TAXATION OF CAPITAL GAINS

While it might be thought that all money earned should, for tax purposes, be treated in the same way, this is not the case under Canadian tax rules. Many types of income receive different, or preferential, tax treatment, often because that income arises from the types of activities—business investment, for instance—which our economic system wants to encourage. While the rule regarding the deduction of business expenses can be stated in simple terms there are, within that rule, myriad exceptions, qualifications, and restrictions. Most of those are the result of provisions in our tax law that limit, in one way or another, the amount of deduction which can be taken for a particular kind or class of expenses.

Such is the case for the tax treatment of what are termed "capital gains". In the simplest terms, a capital gain is what results when a property is sold for more than its original purchase price. As with nearly all things tax-related, of course, the reality is more complex. This article outlines the basic tax rules which apply when a capital gain is earned under current Canadian tax rules.

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What is a capital gain?

Since capital gains receive preferential tax treatment, taxpayers generally want money they receive from any particular transaction to be considered a capital gain and taxed as such. However, from the point of view of the revenue authorities, more tax revenue is generated when a transaction is on "income account", meaning that it is taxed as ordinary income and not as a capital gain. There are, as a consequence, frequent disagreements between taxpayers and the Canada Revenue Agency (CRA) over whether the gain from a particular transaction is on capital or income account. Technically, a capital gain is a gain arising on the disposition of a capital property. However, while that definition may be technically accurate, it's not very helpful from a practical perspective and so it's necessary to look elsewhere for guidance. Over the years, many disagreements between taxpayers and the CRA over what is or is not a capital gain have ended up before the courts and, as a result, the following guidelines have been developed to assist in making that determination.

How long did the taxpayer own the asset before selling it?

Generally, if a taxpayer has owned a property for only a short period of time before selling it, it's more likely that income realized from that sale will be treated as being on income account, and not as a capital gain. Where a property is held for a longer period of time, it's more likely the case that the taxpayer made the original purchase with the intent of holding the property as an investment, which would result in a capital gain on its sale.

How often has the taxpayer sold similar properties in the past?

A series of transactions in which similar properties were sold by the same taxpayer over a period of time would suggest that the taxpayer is in the business of purchasing and re-selling such properties for a profit. Where that is the case, the profit realized would be income from that business and not a capital gain.

Did the taxpayer make any improvements to the property before selling it?

A taxpayer who expends time and effort in re-furbishing or improving a property to improve its marketability prior to selling it is more likely to be seen as engaging in a business transaction which gives rise to business income and not a capital gain.

What are the reasons for selling and the circumstances of the sale?

Where an effort is made to advertise a property and generally engage in a "sales campaign" in order to achieve that sale, the income arising from the sale is likely to be considered business income. On the other hand, where a taxpayer has owned a property for a period of time and sells it because a need for funds arose as a consequence of an unanticipated event (like the loss of a job), the gain realized is probably a capital gain and not ordinary income.

What is the taxpayer's ordinary business?

Generally, where the taxpayer is already in the business of selling the kind of property which is the subject of the disputed transaction, it will be very difficult to argue that the profit realized from that transaction is anything but business income.

The application of the guidelines developed by the courts is perhaps more easily illustrated by way of example. The profit realized from the sale of a house is usually—but not always—a capital gain, and the guidelines outlined above will be used by the revenue authorities to determine when that profit represents business income rather than a capital gain. The profit realized by a taxpayer who sells the home which he or she has owned and lived in for a period of years or even decades will unquestionably be treated as a capital gain. However, a taxpayer who purchases a "fixer-upper" and lives in the property while making repairs and improvements before selling it at a profit may not receive the same tax treatment. In making that determination, the revenue authorities will likely look at the following factors:

- Did the taxpayer live in the property for a period of time after the repairs or renovations were carried out, or immediately put it up for sale once it was in marketable condition? If the latter, it is more likely that the purchase and ownership of the property will be viewed as a business activity and the proceeds of its sale as business income.
- Has the taxpayer carried out this type of transaction in the past? A taxpayer who repeatedly "flips" properties after renovating them will very likely be perceived as being in the business of buying, renovating, and selling such properties.
- Was the renovation work a full-time activity for the taxpayer, and does the profit from the sale of the property represent his or her only source of income? If so, and particularly if the taxpayer has carried out this type of transaction in the past, the

CRA will almost certainly take the position that the taxpayer is in the home renovation business and that monies earned from the sale of properties renovated by the taxpayer is business income.

How are capital gains taxed?

Although capital gains receive preferential tax treatment, that treatment doesn't come about because of special or lower tax rates. The tax rate applied to income earned by a taxpayer from capital gains is, in fact, the same as the rate applied to business income received by that same taxpayer. The preferential treatment arises from the fact that only a part or portion of capital gains earned are included in income for income tax purposes.

The portion of capital gains included in income (technically referred to as the "inclusion rate" or "inclusion portion") has varied a lot over the years, but that inclusion rate has, for 2001 and subsequent taxation years, stood at one-half, or 50% of capital gains earned.

The calculation of the portion of capital gain to be included in income is therefore as follows: a taxpayer purchases a property for $500 and re-sells it for $600. The total gain on the sale is $100 ($600 - $500), but the portion to be included in income (called the taxable capital gain) is one-half of that total gain, or $50 (one-half of $100). The $50 taxable capital gain is then taxed at the taxpayer's usual tax rate, which will depend on both the taxpayer's province or territory of residence and his or her total income for the year.

The practical effect of the one-half inclusion rate is, of course, that capital gains are effectively taxed at one-half the rate applied to the taxpayer's ordinary or business income for the year.

Reducing capital gains by capital losses

Not every sales transaction, of course, results in a profit or gain for the seller. Sometimes an asset has to be sold for less than its original cost, resulting in a loss. Where that loss is considered, for tax purposes, to be a capital loss, the taxpayer is entitled to reduce any capital gains earned during the same taxation year by the amount of any capital loss incurred. Continuing with the above example, take the taxpayer who sold the asset which generated a capital gain of $100. Assume that that taxpayer sold another asset during the same year but incurred a loss of $25 on that transaction. The capital gain of $100 received by the taxpayer on the first transaction is reduced by the loss sustained on the second transaction, leaving the taxpayer with a net capital gain for the year of $75. Under the usual rule providing for a 50% inclusion rate, the $75 net capital gain figure is then reduced to a taxable capital gain of one-half that amount, or $37.50.

Claiming a capital gains exemption

Taxpayers who have long memories may remember a time when it was, for a short period, possible to earn most capital gains on what was effectively a tax-free basis. In 1985, the federal government of the

time introduced a "lifetime capital gains exemption" of $100,000 per taxpayer. However, that exemption began to be phased out beginning in 1992 and was eliminated in 1994, except for certain specialized types of property, including shares of a small business corporation or certain family farming and fishing property. The available capital gains exemption for those specialized types of property was actually increased to $800,000 (for dispositions after January 1, 2014) and is indexed to inflation commencing in 2015.

Shares of a small business corporation

While there is, of course, a technical definition of what constitutes a share of a small business corporation, the type of property which will generally qualify as such is shares of an active family-owned business. More technically, in order to qualify as small business corporation shares for purposes of the capital gains exemption, shares must have the following attributes.

- The shares must be shares of a Canadian-controlled private corporation which, at the time the shares are sold, uses at least 90% of its assets in carrying on an active business in Canada.
- The shares must be owned by a taxpayer, the taxpayer's spouse or common-law partner, or a partnership related to the taxpayer.
- The shares must not have been owned by anyone other than the taxpayer or someone related to the taxpayer during the 24 months prior to the time the shares were sold. As well, during that 24 month period, at least half of the assets of the business must have been used principally in an active business.

Where all of these requirements are satisfied, a capital gains exemption can be claimed on up to $824,176 in capital gains ($412,088 in taxable capital gains) received on the sale of the shares in 2016 ($813,600 in 2015).

Qualified farming and fishing property

As is the case with small business corporation shares, the rules governing capital gains received on the sale of qualified farming or fishing property generally apply to dispositions of family-owned farming and fishing businesses. However, the actual definition of qualified farming and fishing property includes the following:

- A share of the capital stock of a family-farm or family fishing corporation that is owned by the owned by the taxpayer or his or her spouse;
- An interest in a family-farm or family-fishing partnership that the taxpayer or his or her spouse owns;
- Real property: in the case of a qualified farming property, such real property would generally be land or buildings, while for qualified fishing property, that real property could include land and fishing vessels;
- Rights, licences, or quotas, such as milk and egg quotas or fishing licences.

Here again, where the property in question meets these criteria, a capital gains exemption on up to $1,000,000 in capital gains ($500,000 in taxable capital gains) realized on the sale of such property can be claimed.

Specialized types of property

While a general capital gains exemption is now available only with respect to small business corporation shares or qualified farming or fishing properties, there are many other types of properties which receive special or different treatment under the rules governing taxation of capital gains. The rules which apply to the types of property most commonly held by taxpayers are outlined below.

The family home or principal residence

For most Canadians, the purchase of a home is likely both the single biggest financial transaction that they will make during their lifetimes and also represents their single biggest asset. As well, the equity accrued in a family home is, for many Canadians, an important component of their retirement planning.

Recognizing all this, our tax system allows taxpayers to sell the family home without having to pay tax on any profit or gain realized. The mechanism through which this is accomplished is known as the "principal residence exemption" and, although the mathematical calculation required is somewhat complex, the effect is simple. Any increase in the value of a property while it is being used as the principal residence of the taxpayer is exempt from tax when the property is sold.

At one time, it was possible for a family to claim more than one principal residence, which would allow one spouse to claim the principal residence exemption on, for example, the primary family home and the other spouse to claim that exemption with respect to the family cottage. However, that has not been the case since 1981—under current rules, a family is only allowed to claim the principal residence exemption with respect to one property.

Personal use property

While real estate represents the largest single asset that most Canadians own, there are many other types of property that are bought and sold every day for a gain or profit. When it come to most types of personal property, our tax system excludes the smallest transactions from the tax net, so that any capital gains realized on the sale of such property are subject to tax only where the amount received on that sale is more than $1,000. More technically, this is accomplished by a "deeming" rule which provides that each of the cost and the sale proceeds of any such property is at least $1,000.

Personal use property, as the name implies, is property which is owned by the taxpayer primarily for his or her own use or enjoyment. Normally, that would include such things as real estate other than a principal residence, cars, boats, furniture, electronic goods, and the like.

Note that it is the amount for which the particular asset is sold, and not the amount of any gain, which determines whether that gain is a taxable one. So, where a book is purchased for $100 and sold for $900, there would be no tax consequences to the transaction (assuming that the vendor's ordinary business is not that of bookselling). However, where a book is purchased for $1,100 and sold for $1,500, a capital gain of $400 (and a taxable capital gain of $200) has been realized and must be declared for tax purposes. That's the case even though the gain realized on the non-taxable transaction was actually the larger one.

Reporting capital gains

Capital gains are earned, and reported, on a calendar year basis. Consequently, any sales which take place between January 1 and December 31 and which result in a capital gain must be reported on the return for that year, which is filed the next spring.

Some businesses have fiscal year-ends which do not coincide with the end of the calendar year. In such circumstances, the rule which requires that a capital gain be reported in the return for the calendar year in which the sale of the property took place continues to apply. The following example illustrates the application of the rule in such circumstances.

Pauline owns a small business. The fiscal year end for her business is June 30, 2015. In August 2015, she sold a capital property that she used in her business. As a result of the sale, she had a capital gain. Pauline has to report the capital gain on her return for 2015. She does this even though the sale took place after her business's fiscal year end date of June 30.

Conclusion

The rules governing the taxation of capital gains and detailed and frequently complex—the current version of the Capital Gains guide issued by the CRA (and available on the Agency's Web site at www.cra-arc.gc.ca/E/pub/tg/t4037/t4037-15e.pdf), which seeks to explain the most common income tax situations, runs to just under 50 pages. Consequently, in all but the most straightforward of scenarios, taxpayers who believe that they may be required to report a capital gain on the annual return are well-advised to seek professional tax advice in relation to that return.particular question, taxpayers can always contact the CRA's business enquiries line at 1-800-959-5525.