Unintentionally Losing Ground

Eileen Reppenhagen

Losses, just like people, can be superficial (a.k.a. by tax folks as pregnant losses) or in total denial. Don't ask me to explain why they are called pregnant losses, I have no idea. If anyone can tell me, I'd be happy to share it with you.

Superficiality of losses is situational, relational and time sensitive. It depends on the situation, who else is involved and during what time period the loss is created. Eventually the superficial loss will be realized, but creation of the loss will not affect the creator's taxes payable.

Total denial or "stop loss" is where a loss is permanently blocked from realization. No offset, carry back or carry forward is allowed. Not ever.

Identical properties are deemed for superficial loss purposes to include capital, eligible capital and inventory properties as well as shares or debts owned by financial institutions. Included are rights to acquire property, shares of capital stock acquired in exchange for another share. Life insurance corporations and foreign property have identical property rules.

It gets worse. Superficial/pregnant losses and stopped losses not only affect you directly, they affect affiliated parties. The worst part is that there is no deemed compensation for lost benefits. Who was it that said nothing is fair in love and war? They were right. Take it one step further, all is not fair when you affiliate.

Who are Affiliated Parties?

Spouses, partners, (maybe even more than one at the same time), corporations, partnerships, trusts may all be affiliated with each other.

Affiliated Taxpayers Can Affect Your Tax Position

If an affiliated taxpayer purchases identical property within a 60-day window, that is specifically 30 days before or 30 days after your date of loss, the superficial loss rule can hamper your tax planning and produce unintended consequences. Alternatively, you could affect someone else's intended loss strategy and swipe their ACB bump.

You might unintentionally hand someone a tax reduction you intended to utilize. All the affiliated person has to do is purchase an identical property any time within 30 days before or 30 days after you sell your property at a loss.

The affiliated party's adjusted cost base increases and the thing that is hardest to understand is that they are not required to pay you any compensation for the loss. You lose your tax refund or tax reduction. You may have had no intention of gifting the adjusted cost base increase to someone else, especially someone affiliated with you. Why is it a gift? The affiliated person's cost base increases, reducing their future capital gains or increasing their future capital losses.

Why Stop or Block Losses?

Superficial loss and stop loss rules are designed to prevent you or those closest to you from realizing capital losses when there is no intention that affiliated persons in the group stop owning identical property.

Superficial a.k.a Pregnant Losses

If you purchased shares worth $2,000 in 2002 and sold them for $1,500 on January 1, 2007, you would normally have a capital loss of $500. That is, you would think you would have a capital loss, until you discover that someone affiliated with you purchased the identical property within that 60-day window.

Your loss is transferred to their adjusted cost base when you sell an investment that is worth less than its adjusted cost base to an affiliated taxpayer. The effect is that the loss is temporarily deferred if anyone affiliated buys the identical property until it is sold out of the affiliated group.

If any affiliated taxpayer bought the same shares at any time within a 60-day window, 30 days prior or 30 days after you sold your shares, for example between December 2, 2006 to January 31, 2007, any loss you generated would also be deferred and the cost base of the affiliated taxpayer's shares would be bumped up by the $500.

The effect is that you lose the right to claim the loss. The loss will be transferred to the adjusted cost base of the identical property owned by the affiliated party. Your spouse/partner or affiliated company can steal your right to use a loss by buying an identical property before or after you sell yours, any time within a 60-day window.

Stop Losses

If you transfer/sell an investment at a loss to your RRSP, or a deferred profit sharing plan, an employee profit sharing plan, a RRIF or a RHOSP or a plan under which your spouse or partner is the annuitant, the stop loss is permanent.

For example, if you bought shares that were worth $2,000 in 2002 and decide in 2007 to swap those shares to your RRSP out of your non-registered broker account to your RRSP in exchange for some cash held in your RRSP, you would have a permanent loss if the market value of those shares on the day you transfer them is $1,500. The value for your RRSP contribution will be $1,500, not $2,000 and the capital loss, zero, nil, nada.

Normally capital losses carry forward for your whole life and sometimes even reduce the tax you pay on your final date of death tax return. When a loss is stopped, you can never use that loss to offset capital gains. You can not use that loss to carry back to reduce the tax paid (read refund) on a capital gain in any of the three previous years or forward forever, like a regular capital loss.

No Man is an Island

Accounting for investment portfolios takes on a new significance if you and any affiliated persons purchase identical properties. Considering transactions of an affiliated taxpayer becomes very important. Do you currently hire an accountant for your company, calculate your own tax return and does your spouse have their tax return prepared by a friend? This could be a recipe for disaster if you own identical properties.

Purchases and sales of identical properties require cross checking. If no one is cross checking, a tax audit could impose nasty surprises for identical property transactions.

My recommendation is that affiliated parties coordinate tax return preparations and investment accounting under the family/corporate umbrella. At the very least have a professional review all returns and investment portfolio transactions. Comparison of any capital losses and acquisition dates of identical properties should form part of the annual review of financial and tax calculations.

What if you have not been accounting for your portfolio? This is only one of the 27 reasons I know of to start accounting for your ACB and I have a list of all 27 (for a future article).

My software of choice is QuickenXG. The reports necessary to check for purchase dates relative to sale dates for losses make this software a great choice for checking for superficial/pregnant or stop losses. It is important to note that if you buy and sell identical properties in several brokerage accounts, you might need to account for the entire portfolio of accounts within one Quicken account in order to ensure that your calculations of average cost work out.

What Timeframe Would be Relevant?

Twelve months is not enough. It is necessary to consider at least 14 months, one month before the year and one month after the calendar year. Given that capital gains are rather elusive creatures, the likelihood is that if you have investment portfolios held by various parties, there will be capital losses from time to time. Why? Because 30 days before and 30 days after could be triggered by any sales in either January or December.

What Should be Compared?

Comparison of purchase dates of all identical properties sold during the 60-day window by all affiliated parties is required. Why? Ensure that every capital loss has not been made superficial by the purchases of identical properties by any affiliated party. A review of capital losses reported by the affiliated parties is not sufficient. Compare for purchases of identical properties within the 60-day window for all capital losses by all affiliates.

What Properties are Included?

Identical properties are identical with respect to all rights, in equity or otherwise, either immediately, or in the future and either absolutely or contingently and include gold bullion and gold certificates, escrowed and convertible shares, commodities futures contracts, indexed securities, bonds, debentures, bills, notes or similar obligations, rights to acquire property by share exchange or conversion. This is by no means an all-inclusive list. If you own something that is the same as something else except that the principal amount is different, it is likely an identical property.

Are There Exceptions?

Of course there are. Nothing in life is that easy. Here are some situations where you would have to check the special rules. At this point, I would definitely recommend an expert review and prepare the tax filing for:

- Ceasing to be a resident of Canada,
- Death,
- Expiry of option,
- Change of use of property,
- Bad debts / insolvency,
- Loss denied under other rules (modified in December 1997),

- Certain deemed dispositions by trusts,
- Some corporate transactions by mutual funds, insurers, financial institutions and securities dealers,
- Some corporate or partnership dispositions governed by other rules, and
- When there is a change in control of the seller or a change of exempt status within 30 days after the disposition.

For more information, check out Canada Revenue Agency publications available by phone request or online search at www.cra-arc.gc.ca:

- T4037 Capital Gains Guide,
- Income Tax Act S. 40(2)(g)(i), (iv) “Stop loss”,
- Income Tax Act S. 54 Definition of “Superficial loss”, and
- IT-387R2 Meaning of Identical Properties.

Eileen Reppenhagen, CGA, Tsawwassen, BC (604) 943-7414, eileen@taxdetective.ca