When a security is sold for an amount exceeding its cost, the gain is normally a capital gain. When it is sold for less than its cost, the loss is normally a capital loss. These transactions are said to be on capital account. For the purpose of explaining the general rules concerning capital gains, the term capital property is used throughout this chapter.
Some additional points on terminology:

- property is defined in the Act to include all tangible and intangible property (i.e. virtually anything that can be possessed);
- capital property is simply property that gives rise to a capital gain (or capital loss) when disposed of; and
- capital gain is circularly defined in the Act as the gain that arises on the disposition of a capital property.

Consequently, we look to the common law — not the taxing statutes — for the meaning of capital property. There are circumstances when transactions in securities are said to be on income account. Gains or losses realized on income account are business income or business losses. Chapter 16 discusses the distinction between capital account and income account.

I. TIMING OF CAPITAL GAINS AND LOSSES

1. The meaning of disposition

A capital gain or a capital loss arises for tax purposes only when there is a disposition of the capital property. The most common type of disposition occurs when a capital property is sold, but the concept of disposition is broader than a sale.

While taxpayers generally consider it beneficial that capital gains are not taxed until realized (by a disposition), the same rule also applies to capital losses. No deduction may be claimed in connection with any depreciation in the value of a capital property until the property is actually disposed of.

A disposition also occurs, in the case of:

- any capital property, when the ownership is transferred — including gifts and transfers to trusts;
- any capital property, when it is exchanged for other property;
- a security, when it is redeemed, acquired or cancelled by the corporation;
- a debt, when it is settled;
- a share of capital stock, when it is converted upon an amalgamation or merger;
TIMING OF CAPITAL GAINS AND LOSSES

- a share of capital stock, when the corporation is involuntarily dissolved; or
- an option to acquire or dispose of property, when it expires.

A disposition is also defined to include any transaction that entitles a taxpayer to compensation, such as would be received in connection with:

- property unlawfully taken;
- property taken under statutory authority; or
- property that has sustained a loss in value through the harmful actions of others.

Although not common with security portfolios, compensation could be received where a financial institution makes restitution for investments defalcated by an employee; a political jurisdiction compensates shareholders for imposing state ownership over a corporation; or damages are won in a civil action to compensate for impairment in share value caused by the illegal actions of management.

The occurrence of a disposition is not conditional on the transferee being unrelated or at arm’s length to the transferor. A transfer of ownership (including a gift) to related persons (such as a family member) is a disposition for tax purposes. There are two caveats: in non-arm’s length transactions, there are rules that deem the amount of proceeds of disposition and there are also rules that deny or restrict the availability of capital losses. See the discussion below on “Arm’s length and related persons.”

2. Settlement date

In the case of securities that are sold through a public exchange, the disposition is considered to occur for tax purposes on the settlement date, not the trade date. For taxpayers wishing to trigger gains or losses in their portfolio at the end of the taxation year, it is always important to count back the trading days from December 31, to ensure that the sales will settle before year-end.

3. Beneficial ownership and legal ownership

A distinction is recognized in the common law between legal ownership and beneficial ownership. The legal owner holds legal title to the property, but those ownership rights may be subject to the rights of a beneficial owner who is enti-
tled to the use and benefit of the property. Legal and beneficial ownership are commonly divided when property is transferred to a trust.

A disposition does not occur where a transfer of property:

- does not involve a trust; and
- does not result in a change in the beneficial ownership of the property.

Although a transfer of property by an individual to a trust is a disposition for tax purposes, there are a few provisions in the Act that permit the disposition to occur on a tax-deferred rollover basis:

- a transfer of property to an *alter ego* trust;
- a transfer of property to a joint spousal or common-law partner trust; and
- a transfer of property that meets the definition of “qualifying disposition” — the essential (but not sole) test of which requires that the transfer not result in a change in the beneficial ownership of the property.

The terms “*alter ego* trust” and “joint spousal or common-law partner trust” are discussed in chapter 20. For a transfer of property to result in no change in beneficial ownership, the trust may not provide for any absolute or contingent beneficiaries other than the transferor.

(a) Joint accounts — probate fee avoidance

The concept of beneficial ownership is relevant to whether there has been a disposition for tax purposes when a taxpayer transfers capital property to a joint tenancy. This would occur, for example, where a taxpayer changes an existing brokerage account having sole ownership to an account having joint tenancy with right of survivorship (JTWROS). This might be done by an elderly taxpayer, for example, for the purpose of avoiding probate fees on the transfer of property at death.

There is a contradiction in this strategy: the avoidance of a disposition for tax purposes depends on there being a change in legal ownership without a change in beneficial ownership. The law of joint tenancy, however, does not recognize this distinction. Therefore, if a change in beneficial ownership has been
TIMING OF CAPITAL GAINS AND LOSSES

avoided, then a joint tenancy has not been achieved and probate fees should still apply on the transfer at death. The CRA has generally indicated in technical opinions that a transfer to a joint tenancy gives rise to a disposition of a 50% interest in the property. However, it is a question of fact whether beneficial ownership has been transferred. If the parties intend that (and also act in all respects as if) the transferor continues to retain all beneficial interest in the property, then there may not be a transfer of beneficial ownership or a disposition for tax purposes. But then the subsequent avoidance of probate fees would be based on a deception, rather than the creation of a true joint tenancy arrangement.

An alternative to creating a joint tenancy arrangement is the transfer of assets to a trust, with a general power of appointment. This would achieve the objective of excluding the assets from the person’s estate and avoid a current fair market disposition for income tax purposes.

4. Attribution rules — who reports the capital gain or loss?

The person who legally or beneficially owns the property at the time of disposition is not necessarily the person who reports the gain on his or her tax return. Where the property or the funds to acquire the property are traceable to a loan or a gift from a spouse, parent or grandparent, then the attribution rules may dictate that the capital gain or loss be reported on the tax return of the spouse, parent or grandparent. The attribution rules are discussed in chapter 23.

5. Deemed dispositions

There are certain circumstances when a disposition is deemed to occur, without there being an actual disposition of any kind. The purpose of deemed dispositions is to force the recognition of capital gains or losses. For example:

• immediately before death, with respect to capital property owned at that time; and

• immediately before becoming a non-resident, with respect to certain property owned at that time.

See chapter 20 for a discussion on the deemed disposition at death and chapter 21 for a discussion on the deemed disposition at departure. Interestingly, the costs of disposition that one would incur in an actual disposition may not be imputed for the purposes of computing a deemed gain or loss.
6. **Election to dispose of bad investments**

There are special circumstances in which a taxpayer may elect a disposition to occur in a taxation year without there being a sale or transfer. The great benefit of this election is that it permits a taxpayer to claim a loss for an investment that is worthless and has no market.

In the case of a debt owing to a taxpayer at the end of a taxation year, the election may be made if the debt is established by the taxpayer to have become a bad debt *in the year*.

In the case of a share of the capital stock of a corporation owned by the taxpayer at the end of a taxation year, the election may be made if:

- the corporation has *during the year* become a bankrupt;
- the corporation:
  - is insolvent and subject to a winding-up order made *in the year*, or
  - is insolvent at the end of the year but there has been no winding-up order made, and
- neither the corporation nor a corporation controlled by it carries on business;
- the fair market value of the share is nil; and
- it is reasonable to expect that the corporation will be dissolved or wound-up and will not commence to carry on business.

The opportunity to make the election arises for only one particular taxation year (i.e., the year the debt goes bad, the corporation becomes bankrupt or the winding-up order is made). In other words, the election is not available in just any year following these events. Therefore it is important for a taxpayer to remain vigilant in regards to the development of losers in his or her portfolio. If the opportunity to make this election has lapsed, the only remedy is an actual disposition to an arm’s length party for a nominal amount. See the discussion below on “Arms length and related persons.”

There is no prescribed form for the election. The taxpayer makes the election by attaching a signed letter to his or her tax return stating that he or she wants subsection 50(1) of the *Income Tax Act* to apply, and by including a statement that contains the following information:

- the name of the corporation;
COMPUTING THE AMOUNT OF A CAPITAL GAIN

- the number and class of shares, or the type of debt disposed of;
- the insolvency, bankruptcy or wind-up date;
- the date the shares were bought, or the debt acquired;
- the amount of the proceeds of disposition (i.e. normally nil);
- the adjusted cost base of the shares or debt;
- the outlays and expenses on the disposition; and
- the amount of the loss.

A taxpayer who makes the election is deemed to have disposed of the debt or the share at the end of the year for proceeds equal to nil and to have reacquired it immediately after the end of the year at a cost equal to nil.

7. Transactions not resulting in a disposition

A disposition is not considered to occur in the event of:

- a stock split;
- a corporation’s shares being delisted from a stock exchange; or
- a regulatory authority issuing a cease trading order in respect of a corporation’s shares.

II. COMPUTING THE AMOUNT OF A CAPITAL GAIN

The capital gain equals the proceeds of disposition less the adjusted cost base, and less any expenses or outlays of disposition. Alternatively, the capital loss equals the adjusted cost base less the proceeds of disposition, plus any outlays and expenses of disposition.

1. Adjusted cost base (ACB)

The cost of a property for tax purposes is referred to as its adjusted cost base (ACB). In the most simple case, the ACB of a property is equal to its actual out-of-pocket cost. There are a number of other factors that must be considered. Most of the chapters in Part II, “Investment Instruments,” contain comments regarding the determination of the adjusted cost base for the particular investments being covered.
The ACB of a capital property is increased by any costs of acquisition (e.g. commissions and transaction fees).

(a) Identical properties

The ACB of identical properties is averaged. For example, shares of the same corporation and the same class, acquired at different times and at different prices, each have the same cost for tax purposes, based on an average cost that is recalculated after each purchase. This averaging applies to shares, regardless of how or where they are acquired or held. Even where a part holding is sold and it is possible to trace the actual cost of that particular holding, the average cost method still applies. (See the discussion in chapter 3.)

(b) Foreign exchange rate

ACB for Canadian tax purposes is always expressed in Canadian currency. Where the original cost of a property was denominated in a foreign currency, the Canadian dollar cost is based on the exchange rate in effect at the time of purchase. The ACB is fixed as at that point in time, and does not subsequently vary with changes in the exchange rate.

(c) Gifts and bequests

Where a taxpayer acquires property by way of gift, bequest or inheritance, the taxpayer is deemed to have acquired the property at its fair market value. Where a taxpayer has acquired anything from a person with whom the taxpayer was not dealing at arm’s length at an amount in excess of the fair market value, the taxpayer is deemed to have acquired it at the fair market value. An exception to these rules applies to capital property received from a spouse — including by way of a gift or pursuant to a will (see the sections below called “Inter-spousal rollovers” and “Arm’s length and related persons”).

(d) Capital gains election

The ACB of a security may be affected by a capital gains election made in the taxpayer’s 1994 tax return. In connection with the elimination of the $100,000 capital gains election, taxpayers were permitted to utilize their remaining exemption by way of adding it to capital properties having unrealized appreciation. Provided the taxpayer made a proper election in his or her 1994 tax
return, the ACB of a capital property could be increased to an amount up to its
fair market value as at February 22, 1994. Consequently, a copy of the taxpay-
er’s 1994 personal tax return should be consulted to determine what securities, if
any, might be affected in this way. The election was made by filing Form T664,
“Election to Report a Capital Gain on Property Owned at the End of February 22,
1994.”

(e) Exercising employee stock options

The ACB of shares acquired by way of exercising employer stock options is
increased by the amount of any related taxable employee stock option benefits
reported by the employer on the T4, “Statement of Remuneration Paid,” slips, or
otherwise required to be reported on the employee’s personal tax return. Also,
certain shares (and units of mutual fund trusts) acquired through the exercise of
employee stock options are excluded from the average costing rule applicable to
identical properties. (See the discussion in chapter 5.)

(f) V-day elections (1972)

Because capital gains did not become taxable until 1972, there are special
rules for computing the tax cost of capital property owned on December 31, 1971
(Valuation Day). Generally, the tax cost of capital property owned on December
31, 1971, is established by the median rule, which deems the tax cost of the prop-
erty to be the median of three amounts (i.e. the amount which is not the greatest
nor the least):

• the actual cost of the property;
• the fair market value of the property on Valuation Day; and
• the proceeds of disposition of the property.

Where two of the amounts are the same, the tax cost is deemed to be that
amount. The rules provide that for publicly traded shares only, the Valuation Day
is December 22, 1971. Taxpayers had the choice of simply electing the tax cost
for all capital property to be the fair market value on Valuation Day. Once the
election was made, it could not generally be changed. The gain or loss from sell-
ing property owned before 1972 is calculated on Form T1105, “Supplementary
Schedule for Dispositions of Capital Property Acquired Before 1972.”
(g) Foreign spin-off elections

The adjusted cost base of shares of a foreign corporation is affected by a foreign spin-off election made previously in respect of the shares. This includes the spin-off shares and shares on which a spin-off has been received. See the detailed discussion below under the section, “Tax-deferred rollovers.”

2. Proceeds of disposition

In the most simple case, the proceeds of disposition of a property is equal to its realized selling price. There are a number of other factors that must be considered.

The proceeds of disposition of a capital property is reduced by the selling costs (often called costs and outlays of disposition).

Where a taxpayer disposes of anything to a person with whom he or she is not dealing at arm’s length, for no proceeds or for proceeds less than fair market value, the taxpayer is deemed to receive proceeds of disposition equal to fair market value. Where a taxpayer disposes of anything to any person by way of gift, the taxpayer is also deemed to receive proceeds of disposition equal to fair market value. See the discussion below on “Arm’s length and related persons.”

3. Expenses

If expenses are incurred for the purposes of earning capital gains, they are not deductible for tax purposes. As noted already, costs of acquisition are added to the adjusted cost base of a capital property; expenses and outlays of disposition are deducted from the proceeds of disposition. However, carrying costs such as interest on borrowed money and safekeeping charges are not deductible if they are incurred strictly for the purposes of earning capital gains; nor can these costs be added to the adjusted cost base.

An example of where this restriction would apply is precious metals or other commodities bought on capital account. Carrying costs are only deductible if they are laid out for the purposes of earning income from a business or property. Since these investment properties are not capable of generating income while they are held, there is no deduction available for the carrying costs.

No restriction would generally apply to the deduction of carrying costs incurred in connection with shares of capital stock on which there is a dividend
expectation. Virtually all common shares may be regarded as having a dividend expectation. In the case of preferred shares, all related carrying costs are deductible if there is a dividend, without regard to whether the dividend exceeds the costs.

4. Tax-deferred rollovers

(a) Eligible small business corporation (ESBC) shares

All or part of a capital gain realized by an individual on the disposition of eligible small business corporation (ESBC) shares after February 27, 2000, may be deferred where the individual acquires shares of another ESBC. The amount of the capital gain that may be deferred is based on the proportion of the proceeds of disposition that is invested in qualifying replacement shares. See the discussion in chapter 3.

At the time an ESBC share is issued to an individual, the corporation must be a Canadian-controlled private corporation and satisfy other restrictive tests. At the time an ESBC share is sold, however, the corporation may be publicly traded.

(b) Foreign spin-offs

Canadian shareholders of foreign corporations frequently find themselves taxable in Canada on reorganization transactions that are not taxable in the hands of shareholders who are residents of that foreign country. An example of this anomaly is where a U.S. corporation transfers all of the assets of an operating division to a newly incorporated subsidiary corporation, and then makes a pro-rata distribution of its shares in the subsidiary to its common shareholders. This type of corporate reorganization is commonly referred to as a spin-off.

Until recent amendments to the Act, the fair market value of the spin-off shares would be taxable in the hands of a Canadian shareholder as a dividend-in-kind. The ACB of the spin-off shares would be equal to the amount of the dividend and the ACB of the original shares would be unaffected by the transaction. Effective for distributions of spin-off shares received after 1997, new provisions permit a taxpayer to elect a tax deferral. The deferral is effected by allocating a portion of the ACB of the original shares to the spin-off shares in proportion to their fair market values immediately following the distribution. The key conditions for claiming the tax deferral are as follows:
the taxpayer must receive the spin-off shares as a distribution on common shares held in the distributing corporation;

• the distribution must consist solely of common shares;

• the distributing corporation and the spin-off corporation must be residents of the same foreign country that is either the United States or another foreign country with which Canada has a tax treaty;

• the taxpayer’s original shares must be of a class that is widely held and actively traded on a prescribed stock exchange;

• the distribution must not be taxable under the laws of the country of which the distributing corporation is a resident;

• the distributing corporation must provide prescribed information to the CRA concerning the distribution, within 6 months of the distribution; and

• the taxpayer must file an election in writing with his or her tax return for the year in which the distribution occurs. For distributions received in 1998, 1999 or 2000, the election had to be filed on or before September 11, 2001 (i.e. 90 days after June 14, 2001, the day on which the amendments received Royal Assent) to be considered timely filed. Extensions can be granted by the CRA under the fairness provisions of the Act, but generally only when the circumstances causing the delay were beyond the taxpayer’s control.

With respect to the requirement imposed on the distributing corporation to provide information directly to the CRA, it would be prudent of the taxpayer to contact the shareholder relations department of the foreign corporation to confirm compliance.

An election is made by including a letter with the tax return. The letter must contain the following:

• written notification that the taxpayer is electing to defer tax relating to the distribution of spin-off shares from a foreign corporation, including a description of both the original and the spin-off shares;

• the number, cost amount otherwise determined, and fair market value of the taxpayer’s original shares, both immediately before the distribution and after the distribution; and

• the number and fair market value of the spin-off shares immediately after distribution.
(c) Transfers of property under section 85

Where capital property is transferred to a corporation and all or part of the consideration received from the corporation consists of shares of that corporation, an election is available to modify the proceeds of disposition. The taxpayer may generally elect the proceeds of disposition to be any amount between the cost and the fair market value of the transferred property. This election is commonly referred to as a tax-deferred rollover, or a section 85 rollover (in reference to the applicable section of the Act). The term “rollover” has been commonly adopted by tax advisors to describe a situation where the ACB of a property rolls over from the transferor to the transferee without giving rise to a capital gain. The election is made on Form T2057, “Election on Disposition of Property by a Taxpayer to a Taxable Canadian Corporation,” and must be filed by the transferor by the earlier of the tax return filing deadline of the transferor or the transferee, for the taxation year that includes the transfer.

(d) Other rollover provisions

There are several provisions in the Act that provide tax-deferred rollovers to shareholders in situations involving amalgamations, share-for-share exchanges and other corporate reorganizations. Although coverage of these complex rules is beyond the scope of this book, the taxpayer is advised to carefully consult the Information Circular or other regulatory document to ascertain the applicable tax treatment. In some cases the rollovers are automatic, but often the shareholder is required to complete and file an election form on a timely basis in order to obtain tax rollover treatment. Consequently, vigilance in these matters is recommended. A further word of caution: most (but not all) tax-deferred rollovers apply only in respect of Canadian corporations. If there is any question as to whether a disposition of a shareholder’s interest has occurred in connection with a corporate reorganization of a non-resident corporation, it will usually be necessary to consult a Canadian tax advisor.

5. Inter-spousal rollovers

Where a taxpayer transfers capital property to his or her spouse, and both are resident in Canada at the time, the taxpayer’s proceeds of disposition is deemed to equal the adjusted cost base of the property. The spouse is deemed to acquire the property for a cost equal to the same amount. This provision is commonly referred to as the automatic inter-spousal rollover. The effect of this rollover is, of course, that no capital gain or loss arises on the transfer. The application of this rollover is not affected by the amount, if any, of the consideration paid in the
transfer. The same provision applies to property transferred to a trust for the
spouse (commonly referred to as a spousal trust), provided the terms of the trust
satisfy certain conditions. The transferor may override this rollover provision by
electing in his or her return for the year to have the provision not apply.

(a) Spouse and common-law partner

The definition of spouse, for tax purposes, is subject to ongoing change.
Commencing with the 1993 taxation year, the term spouse was extended to include
common-law relationships involving members of the opposite sex. Two individu-
als of the opposite sex are deemed to be each other’s spouse if they are living
together in a sexual relationship and have been for at least 12 continuous months.
The 12-month test is dropped if they are the natural parents of the same child, or
where one individual has adopted the other’s child (in fact or in law). Individuals
who cease to cohabit because of a breakdown in their relationship are deemed to
be cohabiting until the separation has lasted 90 days. Some finer points:

• the 12-month clock keeps ticking through periods of separation lasting less
than 90 days; and

• where cohabitation resumes after a period of separation lasting more than 90
days, there is no requirement to satisfy the 12-month test again, if it has been
met already; otherwise, the clock is reset to zero.

Effective for the 2001 and subsequent taxation years, all references to
spouse are replaced by the term, “spouse and common-law partner.” The defini-
tion of common-law partner is identical to the extended definition described
above, with one exception. The requirement that the individuals be members of
the opposite sex is dropped — but not the requirement that the relationship be a
sexual one. Individuals who would have been common-law partners in any of the
1998, 1999 or 2000 taxation years, had the new definition applied, were permit-
ted to jointly elect in their 2000 tax returns to have it apply for those years.

6. When a gain is not a capital gain

There are circumstances when a gain realized on a security is not a capital
gain:

• when the gain is realized on income account (see chapter 16);
• when the gain relates to the exercise of employee stock options; and
• when the shares are redeemed, acquired or cancelled by the issuing corporation.

Gains realized from the exercise of stock options granted by an employer are generally taxed as employment income. If certain conditions are satisfied, only one-half of the gain is subject to tax — resulting in the same effective tax rate as applies to capital gains and thereby removing any practical distinction.

Part of the proceeds received from the issuing corporation on the redemption or cancellation of its shares are normally deemed to be a dividend, not a capital gain. Dividends are taxed on a different basis than capital gains, though at similar effective rates (see chapter 13). The deemed dividend equals the amount by which the proceeds of redemption exceed the paid-up capital of the shares. The taxpayer is also considered to have disposed of the shares and may consequently also have a capital gain or loss. The proceeds of disposition for the purpose of computing the capital gain is the paid-up capital of the shares.

7. Arm’s length and related persons

Special rules apply to transfers of property between persons dealing not at arm’s length. These rules are discussed in various sections of this chapter. Persons are deemed to be dealing not at arm’s length when they are related by blood, marriage or adoption:

• individuals are related by blood when one is the direct descendant of the other (e.g. parent-child, grandparent-grandchild) or the brother or sister of the other. The meaning of brother and sister is extended to include the spouse of the brother or sister. For example, an individual is related to her sister’s husband;
• individuals are related by marriage to every individual to whom one’s spouse is related by blood. For example, an individual is related, for tax purposes, to his wife’s sister’s husband; and
• adoption is defined to include legal and factual adoptions.

It is not necessary for persons to be related to be considered to be dealing not at arm’s length. Unrelated persons may not be dealing at arm’s length where one person, for whatever reason, subordinates his or her self-interest to the control and direction of the other person — at least with respect to the particular transaction.
The concept of related person extends beyond individuals. A shareholder and corporation are related where the shareholder controls the corporation. Two corporations are related where they are controlled by the same person or group of persons.

III. PREFERENTIAL TAX RATE

Capital gains are multiplied by the capital gains inclusion rate to determine taxable capital gains. Capital losses are multiplied by the capital gains inclusion rate to determine allowable capital losses. The excess of taxable capital gains over allowable capital losses, if any, are added to taxable income for the year. Alternatively, the excess of allowable capital losses over taxable capital gains, if any, become net capital losses, subject to the carryback/carryforward rules discussed below.

For dispositions after October 17, 2000, the inclusion rate dropped to one-half (50%). See the table below for a retrospective of the inclusion rates since capital gains first became taxable in 1972.

The inclusion rate has the effect of lowering the effective tax rate on capital gains in relation to ordinary income. At a one-half inclusion rate, the top marginal tax rate on capital gains is about 23% (for Ontario residents in 2006). Although the lower effective tax rate applicable to capital gains is generally regarded as a factor in favour of earning returns in this manner, it should be noted that capital gains commonly include an inflation factor. The fractional taxation of capital gains was originally intended to compensate (by way of rough justice) for the fact that the nominal gain computed on the disposition of a capital asset often exceeds the appreciation measured in real dollar terms.

Capital gains inclusion rates

<table>
<thead>
<tr>
<th>Period</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972 to 1987</td>
<td>1/2</td>
</tr>
<tr>
<td>1988 and 1989</td>
<td>2/3</td>
</tr>
<tr>
<td>1990 to February 27, 2000</td>
<td>3/4</td>
</tr>
<tr>
<td>After February 27, 2000</td>
<td>2/3</td>
</tr>
<tr>
<td>After October 17, 2000</td>
<td>1/2</td>
</tr>
</tbody>
</table>
1. Gifts of publicly traded securities

Effective May 2, 2006, the inclusion rate applicable to capital gains realized on gifts of certain securities made to registered charities (other than private foundations) has been reduced to zero, i.e. the gains are completely exempt from taxation. For gifts made prior to May 2, 2006, the special inclusion rate was equal to one-quarter (i.e. one half of the normal rate). Securities eligible for this treatment are:

- a share, debt obligation or right listed on a prescribed stock exchange;
- a share of the capital stock of a mutual fund corporation;
- a unit of a mutual fund trust;
- an interest in a related segregated fund trust; and
- a prescribed debt obligation.

This can be a very tax-effective means of making charitable gifts, as the zero inclusion rate makes it more beneficial to gift the securities directly, than to sell them in the market and gift the after-tax cash proceeds. The donor receives a charitable donation receipt equal to the fair market value of the securities gifted. (See table 15-1 for an illustration of the comparative benefit.) The favourable treatment also applies to gifts made at death by way of a will. Faced with a choice of which securities to gift, those with the highest proportion of gain to proceeds derive the most benefit from the preferential treatment. Qualifying gifts made in a year are reported on Form T1170, “Capital Gains on Gifts of Certain Capital Property” and filed with the tax return for the year.

The capital gains tax exemption for donations of publicly-traded securities was broadened by the 2008 federal budget to exempt capital gains on the exchange of certain unlisted exchangeable securities where:

- no consideration other than publicly-traded securities is received on the exchange; and
- the publicly-traded securities are donated to a qualified donee within 30 days of the exchange.

This change applies to donations made after February 26, 2008.
2. Capital gains exemption

Between the years 1985 and 1994, an individual could realize cumulative capital gains up to $100,000, exempt from tax. For qualified small business corporation (QSBC) shares and qualified farm property, the lifetime capital gains exemption was $500,000. In 1994, the $100,000 exemption available in connection with all types of capital property was eliminated. The exemption available

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**Table 15-1**

Donations to Registered Charities - Cash vs. Securities

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net after-tax cost of donating cash of $100,000</strong></td>
<td></td>
</tr>
<tr>
<td>Cash payment</td>
<td>100,000</td>
</tr>
<tr>
<td>Charitable tax credit</td>
<td>(46,400)</td>
</tr>
<tr>
<td>Net cash out-of-pocket</td>
<td>53,600 [A]</td>
</tr>
<tr>
<td><strong>Net after-tax cost of donating securities worth $100,000</strong></td>
<td></td>
</tr>
<tr>
<td>Cash proceeds</td>
<td>100,000</td>
</tr>
<tr>
<td>Income taxes</td>
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</tr>
<tr>
<td>Proceeds</td>
<td>100,000</td>
</tr>
<tr>
<td>Cost base</td>
<td>0</td>
</tr>
<tr>
<td>Capital gain</td>
<td>100,000</td>
</tr>
<tr>
<td>Taxable capital gain (50%)</td>
<td>50,000</td>
</tr>
<tr>
<td>Tax @ 46.4%</td>
<td>(23,200)</td>
</tr>
<tr>
<td><strong>Net cash realized if securities are sold in the market</strong></td>
<td>76,800</td>
</tr>
<tr>
<td>Charitable tax credit</td>
<td>46,400</td>
</tr>
<tr>
<td>Income taxes</td>
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</tr>
<tr>
<td>Proceeds</td>
<td>100,000</td>
</tr>
<tr>
<td>Cost base</td>
<td>0</td>
</tr>
<tr>
<td>Capital gain</td>
<td>100,000</td>
</tr>
<tr>
<td>Taxable capital gain (0%)</td>
<td>0</td>
</tr>
<tr>
<td>Tax @ 46.4%</td>
<td>0</td>
</tr>
<tr>
<td><strong>Net cash forgone by donating</strong></td>
<td>46,400</td>
</tr>
<tr>
<td><strong>Net benefit to donating securities vs. cash [A-B]</strong></td>
<td>23,200</td>
</tr>
</tbody>
</table>

**ASSUMPTIONS**

1. Donor is assumed to be in top tax bracket (based on 2008 rates in Ontario) and to have sufficient net income in the year to absorb the donation (i.e. donation does not exceed 75% of net income).

2. Securities are assumed to have a nil cost base for illustration purposes. The lower the unrealized appreciation as a percentage of total market value, the lower the comparative benefit of donating.
CAPITAL LOSSES

in connection with QSBC shares and qualified farm property continues to be available. The capital gains exemption available on QSBC shares, now increased to $750,000, is discussed in chapter 3.

3. Flow-through entities and exempt capital gains balances

An individual holding an interest in a flow-through entity (e.g. mutual fund trust) on February 22, 1994, could elect in his or her 1994 tax return to realize a capital gain on the interest up to its accrued gain at that date. The purpose of the election was to permit the individual to utilize his or her remaining capital gains exemption. The amount of the gain realized by the election was added to the individual’s exempt capital gains balance. This balance is available for taxation years ending before 2005 to offset capital gains arising from the subsequent disposition of an interest in the entity or capital gains realized by the entity and allocated to the individual.

IV. CAPITAL LOSSES

1. Restrictions on the deductibility of capital losses

There are circumstances where an amount that would ordinarily be a capital loss is deemed to be nil. These rules are commonly referred to as stop-loss rules. The purpose of these rules is to prevent a taxpayer from triggering a tax benefit (i.e. the realization of a deductible loss) in circumstances that are capable of abuse or manipulation.

An individual’s capital loss from the disposition of a property is deemed to be nil if:

- the loss is a superficial loss;
- the loss arises from the disposition of property to:
  - a trust governed by a deferred profit sharing plan (DPSP), an employees profit sharing plan (EPSP) or a registered retirement income fund (RRIF) under which the taxpayer is a beneficiary or immediately after the disposition becomes a beneficiary, or
  - a trust governed by a registered retirement savings plan (RRSP) under which the taxpayer or the taxpayer’s spouse is an annuitant or becomes, within 60 days after the end of the taxation year, an annuitant;
the loss arises on personal debt; or
the loss arises on shares redeemed by affiliated corporations.

(a) Superficial losses

A superficial loss is defined in the Act to mean a loss where:

- during the period that begins 30 days before and ends 30 days after the dis-
  position, the taxpayer or an affiliated person acquires the same or an identi-
  cal property (the substituted property) or a right to acquire the same or an
  identical property; and
- at the end of that period, the taxpayer or an affiliated person owns or had a
  right to acquire the substituted property.

The amount of the superficial loss realized on the disposition of the first
property is added to the adjusted cost base of the substituted property. The adjust-
ment has the effect of preserving the capital loss in the event the substituted prop-
erty is subsequently sold in circumstances not giving rise to a superficial loss.

The Act does not contain a definition of identical properties for this purpose.
Whether a substituted property is an identical property is a question of fact.

(i) Affiliated persons

Affiliated persons are defined in the Act to include:

- an individual and his or her spouse or common-law partner;
- a corporation and the person who controls it (and his or her spouse or com-
  mon-law partner);
- a corporation and each member of an affiliated group of persons who con-
  trol it (and his or her spouse or common-law partner);
- a person and a trust, if the person has a majority interest in the income or the
  capital of the trust or is affiliated with such a person; and
- two trusts, if a person who has contributed property to one of the trusts on a
  non-arm’s length basis (or for inadequate consideration) is affiliated with
  such a person in respect of the other trust, and beneficiaries having a major-
  ity interest in the income or the capital of the trusts are affiliated.
Affiliated persons do not include an individual and his or her:

- child;
- father or mother; or
- brother or sister.

(b) Transfers to registered plans

The stop-loss rules relating to registered plans apply where:

- contributions take the form of securities rather than cash (e.g. in-kind RRSP contributions); or
- securities are swapped between registered and unregistered accounts.

All transfers of securities to registered plans are taxable dispositions at fair market value. For example, when an individual makes an in-kind contribution of securities to an RRSP or swaps a security into an RRSP for cash, the individual’s proceeds of disposition on the transfer (for the purpose of computing the individual’s capital gain or loss) is deemed to be the fair market value of the transferred securities at the time of the transfer. If a loss arises on the transfer, it is deemed to be nil.

Unlike the superficial loss rules, there is no compensating cost base adjustment for losses denied on transfers to registered plans. When a loss arises on a transfer of securities to a registered plan, the loss is forfeited forever. For example, if a security is swapped into an RRSP (at a loss) and then subsequently swapped out, the original cost of the security to the individual is not relevant. The individual’s cost on reacquiring the security from the RRSP is equal to the fair market value of the security at that later time.

(c) Losses sustained on personal debt

A loss from the disposition of a debt is deemed to be nil, unless it was acquired for the purpose of gaining or producing income from a business or property or as consideration for the disposition of capital property to a person with whom the taxpayer was dealing at arm’s length. A loss sustained on a loan to a family member, for example, is deemed to be nil without regard to how the funds were used or whether the loan included arm’s length comparable terms.
(d) **Share redemptions by affiliated corporations**

A capital loss is denied where a taxpayer disposes of a share in the capital stock of a corporation to the corporation, and the taxpayer is affiliated with the corporation immediately after the disposition (e.g. a redemption, acquisition or purchase for cancellation of the taxpayer’s share by the corporation). The amount of the denied loss is added to the cost base of the shares in the corporation owned by the taxpayer immediately after the disposition.

2. **Loss carryback/carryforward rules**

Allowable capital losses incurred in a year must first be applied to reduce any taxable capital gains realized in the same year. To the extent they exceed taxable capital gains in the year, they become net capital losses. Net capital losses may be carried back to any of the 3 preceding years or forward indefinitely, and applied to reduce taxable capital gains in those years. Allowable capital losses and net capital losses are not deductible against any source of income other than taxable capital gains.

These are some useful points to consider when utilizing net capital losses:

- It is generally considered preferable to carry back losses as far as possible, because the oldest available carryback year expires year by year.
- The refund of tax available from a loss carryback can vary based on the specific carryback year(s) selected. This is due to the fact that the capital gains in each of those years may have been taxed at different effective rates, due to the taxpayer’s marginal bracket and the prevailing tax rates.
- The refund relating to a loss carryback arises from a re-assessment of the prior year, not from the assessment of the current year. This distinction is important for the purposes of computing interest, instalment requirements, etc. The re-assessment of the carryback year will inevitably be processed much later than the assessment of the return on which the carryback is requested, and often up to 6 months later. Read the assessment for mention of the loss carryback — if there is no mention, follow-up immediately.

Net capital loss carrybacks are requested by completing Form T1A, “Request for Loss Carryback,” and filing it with the tax return for the year in which the loss arises.
CAPITAL LOSSES

(a) Adjustment to capital gains inclusion rates

It is important to note that net capital loss carryforwards are expressed as a product of the capital gains inclusion rate in effect in the year the loss arose. The carryover rules require net capital losses to be adjusted when they are applied against taxable capital gains arising in a year when the capital gains inclusion rate is different. The purpose of the adjustment is to achieve an offset between gross loss and gross gain. For example, in 1995 a capital loss of $1,000 converted to an allowable capital loss (and a net capital loss carryforward) of $750. In 2008 a capital gain of $1,000 converted to a taxable capital gain of $500. The carryforward rules ensure that the net capital loss carried forward from 1995 is fully utilized by way of offset against the taxable capital gain in 2008.

With the capital gains inclusion rate having dropped — first to two-thirds and then to one-half — during 2000 (after remaining at three-quarters for almost a decade), this issue requires renewed attention. The adjustment to net capital losses carried forward (or backward) is achieved by dividing the loss by the inclusion rate in effect in the year the loss arose, and multiplying by the inclusion rate in effect in the year the loss is applied. The following table shows the required adjustment factors for losses carried forward from previous years and applied against taxable capital gains determined under the one-half (50%) inclusion rate.

<table>
<thead>
<tr>
<th>Source</th>
<th>Inclusion Rate</th>
<th>Adjustment Factor</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972 to 1987</td>
<td>1/2</td>
<td>1.0000</td>
</tr>
<tr>
<td>1988 and 1989</td>
<td>2/3</td>
<td>0.7500</td>
</tr>
<tr>
<td>1990 to 1999</td>
<td>3/4</td>
<td>0.6666</td>
</tr>
<tr>
<td>2000</td>
<td>Blended</td>
<td>(See discussion)</td>
</tr>
<tr>
<td>2001 to present</td>
<td>1/2</td>
<td>1.0000</td>
</tr>
</tbody>
</table>
The inclusion rate for year 2000 — a special case

Because the inclusion rate was changed twice during the 2000 taxation year, a taxpayer’s average inclusion rate for 2000 depends on the taxpayer’s actual distribution of capital gains and losses between the three periods. Following is an illustration of an inclusion rate computation for a taxpayer who realized net capital losses in each of the three periods during the 2000 taxation year:

**Example**

On a hot tip in 1975, Joe purchased 1,000 shares of a high-flying resource stock for $4.50 per share, or $4,500. In 1990, he was able to sell the shares for $0.50 per share, or $500. He therefore realized a capital loss on the sale of $4,000, or an allowable capital loss of $3,000 — based on the inclusion rate of three-quarters (75%) applicable to dispositions in 1990. Since Joe had no other capital gains or losses in 1990 or preceding years, the allowable capital loss of $3,000 became a net capital loss carryforward with an indefinite life. This experience kept Joe out of the market until 2000, when suddenly he could no longer resist its allure. He purchased 1,000 shares of a high-flying bio-tech stock for $45 per share, or $45,000. He sold his position in the latter half of 2008 for $45.00 per share, following a 2:1 split. His 2008 taxable income will be affected as follows:

| Description                                | Amount  
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds ($45.00 X 200 shares)</td>
<td>$90,000</td>
</tr>
<tr>
<td>Adjusted cost base</td>
<td>$45,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>45,000</td>
</tr>
<tr>
<td>Taxable capital gain (50%)</td>
<td>22,500</td>
</tr>
<tr>
<td>Deduct: Net capital loss carryforward ($3,000 X 0.6666)</td>
<td>2,000</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$20,500</td>
</tr>
</tbody>
</table>
CAPITAL LOSSES

<table>
<thead>
<tr>
<th>Period</th>
<th>Capital Loss</th>
<th>Inclusion Rate</th>
<th>Net Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1 — February 27</td>
<td>$ 2,000</td>
<td>75.00%</td>
<td>$1,500</td>
</tr>
<tr>
<td>February 28 — October 17</td>
<td>$ 3,000</td>
<td>66.66%</td>
<td>$2,000</td>
</tr>
<tr>
<td>October 18 — December 31</td>
<td>$ 5,000</td>
<td>50.00%</td>
<td>$2,500</td>
</tr>
<tr>
<td>Total</td>
<td>$10,000</td>
<td></td>
<td>$6,000</td>
</tr>
<tr>
<td>Blended inclusion rate</td>
<td></td>
<td></td>
<td>60%</td>
</tr>
</tbody>
</table>

The simplest case is where the taxpayer realized only net gains or only net losses in all three periods. The inclusion rate computation is complicated by special rules for applying net losses realized in one or two of the periods against net gains realized in the other period(s). An individual’s inclusion rate for 2000 may be reported by the CRA on the individual’s notice of assessment for 2000.

3. **Allowable business investment losses (ABILs)**

The main restriction applicable to capital losses is that they are deductible only against capital gains. Capital losses satisfying certain conditions are free of this limitation. Such losses are referred to as business investment losses. One-half of a business investment loss — referred to as an allowable business investment loss (ABIL — pronounced “able”) — is deductible against income from all sources.

A taxpayer’s capital loss is a business investment loss if it arises from a disposition of:

- a share of the capital stock of a small business corporation; or
- a debt owing to the taxpayer by a small business corporation to a person with whom the taxpayer was dealing at arm’s length. Alternatively, the disposition may occur by virtue of the election available under subsection 50(1) of the Act (discussed above under “Timing of capital gains and losses”). Small business corporations are discussed in chapter 3.

4. **Accessing the unrealized capital losses of a spouse**

It is effective tax planning to offset capital losses and capital gains in the same taxation year, when possible. Sometimes it is possible to achieve this offset between spouses. Example: Mary has unrealized capital gains of $10,000 on a bank stock that she would like to cash out. She does not have any unrealized
Here is a step-by-step plan for achieving an offset:

- Mary purchases the 100 shares of Nortel from Harry for cash of $200 (i.e. their current fair market value). This exchange can be accomplished by transfers between their brokerage accounts and should be documented by a written agreement between them.

- In his personal tax return for the year, Jim must elect to have the spousal rollover provisions not apply to the transaction (see discussion of “Inter-spousal rollovers” above).

- Because Mary and Harry are affiliated persons, the superficial loss rules automatically apply to the transaction. Harry is denied a capital loss. Mary’s cost base in the acquired shares is increased by the amount of the denied loss. Consequently, Mary’s cost base in the Nortel shares is $102 per share (i.e. the cost of $2 plus the denied loss of $100). See the discussion above on “Restrictions on the deductibility of capital losses.”

- Mary should take care to hold the Nortel shares for at least 30 days in order to avoid the application of the superficial loss rules to her. Assuming no recovery in the price of Nortel during this period, she will realize a capital loss of $10,000 upon disposing of the shares in the market.

- Mary is free to dispose of the bank stock at any time. If she realizes a capital gain of $10,000 on the bank stock and engages in no other trading during the taxation year, her Nortel loss and bank stock gain will offset. She will have neither a net gain or a net loss to report for the year.

- Because Harry elected out of the automatic spousal rollover, the capital loss realized by Mary on the Nortel stock does not attribute back to him under the attribution rules. See the discussion of the “Exception for fair market transfers” in chapter 23, “Income Splitting.”

V. TAX REPORTING

Capital gains may be reported to individuals on a number of different tax slips, including:

- T3, “Statement of Trust Income Allocations and Designations”;
SUMMARY

- T4PS, “Statement of Employee Profit-Sharing Plan Allocations and Payments”;
- T5, “Statement of Investment Income”;
- T5013, “Statement of Partnership Income.”

The adjusted cost base or proceeds of disposition relating to transactions in certain securities is reported on Form T5008, “Statement of Securities Transactions.”

An individual reports capital gains and losses on Schedule 3, “Capital Gains (or Losses),” of his or her personal tax return. Dispositions of capital property must be reported on the tax return for the year in which they occurred, even where no gain or loss arises. It is not uncommon for taxpayers to mistakenly believe they can delay reporting capital losses until a year when they realize offsetting gains. Taxpayers who follow this practice run the risk of the applicable tax year becoming statute-barred; or misplacing the documentation that would be needed to prove all of the pertinent facts.

Net capital loss carrybacks are requested by completing Form T1A, “Request for Loss Carryback,” and filing it with the tax return for the year in which the loss arises.

Donations of publicly traded securities to qualified donees after February 19, 1997 are reported on Form T1170, “Capital Gains on Gifts of Certain Capital Property,” and filed with the tax return for the year.

The gain or loss from selling property owned before 1972 is calculated on Form T1105, “Supplementary Schedule for Dispositions of Capital Property Acquired Before 1972.”

The CRA annually updates a very useful tax guide called T4037, “Capital Gains.”

VI. SUMMARY

- A capital gain or loss arises on the disposition of a capital property.
- The most common type of disposition occurs when a capital property is sold, but the concept of disposition includes gifts, transfers, exchanges and redemptions.
• In the case of securities that are sold through a public exchange, the disposition is considered to occur for tax purposes on the settlement date, not the trade date.

• A disposition does not occur where there is a change of legal ownership, without a change in beneficial ownership.

• The law of joint tenancy does not recognize a distinction between beneficial and legal ownership. Consequently, transfers of property to joint tenancy may not avoid probate fees (as commonly intended) unless a transfer of beneficial ownership is recognized for income tax purposes (which often results in the realization of a capital gain).

• The person who legally or beneficially owns the property at the time of disposition is not necessarily the person who reports the gain on his or her tax return — depending on whether the attribution rules apply to a previous transfer of the property.

• There are certain circumstances when a disposition is deemed to occur, without there being an actual disposition of any kind (e.g. at death, or upon becoming a non-resident).

• A taxpayer may elect a disposition to occur in a taxation year without there being a sale or transfer, in connection with certain equity or debt investments in bankrupt or insolvent companies.

• The cost of a property for tax purposes is referred to as its adjusted cost base (ACB). In the most simple case, the ACB of a property is equal to its actual out-of-pocket cost, plus the costs of acquisition. Different types of capital property are subject to various cost base additions and reductions.

• Where a taxpayer disposes of anything to a person with whom he or she is not dealing at arm’s length for no proceeds or for proceeds less than fair market value, the taxpayer is deemed to receive proceeds of disposition equal to fair market value.

• Where a taxpayer transfers capital property to his or her spouse, and both are resident in Canada at the time, the taxpayer’s proceeds of disposition is deemed to equal the adjusted cost base of the property (i.e. tax-free inter-spousal rollover).

• Capital gains are multiplied by the capital gains inclusion rate to determine taxable capital gains. The inclusion rate has the effect of lowering the effective tax rate on capital gains in relation to ordinary income. During 2000, the
capital gains inclusion rate dropped — first to two-thirds and then to one-half, after remaining at three-quarters for almost a decade.)

- A special capital gains inclusion rate of zero applies to capital gains realized on gifts of certain securities made to registered charities (other than private foundations) after May 2, 2006.

- There are circumstances where an amount that would ordinarily be a capital loss is deemed to be nil (e.g. the 30-day superficial loss rule and certain transfers between affiliated persons).

- Allowable capital losses incurred in a year must first be applied to reduce any taxable capital gains realized in the same year. To the extent they exceed taxable capital gains in the year, they become net capital losses.

- Net capital losses may be carried back to any of the 3 preceding years or forward indefinitely, and applied to reduce taxable capital gains in those years. Allowable capital losses and net capital losses are not deductible against any source of income other than taxable capital gains.

VII. REFERENCES

The following publications may be requested in person or by telephone from the nearest office of the CRA. Forms and publications are also available from the CRA website located at www.cra.gc.ca.

Interpretation Bulletin IT-65, “Stock splits and consolidations”

Interpretation Bulletin IT-113R4, “Benefits to employees — stock options”

Interpretation Bulletin IT-126R2, “Meaning of ‘winding-up’”

Interpretation Bulletin IT-133, “Stock exchange transactions — date of disposition of shares”

Interpretation Bulletin IT-232R3, “Losses — their deductibility in the loss year or in other years”

Interpretation Bulletin IT-291R3, “Transfer of property to a corporation under subsection 85(1)”

Interpretation Bulletin IT-328R3, “Losses on shares on which dividends have been received”
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Interpretation Bulletin IT-387R2, “Meaning of ‘identical properties’”

Interpretation Bulletin IT-419R2, “Meaning of arm’s length”

Interpretation Bulletin IT-426R, “Shares sold subject to an earnout agreement”


Interpretation Bulletin IT-448, “Dispositions — changes in terms of securities”

Interpretation Bulletin IT-450R, “Share for share exchange”

Interpretation Bulletin IT-456R, “Capital property — some adjustments to cost base”

Interpretation Bulletin IT-460, “Dispositions — absence of consideration”

Interpretation Bulletin IT-479R, “Transactions in securities”

Interpretation Bulletin IT-484R2, “Business investment losses”

Guide T4037, “Capital gains”

Guide T4091, “T5008 Guide — return of securities transactions”