

Taxation – Capital Gains and Losses

July, 2015



Introduction

This Information Update defines the general terms of capital gains and losses in the context of Canada's income tax legislation and how this can potentially affect the taxpayer. The regulations that govern this legislation are reviewed so as to understand, via some examples, the potential impact this may have when selling and/or transferring farm assets.

Tax legislation changes from time to time, and the information contained in this Information Update is based on the prevailing tax legislation information at the date of publication.

If you have a situation that might involve a capital gain/loss, it is strongly recommended that professional taxation and legal advice be obtained to manage the potential taxation liability that might occur.

The Lifetime Capital Gains Exemption is to increase to \$1,000,000 to be in effect for dispositions of qualified farm or fishing property made on or after April 21, 2015.

The capital gain subjects covered in this publication are:

- Capital Gains and Losses Defined
- What is Capital Property
- Capital Gains Exemption
- Calculating a Capital Gain or Loss
- Capital Gains . . . An Example
- Capital Gain Reserves
- Principal Residence Exemption
- Other Capital Gain Notes

Capital Gains and Losses Defined

The concept of capital gains and losses came into being with tax reform legislation introduced in 1971. The general concept of a capital gain or loss is simply the difference between the original cost of an asset and what the asset sold for upon disposal (including any outlays or expenses in selling). If the difference is negative, this is a capital loss and can be used to reduce other capital gains. However, if the result is positive, this difference is called a capital gain – a portion of which is taxed as income when it is incurred.

At the present time, 50% of a capital gain is taxable income while 50% of a capital loss can be used to reduce a taxable position. The capital loss can be applied against a capital gain in a current taxation year or can be carried back three years and applied. The capital loss can also be used against a taxable capital gain in a future year.

Capital Gains and Losses Defined

Capital property is the assets a farmer or individual has in their possession. Some examples of capital property owned by farmers are:

- Farmland and improvements
- Buildings
- Machinery, equipment, vehicles, etc.
- Farm homes
- Stocks, bonds, and other securities
- Personal use property such as boats, summer cottages, automobiles, and other such assets
- Listed personal property — coins, stamps, rare books, jewelry, drawings, paintings or sculptures
- Shares of a family farm corporation
- An interest in a family farm partnership

In addition, a farmer may own an intangible property used in his or her farming business such as a production quota (e.g. Milk Quota) or other government rights or licenses (e.g. Water Rights). Intangible assets are generally considered to be eligible capital property for tax purposes.

Capital Gains Exemption

Current tax legislation allowed a cumulative capital gains exemption to a lifetime maximum of \$813,600 per individual on Qualified Farm or Fishing Property for disposal of Qualified Farm or Fishing Property prior to April 21, 2015.

The Lifetime Capital Gains Exemption was increased to \$1,000,000 to be in effect for dispositions of qualified farm or fishing property made on or after April 21, 2015.

Qualified Farm or Fishing Property is defined as capital property owned by you, your spouse or your common-law partner. These include:

- Real property such as land and buildings;
- Eligible capital property such as milk and egg quotas;
- Shares of the capital stock of a family farm corporation that you, your spouse or your common-law partner owns; and
- An interest in a family farm partnership you, your spouse.

The current legislative reference refers to qualified farm or fishing property. For simplicity, this document will use this term and farming property interchangeably.

Qualified farm property must be used to carry on a farm business in Canada by any one of the following:

- You, your spouse, or your common-law partner, or any of your parents or children;
- A family farm corporation where any of the above persons owns shares of the corporation;

- A family farm partnership where any of the above persons owns an interest; or
- A beneficiary of a personal trust, or the spouse or common-law partner, parent, or child of such a beneficiary.

Notably, a parent or child includes a grand-parent/child and great-grandparent/child, but excludes a great-great-grandparent/child.

This provides a general overview of the exemption. Further information will be reviewed later in this article.

How Do You Calculate a Capital Gain or Loss?

A capital gain or loss will occur upon the sale or deemed disposition of capital property (see above). Tax legislation introduced in 1971, provides certain guidelines to determine the property values on which the calculation of capital gains or losses are based. If the property was owned prior to December 31, 1971, Valuation Day values are used to determine its adjusted cost base.

Disposition of Capital Property is deemed to have occurred if one of the following has transpired:

- Property is sold.
- Property is gifted.
- The owner of the property dies.
- Property is stolen.
- Property is expropriated.
- Property is destroyed and insurance proceeds are received.
- Property is transferred to a trust, corporation or partnership.

Valuation Day was set by the tax reform legislation of 1971. Basically, it determined that December 31, 1971, was the beginning point in time that any future increases in asset/capital property values would be measured, if they were owned prior to this date. For assets/capital property bought after this date, the cost base is the price paid for the item at that time. For property bought and owned prior to this date the cost has to be determined by a valuation process as of December 31, 1971.

Example: A farmer purchased a piece of land in 1964 and sells or disposes of the same property this year. The first step in calculating whether there is a capital gain or loss is to determine this property's value as of December 31, 1971. This can be done by:

- **Documentation** — information on asset values for December 31, 1971, is still available. Canada Revenue Agency ("CRA") does have a data collection of land values by Rural Municipality for 1971 and 1972 that can be used to provide the information required.
- **Photos** — can be used to portray the condition of an asset at or near valuation day.
- **Information Regarding Neighboring Properties** — property conditions and prices of neighboring properties can also provide a basis for your own valuation. Comparable sales information is also available from the CRA.

- **A Formal Appraisal** – this can be done if the property value is significant. The appraisal cost should be determined prior to using an appraiser to determine the benefits. However, it may be necessary particularly if the land value is being affected by urban encroachment.

Through this process the farmer arrives at the Valuation Day value for the land bought in 1964. This valuation process is the same when other assets such as equipment, etc. are sold or disposed of as well.

If you still have assets that were owned prior to December 31, 1971, it is suggested that the valuation process should be done as soon as possible. Accurate valuations of assets tend to become more complex and potentially expensive as each year goes by. In the event of an estate settlement, this is also one less item that the estate has to contend with to successfully complete their duties.

The **Median Rule (also known as the tax-free-zone method)** is the process allowed by the CRA which takes the median of the original cost, Valuation Day value, and the disposition value to determine the tax cost of capital property.

Using our previous land example to illustrate this:

Original Cost of Property in 1964	\$15,000
Valuation Day Value for 12/31/71	\$28,000
Disposition Value	\$65,000

Using the Median Rule, the **Adjusted Cost Base (ACB)** for this example would be \$28,000. With a disposition value of \$65,000 the capital gain is \$37,000 (\$65,000-\$28,000) for the land.

In the alternative, a taxpayer can elect out of the median rule and determine the tax cost of their pre-1972 property using only the December 31, 1971 Valuation Day value.

Note – a valid election in prescribed form must be made in order for a taxpayer to elect to use the Valuation Day method.

Individual Capital Gains Exemption... An Example

For illustration purposes, this example consists of two components that arise in considering tax implications.

Suppose that an individual has disposed of a piece of land, the N1/2 of 1-1-1 ZPM for \$136,000.

In addition a piece of equipment is sold for \$75,000 with \$50,000 of undepreciated capital cost in the associated **Capital Cost Allowance (CCA)** class.

Let's deal with the tax issue surrounding the land sale first:

- The property was bought for \$27,000 in 1968. We have had to do our homework in determining the value as of December 31, 1971, for its adjusted cost base. According to the comparable sales at that time, the Valuation Day value is \$50,000. The real estate commission came to \$6,000, which is included in the overall calculation for disposal costs.

Legal Description of Property – N1/2 1-1-1-ZPM

Bought in	1968
Disposition Proceeds	\$136,000
Original/Adjusted Cost Base	\$50,000
Less – Outlays/Expenses	\$6,000
Net Proceeds (Gain/Loss)	\$80,000

Based on year 2015 tax calculations, the Taxable capital gain of 50% of \$80,000 is \$40,000. This amount is entered on Line 127 of the T1 General.

- Our next calculation concerns sale of equipment. The original cost of the equipment was \$100,000 with undepreciated capital cost allowance (UCC) for income tax purposes of \$50,000. The recapture of capital cost of \$25,000 in this example is the difference between the \$75,000 sale (disposition) and the undepreciated capital cost allowance. This amount (\$25,000) is considered recapture of capital cost allowance and is added to the Farming Income.

The \$25,000 of farming income is added to the taxable gain on Land (\$40,000) for total additions to Total Income (Line 150) of \$65,000.

The Capital Gain Exemption on the land (\$40,000) is then calculated on Form T657 and is entered on Line 254 of the T1 General, and serves to reduce Taxable Income by this amount.

*Note: machinery is **not considered Qualified Farm or Fishing property**, and therefore, the capital gains exemption cannot be applied to minimize tax on the machinery sale.*

The end result is that the land sale proceeds are sheltered under the capital gains exemption because the land is defined as qualified farm property, while the Equipment sale with the \$25,000 recapture of capital cost allowance is fully taxable.

*Note: income derived from a capital gain may trigger clawback of **Old Age Security (OAS)** benefits, Alternative Minimum Tax and also affect Pharmacare benefits in the province of Manitoba.*

Additional information on Alternative Minimum Tax can be found in the Information Update: **“Alternative Minimum Tax”**.

Capital Gain Reserves

When property is sold, full payment is usually made at the time of the sale. However, when there is a sale where the proceeds are received over time, a **capital gain reserve** can be claimed. This allows the deferral of the capital gain to the year in which you receive the proceeds. To claim a capital gain reserve, Form T2017 is filed with your tax return in the year the reserve is declared.

There are two formulas to be followed if your property is sold after **November 12, 1981**:

1. Land or depreciable property of a prescribed class used in a farming or fishing business carried on in Canada, a share of the capital stock of a family farm or fishing corporation or an interest in family farm or fishing partnership, or qualified small business corporation shares sold to your child who lived in Canada at the time of the sale for tax purposes. As noted earlier, your child is defined as:

- your natural child, adopted child, or your spouse's child.
- your grandchild or great grandchild.
- your child's spouse.

When one of these three types of property is sold after November 12, 1981, the capital gain can be spread over 10 years. You must report at least one-tenth of the capital gain each year until the entire maximum reserve is the lesser of:

- a) Capital gain multiplied by: Amount Payable after end of the year/Proceeds of Sale **or**
- b) Capital gain multiplied by:

Percentage	Year
90%	1st year (year of sale)
80%	2nd year
70%	3rd year
60%	4th year
50%	5th year
40%	6th year
30%	7th year
20%	8th year
10%	9th year
0%	10th year

2. Other Capital Property — for all other capital property that you sell after November 12, 1981, the capital gain can be spread over a maximum of five years. At least 20% of the capital gain must be reported each year until the entire capital gain is reported.

Principal Residence Exemption

Capital gains realized by individual taxpayers from the sale of a home are tax-free. Further information on this topic is contained in CRA's Income Tax Folio, S1-F3-C2.

To qualify as a principal residence, four requirements must be met:

1. The property must be a housing unit and includes the land it stands on up to one-half hectare (approximately 1.25 acres).
2. The property must be owned by the taxpayer or jointly with another person.
3. The property must be ordinarily inhabited by the taxpayer during each year that it is claimed as principal residence. Seasonal residences might qualify.
4. The property must be designated as a Principal Residence. When the residence is disposed of, Form T2091 is legislatively required in the year of disposal with your tax return. If none of the gain is taxable, the form is not required to be filed with the return.

Notes:

1. *Land in excess of one-half hectare, if necessary for the personal use and enjoyment of the property, may be eligible for the principal residence exemption.*
2. *The CRA's current administrative position is that form T2091 is not required to be filed.*

It is strongly recommended that you obtain independent taxation advice with respect to principal residence claims in excess of one-half hectare and/or form T2091.

In general, if your property qualifies as a principal residence throughout the period you own it; the capital gain is tax-free.

Special Alternatives for Farmers

Farmers are allowed two ways in which to calculate the exempt gain on the principal residence:

- Upon selling the farm, it is hypothetically divided into two parcels – the farmhouse (including one-half hectare or more which, “contribute to its use and enjoyment”) and the remainder of the farmland and buildings. A reasonable allocation of the overall sale proceeds is then made between the two parcels. The same allocation is made on the “adjusted cost base” of the property. The capital gain is then calculated for both parcels with the residence portion being tax-exempt.
- The capital gain is calculated for the whole property. The capital gain is then reduced by \$1000, plus \$1000 for every year that the house has been the principal residence since December 31, 1971. Part years are considered full years and the farmer must file a special letter with the tax return under this option.

The method that provides the largest exemption to the farmer can be used.

Principal Residence Example: A farm sale of \$400,000 has occurred. When the farm was purchased in 1971 the value placed on the house was \$30,000, with the land value at \$200,000. The estimated value of the house now is \$55,000. Using the two methods allowed:

Hypothetical Division

Total Capital Gain	\$200,000
Capital Gain on House portion	\$25,000
Principal Residence Exemption	\$25,000
Net Capital Gain	\$175,000

Total Gain less (\$1000 plus \$1000 per year)

Total Capital Gain	\$200,000
2015-1971= (44 yrs x \$1,000) + \$1,000	\$45,000
Capital Gain Exemption	\$45,000
Net Capital Gain	\$155,000

Farm corporations and partnerships are not allowed to own a principal residence that is given tax-exempt status. If exempt status is desired, the house and parcel of adjacent land should be separated and be kept out of the formation of a corporation or partnership.

Claiming home expenses each year may affect the tax-free status of capital gains on the home. Generally, the greatest tax advantage which avoids any undue risk in jeopardizing the tax free status of capital gains on the home will likely be to deduct a yearly business expense for a reasonable portion of the house expenses related to business usage, but not including capital cost allowance. It is recommended that professional taxation advice be obtained with regards to the deduction of home office expenses.

Other Capital Gain Notes

Qualified Farm Property Acquired Prior to June 18, 1987

Property acquired before this date is eligible for the capital gains exemption if the following conditions are met:

- In the year the property was disposed of by the taxpayer, the property was used principally by the taxpayer, or any of the users as defined under the qualified farm or fishing property on page two of this document, or
- In at least five years during which the property was owned by the taxpayer or any of the users defined under the qualified farm or fishing property on page two of this document, the property was used principally in the business of farming by any one of these same users.

Note – “used principally” generally means the property was used more than 50% in the business of farming both on a time and usage basis. For clarification, the time test refers to the years farmed vs. total years owned. Usage refers to the percentage of the property used in farming vs. non-productive or other non-farming uses.

Qualified Farm Property Acquired after June 18, 1987

- The property must have been owned throughout the period of at least 24 months immediately preceding the disposition by the taxpayer or any of the users as defined under the qualified farm or fishing property on page two of this document, and either

1. In at least two years while the property was owned by any one or more of the persons noted above, the property was used principally in the business of farming by any one of the eligible users where that person's gross revenues from farming exceeded all other sources of income, or
2. Throughout a period of at least 24 months, the property was used by a family farm corporation or family farm partnership.

Rollovers

There are special rules that allow you to defer capital gains on farm assets. They can apply to the transfer of property to a spouse, common-law partner, child, Canadian Corporation, or Canadian partnership. This provides a way to decrease, or completely defer a capital gain or a recapture of capital cost allowance on depreciable farm property.

The following types of properties can qualify for the rollover provision:

- Farmland
- Depreciable property such as buildings and machinery
- Eligible capital property such as quotas
- Inventories such as grains and livestock

The various rollovers available to defer capital gains and recapture are outside the scope of this publication. If you wish to transfer farm assets to a spouse, common-law partner, child, corporation or partnership, it is strongly recommended that you obtain independent legal and taxation advice.

For further information refer to *Information Update: "Taxation – Property Transfers"*.

Common-Law Partners

Since 2001, "spouse and common-law partner" has replaced the reference to "spouse" in *The Income Tax Act*. While the term "spouse" applies to someone to whom you are legally married, a common-law partner (for income tax purposes) with respect to a taxpayer at any time means "a person who cohabits at that time in a conjugal relationship with the taxpayer" and

- Has so cohabited throughout the 12 month period previously, or
- Would be the parent of a child (natural or adoptive) with whom the taxpayer is also a parent.

Additions to the Adjusted Cost Base

There are some situations where the adjusted cost base of property can be increased. As per our previous example, if the cost base is increased, this will decrease the potential capital gain.

For farmers, this could be applicable where a taxpayer, who is subject to the restricted farm loss rules, adds to or creates a loss by paying interest or taxes. The restricted farm loss rules state that in this case the taxes and interest payments can be added to the cost base of the capital property for the purposes of determining eventual capital gains.

Note – the restricted farm loss rules limit the amount of losses that can be claimed by a taxpayer whose chief source of income is neither farming nor a combination of farming and some other subordinate source of income.

Based on our previous example, if there was a farm loss over the past two years, the mortgage interest and taxes of \$10,000 per year can be added to the cost base.

Using our page three, land sale example:

Adjusted Cost Base of N1/2 1-1-1-ZPM	\$50,000
Cumulated Interest and Taxes	\$20,000
Adjusted Cost Base of N ½ 1-1-1-ZPM	\$70,000

Deductions from Capital Gains Exemption to be aware of:

- The **annual gains** limit is calculated each year to determine if the individual can use all or a portion of the capital gains exemption.
- The **cumulative gains** limit is the running total of the individual's use of the capital gains exemption and indicates the permitted remaining deduction.

Allowable Business Investment Losses (ABIL) a business investment loss is a capital loss from a disposition of shares or debt of a Small Business Corporation. One half of the business investment loss is considered to be an ABIL.

If you have claimed an ABIL since 1985, the available capital gains exemption is reduced by such losses, for example:

An individual who realizes a taxable capital gain of \$400,000 on the disposition of qualified farm or fishing property will only be entitled to a capital gains exemption of \$300,000 if he/she claimed an allowable business investment loss of \$100,000 in a previous year (since 1985).

Net Rental Income (\$7,000-\$10,000)	(\$3,000)
Deduction from other income each year	\$3,000
Addition to CNIL each year	\$3,000
CNIL at end of 2014 (2 x \$3,000)	\$6,000

The CNIL balance of \$6,000 is recorded on Form T936 and also entered on the calculation of the capital gains deduction for the taxation year on Form T657. *The net effect is that, upon the sale of the property, the CNIL balance will reduce the capital gains deduction resulting in an increase in taxable income.*

Cumulative Net Investment Loss (CNIL) is based on the principle that if you borrow money to buy a passive investment asset such as a rental property, and the interest and other costs of your investment exceed the income from it, creating a deduction for tax, you should then not be able to sell the property for a tax free capital gain. CNIL applies to all types of investment income/expenses.

In theory, since 1988 the CNIL account is to be calculated every year and is submitted on Form T936. It is not sufficient to calculate this when a capital gains exemption occurs as you stand to lose the benefit of the income calculations if you should have losses. It is recommended that an individual complete the calculation every year even if they are not going to claim the capital gains exemption.

CNIL Example: The taxpayer purchased 80 acres with a house in 2013. The house is rented at \$7,000/year. Interest and taxes allocated to the house are \$10,000/year.

Summary

From the basic examples provided in this Information Update, the tax liabilities that can occur under capital gains are clearly illustrated, as well as how this must be taken into account when disposing of property. Because of the complexities and different scenarios that can arise when transferring or selling property it is strongly recommended that both legal and accounting professionals be consulted. Additional information for Tax Calculation Assumptions can be found on the **“Tax Planning Worksheet”**.



For more information

- Go to manitoba.ca/agriculture and click on Business and Economics
- Email us at MBFarmBusiness@gov.mb.ca
- Visit your local Manitoba Agriculture, Food and Rural Development GO Office