TAX LETTER

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CAPITAL GAIN RESERVE
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CAPITAL GAIN RESERVE

If you sell a capital property for more than your cost of the property, you will have a capital gain. More technically, if your "proceeds of disposition" exceed your "adjusted cost base" of the property plus any sales costs like commissions, you will have a capital gain. One-half of the capital gain is included in your income as a "taxable capital gain".

Normally, you include in income the full taxable capital gain in the year in which the proceeds are received or receivable by you.

However, if some or all of the proceeds of disposition are due after the year of sale, you can normally claim a capital gain reserve, which effectively spreads out the inclusion over up to 5 years in which you receive the proceeds.

The maximum allowable reserve in a year is the lesser of two amounts.

The first amount is sometimes called the "reasonable portion" amount, because it is the portion of the capital gain that can reasonably relate to the proceeds of disposition that are due after the year. Typically, this amount is determined by multiplying the gain by the fraction equal to: proceeds due after year / total proceeds. (An example is provided below.)

The second amount is sometimes called the formula amount because it is subject to a specific numerical formula. Basically, the amount is a fraction multiplied by the gain. In the year of sale (year 1) the fraction is 4/5ths, and in subsequent years 2 through 4, assuming the reserve still applies, the fraction is 3/5ths, 2/5ths, and 1/5th, respectively.

Since the reserve is based on the lesser of the two amounts, a couple of things become apparent. Because of the first amount, the reserve is not available in a year if no further proceeds are due after that year. That obviously makes sense, since it means you will have received all of the proceeds by that year. Because of the second amount, which only allows a reserve up to year 4, you will have to recognize any remaining gain in year 5 even if some proceeds have not yet been received.

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If you claim a reserve in one year, you **must** add that amount back into your income in the next year, at which point you may be able to claim a further reserve, subject to the above rules. (If you did not add back the reserve, that portion of the gain would never be reported, which explains the reason for the add-back.)

Example

In year 1, I sell some real estate (not my home) for $700,000. My adjusted cost base was $180,000 and I incur $20,000 in sales commissions. As a result, I have a capital gain of $500,000 ($700,000 minus $200,000).
I agree for the purchaser to pay me the $700,000 over seven years, at $100,000 per year.

Year 1:

In year 1, I can claim a reserve equal to the lesser of:

1) $500,000 gain x ($600,000 proceeds due after year / $700,000 total proceeds) = $428,571; and
2) $500,000 gain x 4/5 = $400,000

If I claim the full $400,000 reserve, I will have a capital gain of $100,000, half of which is a taxable capital gain of $50,000, and is included in my income in year 1 as a taxable capital gain.

Year 2:

I must add back the $400,000 reserve claimed in year 1 into year 2.

Then I can claim a reserve equal to the lesser of:

1) $500,000 x ($500,000 / $700,000) = $357,143; and
2) $500,000 x 3/5 = $300,000.

My net capital gain in year 2 will equal the $400,000 inclusion minus the $300,000 reserve, or $100,000. One half of that gain, again being $50,000, is again included in my income for year 2 as a taxable capital gain.

The process will continue through year 4, after which no further reserve would be available. Therefore, any gain not yet recognized by year 5 must be reported in that year even though some of the proceeds aren’t due until years 6 and 7.

Reserve optional

The reserve is optional. Although you would normally claim it, in some cases you might choose not to.

For example, if you had capital losses that could offset your capital gains in year 1, you might choose to report a larger capital gain in year 1 by claiming less than the maximum reserve.

As another example, if you expect to be in a higher tax bracket in later years, you might choose to trigger more of the gain in year 1 and forego the reserve.

Reserve not allowed for certain sales

You are not allowed to claim the reserve if the purchaser of the property is a corporation that is controlled by you immediately after

the sale. Control for these purposes usually means ownership of more than 50% of the voting shares of the corporation, but it also includes "*de facto*" control, which means control "in fact" even if you own less than 50% of the voting shares.

If the vendor of the property is a corporation, the reserve is not allowed if the purchaser is a corporation controlled by the same person or group of persons that control the vendor. Also, the reserve is not allowed if the purchaser corporation controlled the vendor corporation.

In the case of a sale to a partnership, the reserve is not allowed if you are a "majority-interest partner" of the purchaser partnership. In general terms, you will be a majority-interest partner if you are entitled to more than 50% of the income or capital of the partnership.

Interest on future proceeds

If you, as vendor of a property, agree to the payment of the proceeds of disposition over two or more years, you may also be paid interest since the proceeds are being paid over time. If so, the interest that it is received or receivable in each year is included in your income in that year, and is not affected by the capital gain reserve, which is a different issue.

THE CAPITAL GAINS EXEMPTION

The lifetime capital gains exemption (technically called capital gains *deduction*) allows Canadian resident individuals to earn tax-free capital gains on certain kinds of property (active business shares and farm/fishing property), up to the exemption amount.

The lifetime exemption is indexed to inflation. For the 2020 taxation year, the exemption amount is $866,912 of capital gains ($1 million for farm/fishing property). Technically, the exemption is expressed as being a deduction in calculating taxable capital gains, which is $433,456.

Since the exemption is a lifetime amount, the exempt amount for 2020 is reduced to the extent that you previously claimed the exemption (including in years up to 1994 when it was a $100,000 general exemption, not limited to specific kinds of property).

The exemption is allowed for taxable capital gains resulting from the disposition of shares in a qualified small business corporation ("QSBC shares"). In order to qualify, the following conditions must be met.
First, at the time of the disposition, the corporation must be a "small business corporation", which is defined as a Canadian-controlled private corporation, all or substantially all of the assets of which consist of (on a fair market value basis):

- assets used principally in an active business carried on primarily in Canada by the corporation or by a related corporation ("principally" and "primarily" generally mean more than 50%);
- shares or debt in other small business corporations; or
- any combination of the above.

A Canadian-controlled private corporation (CCPC) is basically a private corporation resident in Canada that is not controlled by non-residents or public corporations.

Second, throughout the 24 months prior to the disposition, the corporation must have been a CCPC and more than 50% of the corporation's assets (on a fair market value basis) must have consisted of assets used principally in an active business carried on primarily in Canada by the corporation or by a related corporation, or shares or debt in another corporation that was "connected" with the CCPC. The corporations will be connected, generally if the CCPC controls the other corporation or owns more than 10% of the shares in the other corporation on a votes and fair market value basis.

There is a general holding period for the shares. At the time of the sale of the shares, no person except you or a related person can have owned the shares for at least 24 months (there are some exceptions).

Exemption reduced by CNIL

The capital gains exemption is reduced by the amount of your cumulative net investment losses (CNIL), going back as far as 1988. Basically, this equals the amount by which your investment losses exceed your investment income over that period, if any.

Exemption reduced by ABILs

The exemption is also reduced by your claimed allowable business investment losses (ABILs). In general terms, an ABIL is an allowable capital loss incurred on the disposition of the shares or debt invested in certain types of CCPCs. Unlike regular allowable capital losses, an ABIL is deductible from all sources of income. As such, for tax policy reasons, the government decided that it should in turn reduce your capital gains exemption.

Example

In 2018, you claimed a $70,000 ABIL. In 2020, you have a $200,000 taxable capital gain from the disposition of QSBC shares. Only $130,000 of the taxable capital gains will qualify for the exemption. The remaining $70,000 will be included in your 2020 income.

The capital gains exemption also applies to taxable capital gains from the disposition of qualified farm or fishing property. In very general terms, this category of property includes real property and depreciable property (e.g. equipment) used in a farm or fishing business. It also includes shares in a farming or fishing corporation or partnership, with conditions similar to those that apply to QSBC shares (although similar, there are some significant differences). The exemption for qualified farm or fishing property is $1 million of capital gains or $500,000 of taxable capital gains. As with the QSBC exemption, it is reduced by the amount of the exemption you claimed in previous years.

PERSONAL-USE PROPERTY GAINS AND LOSSES

If you sell a personal-use property (PUP) at a gain, one-half of the amount is included in your income as a taxable capital gain.

On the other hand, if you sell a PUP at a loss, the loss is not allowed for income tax purposes (except in the case of "listed personal property", as explained below).

PUP includes property that is primarily used for personal purposes. Thus, it can include your home, car, bicycle, furniture, clothing, and so on.

If the PUP is listed personal property (LPP), any loss is deductible against gains from other LPP, but not other gains. If the net result is a positive gain, one-half is included in your income as a taxable capital gain.

If the losses from LPP exceed the gains from LPP in a year, the losses **cannot** be applied against other income. However, the excess LPP losses can be carried back three years or forward seven, to offset capital gains from other LPP.

Example of LPP

In 2020, you sold an LPP at a gain of $2,000. You also sold another LPP at a loss of $3,000.
In 2019, you sold an LPP at a gain of $700.

Your net gains from the LPP for 2020 will be nil. Of the excess $1,000 losses, $700 can be carried back to offset the LLP gain in 2019. That leaves $300 LPP losses that can be carried forward.

What is LPP?

LPP is defined as:

- Artwork
- Rare books and manuscripts
- Jewelry
- Stamps
- Coins

Minimum thresholds for PUP

For all PUP, whether LPP or not, there are deemed minimum proceeds of disposition and cost of the property. Each is a minimum of $1,000, regardless of the actual cost or proceeds.

For example, if you sell a painting for $2,000 and your cost was $800, your capital gain will be $1,000 ($2,000 minus the deemed cost of $1,000) and your taxable capital gain will be $500.

As another example, if you sell some jewelry for $800 and your cost was $500, you will have no capital gain, since your deemed cost and proceeds will be both bumped up to the minimum amount of $1,000.

DEDUCTION OF INVESTMENT FEES

If you own investment properties, such as stocks, bonds, and mutual funds, you will likely incur some investment fees. Some of the fees are deductible for income tax purposes. Some are not.

Deductible fees include those paid fees for the management and custody of your investments. However, such fees in connection with a tax-deferred plan, such as your registered retirement savings plan, registered retirement income fund, or tax-free savings account, are not deductible.

Investment counsel fees are normally deductible. However, the fees must be paid to a person the principal business of which is advising as to the advisability of purchasing or selling specific shares or securities, or includes the provision of services in respect of the administration or management of shares or securities.

Commissions paid for the purchase or sale of securities are not deductible. Instead, if paid on a sale they reduce any capital gain or

increase any capital loss, or on a purchase are added to the cost of the securities. (However, if you trade very actively, the commissions are fully deductible as part of the business income or loss calculation.)

Safety deposit box fees are not deductible under any circumstances, even for a business.

CHANGE IN USE RULES

Personal to income use

If you use a property for personal purposes and subsequently start to use the property for income-earning purposes, you will have a deemed disposition of the property for fair market value proceeds and a deemed new cost of the property at fair market value.

Although this rule seems strange, the main rational for the rule is to prevent you from claiming capital cost allowance (CCA – tax depreciation) or a loss on the property based on its original cost. For example, if you purchase a table for $5,000 for personal purposes and later move it to your office for business purposes when it is worth only $2,000, it would not make sense to allow you tax deductions based on the original value, since it depreciated while you were using it personally.

In this regard, if the fair market value of depreciable property at the time of the change in use happens to be greater than the original cost, the deemed acquisition cost for CCA purposes will normally be half-way between the original cost and the fair market value.

Income to personal use

Similarly, if you use a property for income-earning purposes and subsequently use the property for personal purposes, you will have a deemed disposition and new cost of the property at fair market value.

One of the rationales for this rule is to ensure that you are taxed on any "excessive" CCA on the change in use. That is, if the value of the property at that time is greater than its "undepreciated capital cost" (cost minus the CCA you have claimed), you will have an income inclusion, as the excess will be "recaptured" back into your income. If the rule did not exist, you could easily avoid (or at least defer) the recapture by changing the use to personal.

Partial change in use

The above rules also apply to a partial change in use, with modifications to take into account the partial change on a proportionate basis.

For example, say you were using a property entirely in your business (100% income use) and later began to use it personally 40% of the time. You would have a deemed disposition of a part of the property for proceeds equal to 40% of the fair market value of the entire property, and that amount would form the cost of that part of the property.

Election out of the change in use

You can elect out of the change in use from personal to income-earning purposes (the first rule above) in certain cases. For example, if you move out of your personal home and start to rent it out, you can make this election.

Conversely, if you rent out a home and subsequently move in and make it your

principal residence, you can elect out of the second rule above.

Under both elections, you will not have a deemed disposition. Furthermore, you can normally designate the home as your principal residence for up to four years while you rent it out.

AROUND THE COURTS

Car expenses allowed for employee travelling from home office

In general terms, an employee can deduct car expenses incurred for travelling "in the course of employment", if that is required under the terms of the employment and the employer provides the employee with a T2200 form. Certain other conditions apply.

Travel "in the course of employment" includes travel from the place of employment to another place of employment (e.g. from one office of the employer to another office). It does not normally include travel from your home to the employer's office, as that is normally considered personal travel.

In the recent *Gardner* case, the taxpayer was employed as a sales representative with a company whose office was located in Oakville, Ontario. Her home was about 70 kilometres from the office. In the year in question, she had a home office where she performed about 90% of her employment duties. However, she would also drive to the company's office for meetings and similar work reasons. She claimed a deduction for her car expenses incurred in driving from her home to the company's office. The CRA denied the deduction.

On appeal to the Tax Court of Canada, the sole issue was whether the taxpayer's travel from home to the company office was in the course of employment or personal. The Tax Court Judge allowed the taxpayer's deduction. The Judge reasoned that travel between places of employment was in the course of employment, because the taxpayer's home office constituted her main place of employment and the employer required her to work there.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.