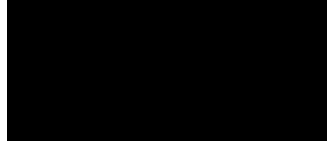


May 1, 2023

Steven L. Kobes



CRA – Income Tax Rulings Directorate  
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Ottawa, ON K1A 0L5

**Request for Technical Interpretation – superficial loss and 7(1.31) designation**

A Technical Interpretation is hereby requested in accordance with the procedure set forth in Information Circular No. IC70-6R12.

The requestor's name, address, and telephone number appear at the top of this page.

A description and detailed analysis of the tax issue are set forth below.

I invite the Directorate to respond by email, and have attached the standard authorization form for email or facsimile transmission.

Regards,

A handwritten signature in cursive script that reads "Steven L. Kobes".

Steven L. Kobes

## I. Description of Tax Issue

Consider the following example:

An individual taxpayer enters into a Restricted Stock Unit (RSU) agreement with their employer, X Inc., the units of which are settled in shares of the capital stock of X Inc.

The taxpayer acquires shares under the agreement on three dates as shown in the table below, on each date realizing a benefit under s. 7(1)(a) of the *Income Tax Act*<sup>1</sup> according to the fair market value (FMV) of the shares on that date:

	acquisition	FMV/share	benefit value
Nov 1, 2021	1 share	\$60	\$60
Dec 1, 2021	3 shares	\$80	\$240 (\$80 × 3 shares)
Jan 1, 2022	1 share	\$50	\$50

On Dec 15, 2021, the taxpayer sells 3 shares of X Inc., for net proceeds of \$70 per share (or \$210 in total). On their 2021 income tax return, pursuant to s. 7(1.31), the taxpayer identifies the 3 particular shares acquired on Dec 1, 2021 as being the 3 particular shares sold on Dec 15, 2021.

All shares of X Inc. are of the same class of stock and carry the same interests, rights and privileges. The taxpayer has no other acquisitions or sales of X Inc. shares.

What portion, if any, of the taxpayer's apparent capital loss of  $\$240 - \$210 = \$30$  sustained on Dec 15, 2021, is disallowed as superficial loss?

## II. Analysis

### A. Background

#### 1. Superficial loss

A loss realized upon disposition of a particular property is deemed nil by s. 40(2)(g)(i) to the extent that it is a "superficial loss" as defined in s. 54, which applies "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 (in this definition referred to as the 'substituted property') that is, or is identical to, the particular property, and

(b) at the end of that period, the taxpayer or a person affiliated with the taxpayer owns or had a right to acquire the substituted property,"

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<sup>1</sup> RSC 1985, c 1 (5th Supp), as amended ("the Act"). All statutory references are to the Act unless otherwise stated.

subject to various exclusions.<sup>2</sup> Thus, whether a loss is a superficial loss depends in part on whether acquired property is “identical to” the property disposed of.

Generally, whether properties are identical is “a question of fact which must be decided on the basis of the relevant details in each situation.”<sup>3</sup> But in certain cases, the Act may deem properties identical, notwithstanding their factual resemblance.<sup>4</sup>

The CRA accepts an algebraic formula for calculating superficial loss,<sup>5</sup> which can permit a more equitable result than a literal reading of the Act.<sup>6</sup>

## 2. Subsection 7(1.31)

Where a taxpayer acquires shares under an RSU agreement giving rise to a benefit under s. 7(1), they may dispose of the shares so acquired within 30 days and designate or identify them in accordance with s. 7(1.31), subject to the requirements of that subsection.

The utility of such a designation comes mainly from s. 47(3), which provides that “[f]or the purpose of subsection (1), a security” to which s. 7(1.31) applies “is deemed not to be identical to any other security”. Subsection 47(1) provides an averaging rule for determining the adjusted cost base of “identical properties”.

Thus, s. 7(1.31) allows the taxpayer to determine gain or loss on designated shares without averaging the cost base of those shares with the cost base of other shares the taxpayer may own which would be identical to the s. 7(1.31) shares but for the operation of s. 47(3).<sup>7</sup>

## 3. Ambiguity of superficial loss and s. 7(1.31)

The example is probative of the interaction between superficial loss and s. 7(1.31): may shares designated under s. 7(1.31) be treated, by virtue of such designation, as not identical to other shares for the purpose of the s. 54 definition of “superficial loss”? This in turn hinges on the interpretation of s. 47(3): does it make shares non-identical for the purpose of defining superficial loss, or does it do so solely for the purpose of s. 47(1) cost base averaging?

If s. 7(1.31) shares are identical to other shares for superficial loss purposes, further questions are raised about the application of the CRA’s algebraic formula.

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<sup>2</sup> s. 54, definition “superficial loss” (emphasis added). None of the exclusions in clauses (c) through (h) are implicated by the facts of the example.

<sup>3</sup> Bulletin IT-387R2, para. 1.

<sup>4</sup> An example of such a deeming provision is s. 248(12), which disregards the principal amounts of debt obligations in determining whether such obligations are identical to each other “[f]or the purposes of this Act”.

<sup>5</sup> See e.g. T.I. 2002-0176785, T.I. 2004-0073011, and T.I. 2005-0150811E5.

<sup>6</sup> For example, if two identical shares are each sold at a loss on the same date and only one share is acquired as substituted property within the 61-day window, the algebraic formula makes 50% of the loss superficial, while a literal interpretation arguably makes both losses superficial (by considering them separately).

<sup>7</sup> In the example, applying s. 7(1.31) to the 3 shares acquired on Dec 1, 2021 allows gain or loss from their disposition on Dec 15, 2021 to be determined ignoring the cost base of the share acquired on Nov 1, 2021.

## B. Possible theories applied

Four possible positions are presented below with analysis of their consequences for the example.

### 1. Superficial loss disconnected from s. 7(1.31); literal application

We may adopt a “disconnected” interpretation of the definition of superficial loss, holding that it treats all shares of X Inc. as “identical” to each other notwithstanding any s. 7(1.31) designation.

If, under this interpretation, the definition of superficial loss is applied literally on a share-by-share basis, then the entire loss of \$30 is superficial. This is because, for each of the 3 shares sold on Dec 15, 2021, considered separately, the conditions of the definition are satisfied:

- (a) the taxpayer acquired an identical property during the relevant 61-day period, namely the share acquired on Jan 1, 2022 (the “substituted property”); and
- (b) the taxpayer owned that substituted property at the end of the period.<sup>8</sup>

### 2. Superficial loss disconnected from s. 7(1.31); algebraic formula

The CRA allows the use of an algebraic formula set out in T.I. 2005-0150811E5 which computes superficial loss on a particular disposition as:

$$SL = (\text{Least of S, P and B}) / S \times L$$

where

SL is the superficial loss,  
S is the number of items disposed at that time,  
P is the number of items acquired in the 61-day period,  
B is the number of items left at the end of period, and  
L is the loss on the disposition as otherwise determined.

Applying this formula to the example:

- S = 3: three shares were sold on Dec 15, 2021.
- P = 4: three shares acquired on Dec 1, 2021, and one share acquired on Jan 1, 2022.
- B = 2: both of the shares acquired on Nov 1, 2021 and Jan 1, 2022 are still owned at the end of the 61-day period.<sup>9</sup>
- L = \$30: excess of \$240 adjusted cost base over \$210 net proceeds

Under a disconnected interpretation of superficial loss, with the algebraic formula as given, the superficial loss is  $2/3 \times \$30 = \$20$ . The residual loss of \$10 is counted as the taxpayer’s capital loss for the year 2021 under s. 39(1)(b).

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<sup>8</sup> The total superficial loss of \$30 may then be added to the adjusted cost base of the substituted property (that is, the share acquired on Jan 1, 2022), pursuant to s. 53(1)(f).

<sup>9</sup> But see section B.3, below, for further discussion of amount B.

### 3. Superficial loss disconnected from s. 7(1.31); proposed modified algebraic formula

Curiously, the algebraic formula as set out in T.I. 2005-0150811E5 includes the share acquired on Nov 1, 2021 in amount B, even though that share cannot be “substituted property” under the text of the Act because it was not acquired within the 61-day period.

With regard to amount B, the CRA has stated: “Generally, we are of the view that the number of items left at the end of the period means all the items that are identical to the particular property including the initial purchase.”<sup>10</sup>

But if the CRA believes that s. 7(1.31) shares may be identical to other shares for superficial loss purposes, then it should modify the definition of amount B to better accord with the textual requirements of “substituted property”. Amount B should consider only those items left at the end of the period *which were acquired during the period*.<sup>11</sup>

Applying a disconnected interpretation of superficial loss with this modified algebraic formula to the example, we find that  $B = 1$  (the share acquired on Jan 1, 2022), the superficial loss is  $1/3 \times \$30 = \$10$ , and the residual loss of \$20 is counted as the taxpayer’s capital loss for the year 2021.

### 4. Superficial loss connected with s. 7(1.31)

Finally, the CRA may endorse the position that s. 7(1.31) shares are not identical to other shares for purposes of defining superficial loss.

This “connected” interpretation assigns the same meaning to the concept of “identical” properties for both superficial loss and cost base averaging.

Under this theory, there is no superficial loss in the example, because the share acquired on Jan 1, 2022 is not identical to any of the shares sold on Dec 15, 2021 which are subject to s. 7(1.31). The entire loss of \$30 is counted as the taxpayer’s capital loss for the year 2021.<sup>12</sup>

### *C. Argument for connected interpretation*

The CRA has indicated that generally, “identical properties” is understood to have the same meaning for purposes of s. 47(1) and for the s. 54 definition of superficial loss.<sup>13</sup> However, it has not issued explicit guidance on the interaction between superficial loss and s. 7(1.31).

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<sup>10</sup> T.I. 2005-0150811E5.

<sup>11</sup> In applying this modified algebraic formula to shares that are *not* subject to 7(1.31), attention must be given to the “first in, first out” (FIFO) ordering rule which s. 7(1.3) imposes generally for purposes of Subdivision C (even for shares not acquired under a section 7 agreement).

<sup>12</sup> Only 50% of the taxpayer’s capital loss is “allowable capital loss” under s. 38(b). The tax benefit which may be obtained from a capital loss is further constrained by the s. 3(b) requirement of having a gain for the loss to offset.

<sup>13</sup> Bulletin IT-387R2, para. 1.

To select the best position among the competing theories, we must find the best interpretation of s. 47(3), which deems s. 7(1.31) shares non-identical for certain purposes, in concert with s. 54, which defines “superficial loss”.

Judicially adopted principles of interpretation demand “a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole”.<sup>14</sup>

## 1. Text

Subsection 47(3) deems certain securities non-identical “[f]or the purpose of subsection (1)”. That phrase may be read as limiting the scope of the provision, so it does not strictly compel that such shares are non-identical for the purpose of any other section of the Act.

Section 54 defines “superficial loss” by reference to “identical” property. But the Act does not provide an explicit definition of when two properties are identical for purposes of s. 54, or for purposes of the Act as a whole.

Therefore, there is ambiguity at a textual level as to whether shares which are deemed non-identical for the purpose of s. 47(1) are similarly non-identical for the purpose of the s. 54 definition of “superficial loss”. To resolve that ambiguity, we turn to context and purpose.

## 2. Context

Context entails the consideration of interrelated provisions of the Act which “work together to give effect to a plausible and coherent plan”.<sup>15</sup>

A contextual analysis of the superficial loss rule indicates that it is designed to cooperate with the cost base averaging rule as part of a unified code in Subdivision C for taxing capital gains.

These provisions share the common phrase “is identical to”,<sup>16</sup> and a superficial loss is paired with a corresponding addition to the adjusted cost base of substituted property.<sup>17</sup>

A “connected” interpretation which deems s. 7(1.31) property non-identical to other property for superficial loss purposes would recognize contextual nuance in the superficial loss rule, and create greater harmony between s. 47(1) and s. 54 of the Act.

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<sup>14</sup> *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54 (CanLII), para. 10. This is a reformulation of the so-called “modern rule” in Elmer A. Driedger, *Construction of Statutes*, 2d ed. (1983).

<sup>15</sup> *Cophorne Holdings Ltd. v. Canada*, 2011 SCC 63 (CanLII), para. 91, citing R. Sullivan, *Sullivan on the Construction of Statutes* (5th ed. 2008).

<sup>16</sup> s. 54 defn. “superficial loss” clause (a) “acquires a property... that is, or is identical to, the particular property”; s. 47(1) “acquires one or more other properties... each of which is identical to each such previously-acquired property”.

<sup>17</sup> s. 53(1)(f).

### 3. Purpose

The superficial loss rule is part of an anti-avoidance framework aimed at refusing “the recognition of artificial, superficial or undue losses”.<sup>18</sup> Its purpose is to ensure a degree of correspondence between allowable capital loss and true economic loss.

The concerns which motivate the superficial loss rule have limited application to the type of property which may be identified under s. 7(1.31).

Harvesting “artificial” losses requires strategic control over both the disposition of property and the reacquisition of substituted property. But a typical RSU plan provides for an automatic acquisition of shares at regular intervals, for example on a monthly basis. Such acquisitions are not undertaken as part of an avoidance strategy.

Furthermore, s. 7(1.31) includes a requirement that the shares to which it applies are sold within 30 days of acquisition. This limits its usefulness in loss harvesting schemes, even under the connected interpretation:

- If s. 7(1.31) shares are sold, the recency of their acquisition makes it improbable that a sizeable loss is realized.
- If shares sold at a loss are replaced with s. 7(1.31) shares, the taxpayer enjoys at most 30 days of continued exposure to the position.

A “connected” interpretation which deems s. 7(1.31) property non-identical to other property for superficial loss purposes would accord with the legislative purpose of the superficial loss rule.

### 4. Ease of administration

A “disconnected” interpretation which allows s. 7(1.31) property to be identical to other property creates challenges and ambiguities for the CRA’s algebraic formula for superficial loss. This is illustrated above by the approach in section B.2 (yielding a \$20 superficial loss) contrasted with the “modified formula” proposal in section B.3 (yielding a \$10 superficial loss).

As argued in section B.3 above, if the CRA adopts the disconnected interpretation, the algebraic formula should be revised to specify that amount B may count only those items left at the end of the period which were acquired during the period.

In considering the merits of the disconnected interpretation, the CRA should weigh the increased complexity and costs of auditing and enforcing it, including revising the algebraic formula, against the marginal increase in tax revenue it is likely to generate for the nation.

The “connected” interpretation, which treats s. 7(1.31) property as non-identical to other property for superficial loss purposes, is comparatively simple to apply, and requires no revision of the algebraic formula.

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<sup>18</sup> *Triad Gestco Ltd. v. The Queen*, 2011 TCC 259 (CanLII), para. 98.

### **III. Concluding remarks**

A tax issue has been presented through an example illustrating an ambiguity in the interaction of superficial loss and a designation under s. 7(1.31). Four possible answers have been examined. Finally, an argument has been made in favour of an interpretation which connects superficial loss and cost base averaging to a common meaning of “identical” properties.

The position that s. 7(1.31) shares may be identical to other shares for superficial loss purposes

- produces tax results that depart from economic realities,
- creates new ambiguities in applying the CRA’s algebraic formula, and
- substantially increases the complexity and costs of tax compliance for employees with monthly-vesting RSU grants, and the costs to the CRA of enforcing such compliance.

The alternative position that s. 7(1.31) shares are not identical to other shares for superficial loss purposes avoids those problems, and can be supported under a contextual and purposive analysis.

I welcome any questions, comments or feedback of the Directorate to provide clarity on the issue.

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## Appendix F – Standard authorization for email and facsimile transmission for communication with the Income Tax Rulings Directorate

Where the taxpayer or their representative wishes to communicate with the Directorate by email or facsimile, an authorization for email and facsimile transmission must be completed. If an advance income tax ruling is being requested, this authorization will also apply to a subsequent supplemental ruling, unless a new representative has been appointed, in which case a new authorization must be provided.

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FROM: Steven L. Kobes [REDACTED]

RE: Superficial loss and s. 7(1.31) designation

I hereby authorize the Canada Revenue Agency (CRA) to email and/or fax all correspondence concerning the above-noted request, made by, or on behalf of, the above-noted taxpayer. The correspondence is to be transmitted to the following email address and/or fax number:

Name(s): Steven L. Kobes

Email Address: [REDACTED]

Fax number: \_\_\_\_\_

I am aware that the CRA does not provide assurance with respect to the protection, confidentiality, or security of email or facsimile transmissions. I accept the risks inherent in sending information by email and/or fax and further recognize that all email messages sent over the internet may be considered as being accessed and disclosed to unknown third parties somewhere in the world. I agree not to hold the CRA or its employees liable for any damage or loss, however caused, arising out of the email and/or facsimile transmissions of correspondence related to this request.


### CERTIFICATION

This authorization must be signed and dated by an authorized person of the taxpayer such as an owner, a partner of a partnership, a director of a corporation, an officer of a non-profit organization or a trustee of a trust.

Steven L. Kobes

Name (print)

\_\_\_\_\_  
Position



\_\_\_\_\_  
Signature of taxpayer or authorized signing officer of the taxpayer

2023-03-27

\_\_\_\_\_  
Date

**See the Privacy notice in ¶56 and 57 of IC70-6**

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