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What is a Capital Gain and How is it Taxed?

Background

Prior to 1972, capital gains on the disposition of property were not subject to tax pursuant to Canada's Income Tax Act (ITA). Over the last 44 years, Canada's Department of Finance, pursuant to its objective of taxpayer fairness, has introduced various tax measures impacting the reporting and taxation of capital gains, such as:

- Defining what portion of a capital gain would be taxed (ie. capital gains inclusion rate)
- Special rules for certain types of property such as a Principal Residence, Personal Use Property, and Listed Personal Property
- The introduction of, and changes to, the Lifetime Capital Gains Exemption (CGE) for individual taxpayers on the sale of qualified small business corporation shares and qualified farming or fishing properties
- How capital gains are calculated given the nature of the property

A history of the taxation of capital gains

Important Date or Range of Dates	wCapital Gains or Capital Gains Exemption Impact	Capital Gains Inclusion Rate
December 31, 1971	Valuation Day – Unrealized capital gains on capital property held on this date were not taxable. The FMV of capital property held on this date represents its adjusted cost basis on a go-forward basis.	0%
January 1, 1972	Capital gains now a taxable income receipt.	50%
January 1, 1972 – December 31, 1987		50%
January 1, 1982	Only one Principal Residence Exemption per family unit.	
January 1, 1985	Introduction of $500,000 lifetime Capital Gains Exemption.	
January 1, 1988 – December 31, 1989		66-2/3%
January 1, 1990 – February 27, 2000		75%
February 22, 1994	Elimination of general Capital Gains Exemption on first $100,000 of capital gains; $500,000 for qualified small business corporation shares and farm property remained.	
February 28, 2000 – October 17, 2000		66-2/3%
October 18, 2000 – today		50%
May 1, 2006	$500,000 Capital Gains Exemption expanded to include qualified fishing property.	
March 19, 2007	Capital Gains Exemption raised from $500,000 to $750,000.	
January 1, 2014	Capital Gains Exemption raised from $750,000 to $800,000 on qualified small business corporation shares, and will be indexed annually.	
April 20, 2015	Capital Gains Exemption raised from $750,000 to $1,000,000 for qualified farm and fishing property (no indexing).	

Capital gain versus income receipt

Determining if a receipt is on account of income or capital is not simple and straightforward. In fact, since 1972, there have been many tax court cases that have focused on determining if a receipt was on account of capital or income.

The ITA does not define "capital gain." To report a capital gain, the property disposed of, or deemed disposed of, must be capital in nature. However, "capital property" is also not defined in the ITA, and the determination of whether a receipt is on account of capital or income is dependent upon the nature of the property and the manner in which the taxpayer holds the property.

While taxpayer intent – what was the primary purpose behind the taxpayer purchasing the property – is always a key determinant, the following guidelines are used by CRA and the courts when evaluating a particular transaction to determine if the taxpayer should report on account of capital or income:

- Period of ownership – short versus long term. The latter lends itself to capital if a particular property is purchased and held over a long period of time by the taxpayer.
- Frequency of transactions – regularity of similar type transactions versus a single, one-time transaction. The former is more likely to be considered on account of income by way of business or the adventure in the nature of trade – a regular, business transaction.
- Relationship of the transaction to the taxpayer's ordinary business or income. A stockbroker, who on a daily basis researches his positions and trades securities, may report such dispositions on account of income, whereas a client of the stockbroker, who is medical doctor, may sell a particular security that had been held for three years and report such a disposition on account of capital.
- Improvement and supplemental work on the property to position for sale or to retain over a longer period. If improvements are made to capital property to prolong its overall use or period of ownership, such expenditures lend themselves to being on account of capital.

A common analogy that tax advisors use to differentiate a capital versus income property is a fruit tree – the tree itself is capital property, it is bought infrequently and held for a long period, it is not an asset a fruit farmer regularly buys and sells. If the tree or orchard is sold, it is on account of capital. Meanwhile, the fruit borne by the tree annually is an income receipt that a fruit farmer regularly generates on account of income, business or adventure in the nature of trade, not on account of capital.

Let's take a look at certain tax concepts and tax legislation as it applies to clients who hold investments in open, non-registered accounts.

Capital gains

Today, if a client disposes of a particular security held on account of capital, the capital gain – proceeds of disposition less the adjusted cost basis – is included for income tax purposes at 50%. Capital gains are reported on Schedule 3 for individual taxpayers, Schedule 6 for corporate taxpayers and Schedule 1 for trusts.

Calculation of capital gains

A capital gain is simply proceeds of disposition (POD) received less adjusted cost basis (ACB) paid by the taxpayer. However, sometimes there are adjustments to POD and ACB that need to be considered. Here are a few adjustments clients should consider as it relates to investment securities held in open, non-registered accounts.

ACB considerations:

- Identical property – properties that are the same in all material aspects, so that a prospective buyer would not have a preference for one as opposed to another. To determine which properties are identical, it is necessary to compare the inherent qualities or elements that give each property its identity.

  When determining the capital gain from the disposition of Canadian securities, the identical property rule is taken into account when calculating the ACB of units sold using a weighted average cost.

  For example: Mrs. Smith bought 1,000 units of Fund A on January 15 for $10,000, 325 units on March 15 for $4,000, and received 30 units worth $400 (her annual T5 reported an eligible dividend of $300 and a capital gain dividend of $100) at year-end. On December 27, Mrs. Smith sold 500 units for $6,000. What is her capital gain?

$$\frac{(\$10{,}000 + \$4{,}000 + \$400)}{1{,}000+325+30} = \frac{\$14{,}400}{1{,}355} = \$10.63/\text{unit}$$

$$\$6{,}000 - (500*10.63) = \$685$$

- Commissions paid to brokers relating to the *purchase* of a particular security position are on account of capital. As this expenditure relates to the purchase of capital property, it is not an income deduction and is added to the ACB of the securities purchased. A commission is not to be confused with advisory fees relating to the provision of investment counsel.

- Where securities are acquired by a dividend re-investment plan (DRIP) or received in kind to support an income distribution, the FMV of the dividend/distribution used to purchase additional shares or units represents additional ACB. The additional shares or units are deemed to be acquired with after-tax dollars – as the dividends or distributions are taxable income in the hands of the investor.

  For example: Mr. Jones bought 4,000 shares of Canadian Auto Corp. (Corp) on January 5 for $50,000. On January 15, he received an eligible dividend of $1,200, and $1,150 was used to purchase an additional 90 shares through Corp's DRIP. On July 15, he received another eligible dividend of $1,200 and $1,190 was used to purchase 85 shares through Corp's DRIP. What was the ACB of Mr. Jones' shares on December 31?

$$\frac{(\$50{,}000 + \$1{,}150 + \$1{,}190)}{4{,}000+90+85} = \frac{\$52{,}340}{4{,}175} = \$12.54/\text{unit}$$

POD considerations:

- Commissions paid to brokers relating to the *disposition* of a particular security position are, again, on account of capital. As this expenditure relates to the disposition of capital property, it is not an income deduction, and reduces the POD received from the securities. Once again, a commission is not to be confused with advisory fees relating to the provision of investment counsel.

  For example: Mr. Donald's broker purchased 1,000 shares of Corp for $40,000 on February 15 and the brokerage charged him a $75 commission for the purchase transaction. On September 30, he sold the 1,000 shares of Corp for $40,500 and was charged another $75 commission for the disposition. What was Mr. Donald's capital gain?

$$(\$40{,}500 - \$75) - (\$40{,}000 + \$75) = \$350$$

Special considerations and exceptions

Gifts of publicly traded securities to charities are included at 0% (as opposed to 50%) for taxable capital gain purposes – thus any inherent capital gains triggered when securities are donated in kind generate a $nil tax liability. As well, the donor receives a charitable donation slip representing the FMV of the securities donated. When evaluating a client's philanthropic wishes, a gift of securities is often a preferred method.

For example: Mrs. Anderson wants to donate $10,000 to her local hospital, a Canadian charity where she has worked as a volunteer for a number of years. Mrs. Anderson calls her advisor to sell securities to fund the donation. She currently has several mutual funds that have significant accrued gains. For the purposes of this example, Fund A has a FMV of $20,000, and an ACB of $12,000. If you were Mrs. Anderson's advisor, what would you suggest?

Looking at the table below, there are two options – sale of units of Fund A to generate $10,000 cash, or Mrs. Anderson can donate $10,000 worth of Fund A units in kind.

As Mrs. Anderson would have to dispose of additional units of Fund A to cover the tax liability resulting from her disposition if she chooses to donate cash, it is recommended she donate the units in kind – it is a more tax-efficient manner to support her philanthropic intentions.

For individual taxpayers, where securities have been donated in kind, the disposition is not reported on Schedule 3 Capital Gains (or Losses) for (Taxation Year), but is reported on form *T1170 Capital Gains on Gifts of Certain Capital Property.*

	Cash Donation of $10,000	Donation of Shares in kind
Proceeds of Disposition	$11,000	$10,000
Adjusted Cost Base	$(6,600)	$(6,000)
Capital Gain	$4,400	$,4,000
Taxable Capital Gain - 50%, 0%	$2,200	–
Taxable Capital Gains tax rate - 45%	$(990)	–
After-tax proceeds to fund donation	$10,010	$10,000
Donation	$10,000	$10,000
Donation Tax Credit rate - 40%	$(4,000)	$(4,000)

Miscellaneous disposition of foreign currency, such as the conversion of foreign currency or traveller's cheques denominated in foreign currency to another currency is to be reported on account of capital. In the case of individuals, Canada's ITA provides that only amounts in excess of $200 need to be reported for tax purposes.

From a foreign exchange perspective, any additional income/expense or gain/loss resulting from a foreign exchange component is linked with the resulting transaction. Meaning, if a security purchased and disposed of in a foreign currency is treated on account of capital, any additional gain or loss from the disposition from foreign currency is also treated on account of capital.

For example: Mr. Zhang bought 1,000 shares of Apple in October 2011 when it was priced at US$55 (US$1 = C$1.02). He sold 500 shares in October 2016 for US$107 (US$1 = C$1.32). What is Mr. Zhang's capital gain to be reported on his 2016 T1?

(500 * $107 * 1.32) – (500 * $55 * $1.02)
$70,620 - $28,050 = $42,570

The reporting of capital gains by Canadian mutual fund investors

All Canadian mutual fund investors (individuals, corporations and trusts) should be aware that there are two levels of capital gains reporting – gains that are reported at the fund level, and then those that are triggered by the investor.

When a fund manager sells holdings in a particular mutual fund and a capital gain is realized, the capital gain may be passed on to the unitholder (or shareholder for corporate class funds) through a fund distribution. Capital gain fund distributions are reported in box 21 Capital Gains on a T3 (trust pools) and box 18 *Capital Gains Dividends* on a T5 (corporate class funds). If the distribution is reinvested, it increases the investor's ACB for tax purposes. These are known as capital gains at the fund level.

As well, for non-registered accounts, clients who redeem or trigger a disposition of units or shares will need to report the disposition and the resulting capital gain (or loss) triggered on their respective annual tax return. Such transactions occur when units or shares are redeemed for investment counsel fees, to rebalance the client's portfolio to align with their investment policy statement, or if the client redeems or withdraws cash, triggering a redemption.

Investors in segregated insurance funds should note that both fund and investor level capital gains (and losses) are reported on the T3 collectively, while mutual fund trust and corporation dispositions by an investor are normally reported on a capital gain or loss summary on year-end statements.

In summary

The above points relating to the calculation and tax reporting of capital gains are by no means exhaustive, and the tax rules overseeing the calculation and reporting of capital gains are complex. If a client has disposed of capital property, and is unsure of the reporting and taxation of such, please refer them to a competent tax advisor.

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