The Capital Gains Tax

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THE CAPITAL GAINS TAX

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The Capital Gains Tax was introduced in 1972 and is part of the Income Tax Act. It is useful to examine some of its features after seven years and outline how it affects most of us.

Although capital gains is a federal tax the provices share significantly in its return by way of tax sharing agreements with Ottawa. Since it was a new source of revenue to the provinces, Ontario declared its intention of vacating the provincial succession duty and gift tax fields as the capital gains tax "matured".

This was, of course, a euphemistic way of saying that when the new tax produced sufficient revenue, the old taxes would be discarded. In fact, this has been going on gradually. Estates below a certain size have long been exempt from succession duties and this figure was raised to $300.000 in 1975. Furthermore, duties have been removed entirely on property passing between spouses. As the final act, the Ontario Government repealed all succession duties and gift taxes on May 18, 1979, effective April 10.

Now, what of Capital Gains Taxes? Briefly, when property is disposed of and the proceeds exceed the cost of the property, a capital gain has been made. One-half of this, called the "taxable capital gain" in the Income Tax Act, is the taxable portion which generally is to be included in the income of the taxpayer in the year it was made.

If the proceeds are less than the cost, a so-called capital loss arises. One-half of this amount (called the allowable capital loss) may be offset against any taxable capital gains for that tax year.

If allowable capital losses exceed taxable capital gains, the excess up to $2,000 may be used to reduce other taxable income. If this amount exceeds $2,000, the excess over $2,000 can be applied against all taxable capital gains and $2.000 of other income in future years for an unlimited period.

As everyone is well aware, in the seven years life of the Capital Gains Tax, inflation has had a dramatic impact on the value of many kinds of property. So much so that many people argue—so far without success—that the gain should be adjusted for inflation using the Consumer Price Index.

Let us deal for a moment with so-called "depreciable property". It is generally understood that if an item of property is used to earn income, a certain amount of the cost can be written off or depreciated against income each year for tax purposes. The items which qualify for this write-off are set forth in the Income Tax Act. If this asset is sold for a value greater than the current undepreciated balance, the excess over this balance will be treated as full income up to the original cost. Any proceeds over the original cost will be treated as a capital gain and, therefore, only one-half of this amount will be taxed as a taxable capital gain.

For example, if an asset is purchased for $8,000 and $2,000 is written off each year for two years, its current undepreciated balance is $4,000. If it is then sold for $5,000, $1,000 will be treated as full income ($5,000 - $4,000). If the asset is sold for $9,000, $4,000 will be treated as full income ($8,000 - $4,000) and $1,000 as a capital gain ($9,000 - $8,000) of which only one-half or $500 will be taxable.

It should perhaps be observed in passing that some profits on the sale of property have always been treated as fully taxable under the general provisions of the Income Tax Act and are still so treated. This hinges on the activities and intentions of the taxpayer in making his living and has been the subject of much contention and many law suits over the years. The taxpayer always stands to benefit, of course, by having the profit of any particular transaction considered to be a capital gain rather than income by the tax collector. Since 1972 the advantages are not quite so favourable, nonetheless, they remain significant.

In determining whether the profit on the sale of property is to be treated as a capital gain or fully taxed as income, the tax department, and ultimately the courts, seek the answers to certain questions. For example, was it the intention of the taxpayer to simply acquire an investment or was it to carry on a business? How long was the property owned and how often were similar transactions made? If the answers indicate the taxpayer is carrying on a business, the profit or gain will be treated as income and fully taxed.

Reporting Capital Gains

The Income Tax forms contain a schedule for the taxpayer to use in calculating capital gains or losses. He is entirely on the honour system. There is, as yet, no third party required to report capital gains, similar to where an employer reports income of an employee or a bank reports interest on deposits. No doubt stockbrokers would regard with horror the reporting of stock transactions.

Types of Property Under Capital Gains Taxes

It is very important to understand that different kinds of property are treated differently under the Capital Gains Tax provisions. Certain items are exempt altogether from capital gains taxes and others receive special treatment.

Principal Residences and Cottages

If a residence is disposed of at a price above cost, the gain will not be taxable if the property is designated as the taxpayer's principal residence. To qualify, it must be owned by the taxpayer and ordinarily inhabited by him during the year.

Many families own two residences —a home and a vacation property. Where one spouse owns one property and the other spouse owns the second property, and neither property is used to produce income, Ottawa has indicated that each may be claimed as a principal residence by the respective owner. In this situation each property will presumably be exempt from the capital gains tax. There are complex ramifications of this subject. An entire farm

would not be regarded as a vacation property although the dwelling could be.

Personal-Use Property

Personal-Use Property is also treated differently. Personal-Use property is defined as property owned and used primarily by the taxpayer for his or her enjoyment or for the use or enjoyment of individuals related to the taxpayer. Examples are automobiles, boats and furniture. All are items which generally depreciate through use.

In calculating the capital gain or loss on disposal of personal-use property, the taxpayer's cost is deemed to be the greater of the cost or $1,000. In the same manner the proceeds are the greater of the actual proceeds or $1,000. It is important to note that although capital gains in the case of personal-use property are subject to tax, capital losses are not deductible, presumably because the loss is attributable to the wear and tear of personal use.

This treatment exempts items which were bought and sold for prices under $1,000 as both the proceeds and the cost would be deemed to be $1,000. Thus, a Persian rug bought for $500 and sold for $900 would be deemed to have been bought and sold for $1,000 and no gain would arise.

Listed Personal Property

Some items of personal-use property called "listed personal property" have a slightly different tax treatment from other personal-use property. Listed personal property consists of the following items:

1. a print, etching, drawing, painting, sculpture, or similar work of art;
2. jewellery;
3. rare folio, manuscript or book;
4. stamps, and
5. coins.

The above items are treated in the same manner as personal-use property. However, as these items do not normally depreciate in value through use, capital losses may be offset against gains but only gains on other listed personal property. If these losses are not claimed in the year of loss, the un-used portion can be offset against gains on listed personal property in the preceding one year or in the next five years.

Forward-Averaging

A capital gain arising in a particular year may impose a large tax burden on the individual and, of more importance, may increase the individual's marginal tax rate. Recognizing the fact that the gain may have arisen over a period of many years, the Income Tax Act allows taxable capital gains to be forward averaged over future taxation years through the purchase of income averaging annuity contracts.

A certain portion of the taxable capital gain must be retained in the year of the gain and taxed in that year. The remainder is used to purchase an annuity which may be a term certain annuity for up to 15 years or a life annuity with a guaranteed period not greater than 15 years. The annuity payments are taxed in full in the year in which they are received. The use of the annuity permits the taxpayer to keep his marginal tax rate lower, to defer payment of taxes and earn an attractive interest rate on a tax deferred basis.

Some taxable capital gains are also eligible for the $1,000 interest, dividends and capital gains deduction. Only gains on the disposition of Canadian securities qualify for this deduction.

Deemed Dispositions

There are certain circumstances where a disposition is deemed to have taken place even if the property has not been actually sold. These occur on the death of the taxpayer, when a gift is made during the taxpayer's lifetime and when the taxpayer ceases to be a resident of Canada. In addition, a capital gain will be deemed to have occurred if property is transferred in a non-arm's length transaction for no proceeds or proceeds less than fair market value.