA technical interpretation (2004-0073011) released in 2004. The situation involved an employee share purchase plan where the employee purchased shares of his employer on a bi-weekly basis. On May 31, 2003, the employee owned 50 shares and, during the month of June, he acquired an additional 10 shares of his employer through the stock purchase plan.

As of July 1, 2003, the shares decreased significantly in value and the employee decided to dispose of 50 of the 60 shares that he owned and realized a capital loss. Despite the loss in value of these shares, the employee continued to participate in the share purchase plan and acquired another 10 shares of his employer in July 2003.

The CRA was asked what, if any, portion of the capital loss would be superficial. Applying the aforementioned formula, where S is the number of items disposed of (50), P is the number of items acquired in the 61-day period (20, comprising the 10 in June and the 10 in July) and B is the number of items left at the end of the period (20), the superficial loss rule would deny the taxpayer's loss on 20/50 of the shares.

Again, recall that the loss is not denied completely but rather is added to the ACB of the taxpayer's shares so that he may realize the benefit of this loss when he ultimately disposes of the shares.

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