CHAPTER 8

Gains and Losses on the Disposition of Capital Property—Capital Gains

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Capital gains (or capital losses) refer to the gain (or loss) realized on the disposal of capital property. Capital property, by definition, is property that provides a long-term and enduring benefit to its owners; consequently, disposals of such property tend to occur irregularly and infrequently over a taxpayer's lifetime. Properties that are held for personal use and enjoyment, for investment purposes, or for the purpose of assisting in generating business activity, all have the potential for capital gains. Calculating a capital gain or loss for tax purposes is a very simple matter; however, it will become readily apparent that this calculation departs radically from the one used to determine other types of income with respect to the timing of income recognition, the amount of income subject to tax, and the utilization of losses when they occur. Some people regard the tax treatment of capital gains as preferential, and the treatment of capital losses as unfair. In either case, their tax treatment is a significant factor to consider when an investment in capital assets is being contemplated.

Of primary importance is the ability to recognize when a gain or loss on the sale of property is classified as a capital gain or loss as opposed to income or loss from business. Because the *Income Tax Act* does not provide specific guidelines, establishing whether a transaction is a capital one is the most complex aspect of the study of capital gains and losses.

This chapter develops a definition of capital gains for tax purposes, presents the basic rules for determining the amount and timing of gains and losses, and examines certain unique types of properties. In addition, the broad impact of the tax treatment of capital transactions on investment and business decisions is examined.

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I. Capital Gain and Capital Loss Defined

A capital gain (or capital loss) is the gain (or loss) realized on the disposition of capital property. For a property to be classified as capital property, it must have been acquired and used for the purpose of providing the owner with a long-term or enduring benefit.

Note that the definition does not indicate that the property must be held for a long time or that it must provide a benefit; instead, it is enough that the *intended purpose* of the acquisition was to achieve benefits over a long period of time. Whether or not the property actually achieves its intended purpose is governed by future events that may or may not be controllable by the owner. The key to understanding the concept of capital gains (or losses) lies in focusing on the intended purpose of acquisition. Unfortunately, the ultimate results do not always provide proof of this intended purpose, and consequently, there are frequent disputes between the CRA and taxpayers as to what was, in fact, the original intention.

It is necessary to clarify the term "benefit." In the context of capital property, *benefit* refers to both direct and indirect benefits achieved from the use of the property. These benefits need not be financial in nature. The acquisition of a rental building will result in direct financial benefits in the form of rent receipts. The purchase of a warehouse building for use in a business will result in indirect financial benefits by creating the ability to store merchandise held for resale. The purchase of a summer cottage will result in a non-financial benefit in the form of personal enjoyment. Each of these items is capital property and is subject to capital gains treatment for tax purposes.

The general definition of capital gains and losses is subjective because it is based upon the intended purpose of the property acquisition, rather than on the actual results achieved. Because the circumstances surrounding each acquisition are different, each property must be assessed in the context of its unique position. Because the *Income Tax Act* does not provide definitive guidelines, it has been left to the common-law process to establish some general considerations. In order to fill out the

overall definition of capital property subject to capital gains treatment, it is useful to do the following:

(a) compare the definitions of capital income and business income;
(b) review the principles established by common law for assessing intended purpose; and,
(c) examine the categories of capital property established by the *Income Tax Act*.

A. Capital versus Business Income

The sale of property by any taxpayer can be classified as a business activity or as a capital transaction—it depends on the intended purpose of acquiring the property. The following points were made in Chapter 5:

1. Property acquired for the purpose of resale at a profit is classified as inventory. Its disposition results in business income or a business loss.

2. Property acquired for the purpose of providing the owner with a long-term or enduring benefit is classified as capital property. Its disposition results in a capital gain or loss.

Obviously, the above comparison does not mean that one cannot realize a profit on the sale of capital property. It does, however, hinge on the way in which that profit was generated. The profit on capital property (capital gain) arises from the mere enhancement of the capital value of an asset that was acquired for some other purpose.[1] The profit on other property (business income) results from a scheme of profit making that was the owner's intended purpose.

As stated in Chapter 5, the nature of the asset is not relevant. The same property may be capital property to one taxpayer but inventory to another. A truck that makes product deliveries provides a long-term benefit to the owner and is capital property, but a truck purchased by an automobile dealer for resale at a profit is inventory. Even within the same entity, similar assets may be classified differently. Land acquired to provide parking for customers is capital property. If that same business acquired other land for speculative purposes, it would be classified as inventory. The tax treatment on each land sale would be different.

It is recommended that the reader review the first few pages of Chapter 5, which provide a more detailed comparison of business income and capital gains on similar properties.

In some cases, the nature of the transaction is more complex, and the distinction between business income and capital gains is not so apparent. Consider the following example:

Situation: A Canadian corporation that was previously not active in business purchased a 40-year franchise permitting it to operate particular hardware stores across Canada. Subsequently, the corporation sold subfranchises (one for each province) to separate buyers in return for a cash amount and continued royalties based on sales. After seven years, the corporation sold the master national franchise at a substantial profit and ceased all operations in the hardware business. The purchaser of the national franchise obtained the rights to all future royalties from the subfranchises.

Analysis: The national franchise is capital property because it is an income source that brings an enduring benefit to the corporation in the form of continued royalties from the subfranchises. Because of its limited life of 40 years, the master franchise also qualifies as depreciable property under class 14 and can be amortized over 40 years against the royalty income (see Chapter 6).

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1 *California Copper Syndicate Ltd. v. Harris* (1904), 5 DTC 159.

The sale of subfranchises constitutes business income. The right to subfranchise the master franchise is property that was acquired for the intended purpose of resale. It is therefore inventory, and the sale to 10 separate buyers constitutes income from business.

The sale of the master national franchise is a sale of capital property that has appreciated in value. To the extent that the selling price is in excess of the original cost, a capital gain results. A recapture of capital cost allowance (business income) also occurs if capital cost allowance is claimed on the original cost.

The above example highlights the issue of "intended purpose" in a complex situation. The situation assumed that the taxpayer meant to obtain long-term benefits from the master franchise by selling royalty-based subfranchises. The corporation's original intention may have been to acquire the master franchise in order to sell it at a profit; if this had been the intention, the gain would have been classified as business income. But the facts were that the master franchise was held for seven years and that the corporation went through the process of selling subfranchises; neither fact is consistent with this intention.

B. Intention

Because the history of a transaction does not always reflect its original intention, numerous disputes between the CRA and taxpayers have been heard by the courts. These hearings attempt to determine the intended purpose by examining the manner in which the owner dealt with property.[2] While the facts surrounding each case are always different, the courts have consistently taken certain factors into account when establishing the original intention. These factors, which are outlined below, are not ranked, as the importance of each depends on the relative strength and weakness of the others in a particular case.

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- **Period of ownership** That a property is held for a long period of time substantiates the claim that it is capital property which was purchased to provide a long-term and enduring benefit. That a property is held for a short period of time speaks against such a claim, in that it is evidence that the property may have been purchased for resale. Obviously, property purchased for a long-term benefit may, owing to special factors, be sold after a brief ownership period, and property purchased for resale may be held for a long period of time; so, period of ownership by itself does not provide compelling evidence of intention. It is, however, a factor when examined in conjunction with the other factors discussed below.

- **Nature of the transaction** The courts will examine the entity's course of conduct over the ownership of the property, dwelling on the point of acquisition, the use of the property during its ownership, and the reasons for and nature of its disposition.[3] The sale of raw land, even when it is held for a period of 15 years, may be regarded as business income if the owner cannot provide evidence of enduring benefit through rental or personal use and enjoyment. On the other hand, an individual who purchased vacation land with the intention of building a summer cottage but sold the raw land for a profit after a brief ownership period may be considered to have achieved a capital gain if the reason for the sale was that the original intention was frustrated by a sudden need for money, an inability to finance the cottage, a job transfer, or the like.

2 *Regal Heights Ltd. v. MNR*, 60 DTC 1270; IT-459, IT-218R.
3 *MNR v. Taylor*, 56 DTC 1125.

- **Number and frequency of transactions** A historical pattern of frequent buying and selling supports the premise that the intended purpose of acquisition was to resell at a profit.[4] This factor may be significant even though the property generated benefits during the ownership period. The frequent acquisition and sale of rental real estate properties may be considered as resulting in business income even though those properties were held for a respectable time period and reasonable rental profits were achieved. In some cases, the courts have decided that an individual has earned business income on the sale of his or her home when a historical pattern of acquisition, renovation, and sale has emerged, even though the home was used as a residence during the ownership period.

  It should be pointed out that while a history of frequent transactions in similar property is strong evidence that the gains or losses are business income, the reverse is not true. The courts will consider but have not given significant weight to the argument that an isolated transaction suggests a capital transaction.

- **Relation of transaction to taxpayer's business** If the property sold is similar in nature to property normally dealt with as part of the owner's trade or occupation, it is difficult to establish that the ownership of such property was of a capital nature.[5] A person who makes his or her living by selling real estate is normally considered to have generated business income by selling a unit of rental real estate even when the property was held for a reasonable period of time and generated normal rental returns. Similarly, a lawyer whose practice consists extensively of real estate transactions will have a more difficult time proving that real estate was acquired for the purpose of providing a long-term and enduring benefit.

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The above factors indicate that even when the reason for acquiring a property is clear to the purchaser, it may not be so clear to the tax assessor. It is important that taxpayers, when possible, document their course of conduct relating to the acquisition, period of use, and sale of property. Evidence, such as copies of correspondence, internal memos, and the like, is invaluable, especially when the original intention was thwarted by external factors.

It is important to remember that the above factors are only guidelines that assist in establishing the primary intention. Each factor by itself is not significant; it is when *all* are considered together that a course of conduct becomes evident. Each transaction must be judged on its own merits. Do not lose sight of the fact that the process of establishing that a transaction was of a capital nature begins with establishing the original purpose of acquisition—that is to obtain a long-term or enduring benefit from its use.

There are two areas with respect to intention that require special mention. First, sometimes the intended purpose of ownership changes so that the property is held for a period of time for one purpose and for a period of time for another purpose. Second, certain properties—marketable securities, in particular—are often acquired for the dual purpose of providing annual benefits *as well as* a profit on sale. Each of these situations has a special tax treatment, which is discussed shortly.

It is worth noting first that the issue of intention may be further confused when a taxpayer enters into a transaction with both primary and secondary intentions. In other words, the taxpayer has considered that if one objective fails, a fall-back plan is available and viable. In such circumstances, there must be evidence that the taxpayer had the secondary objective in mind when acquiring the property.[6]

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4 *Brown v. MNR*, 50 DTC 200.
5 *McDonough v. MNR*, 49 DTC 621.
6 *Racine v. MNR*, 65 DTC 5098.

1. Change in Purpose

Property that was acquired to provide a long-term benefit and has been used for that purpose may, at some point, be converted into inventory and held for the purpose of resale. For example, farmland that has been used to produce farm revenue or a parking lot used for customer parking may cease to be used for such purpose and be subdivided and held for property development and resale. Such a change of purpose does not constitute a disposition for tax purposes. Similarly, property that was acquired as inventory for resale, such as a piece of equipment, may, if not sold, be converted to capital property and used to produce income. In both situations, when the property is ultimately sold, this question arises: Is the gain a capital gain, a business gain, or a combination of the two?

While the *Income Tax Act* provides no rules for such situations, the CRA has developed a policy which requires that the gain or loss be allocated between capital and business income in accordance with the property's value at the time the purpose changed.[7] In the land example above, the capital gain would be set at the difference between the property's market value at the time of change and the original cost. Any further gain would be business income. Both gains are recognized only at the time of the actual sale. In such circumstances, it is important that the owner attempt to establish the property's value at the time of the change in use, in order to take maximum advantage of the allocation.

2. Canadian Securities

Investments in marketable securities almost always have a dual purpose: to generate annual returns and to realize a profit on resale. Historically, the CRA has applied the common-law principles described previously in a lenient manner; that is partly in recognition of the dual purpose but also a reflection of the government's desire to promote investment in equity securities. With respect to the investment in *Canadian* securities only, the *Income Tax Act* permits taxpayers (other than security dealers) to remove themselves from the common-law rules of intention and simply elect to have all sales of Canadian securities treated as capital transactions.[8] A Canadian security is considered to be (with some minor exceptions) a share of the capital stock of a resident Canadian corporation, a unit of a mutual fund, or a bond, debenture, bill, note, mortgage, or other similar obligation issued by a resident of Canada.

While making this election ensures capital treatment of all security transactions, it also locks the investor into using this method indefinitely. This may not always be desirable, especially considering the limitations on the use of capital losses when they occur. Many investors choose not to make the election and subject themselves to the lenient application of the common-law rules. This gives them the option of treating substantial trading losses as business losses (if the facts support that position), which can readily be offset against other sources of income.

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C. Categories of Capital Property

In order to understand which properties are subject to capital gains treatment for tax purposes, it is useful to outline the categories of capital property. The *Income Tax Act*, directly or indirectly, defines three categories of capital property:

- personal-use property
- listed personal property
- financial property

7 IT-102R2, IT-218R; *Armstrong v. The Queen*, 85 DTC 5396.
8 ITA 39(4) to (6); IT-479R.

Of the above, only personal-use property and listed personal property are specifically defined in the *Income Tax Act*. After these two specific definitions have been examined, the third definition—for financial property—will be clear.

• **Personal-use property** Personal-use property is property owned by the taxpayer that is used primarily for the personal use or enjoyment of the taxpayer, or persons related to the taxpayer, and that does not generate financial returns.[9] All personal property, such as a car, a boat, land, a house, a cottage, furniture, a piano, and so on, is personal-use property and subject to capital gains treatment.

• **Listed personal property** Property in this category includes items that are for personal use but also have some element of investment value. This category is limited to several specific items, which are listed in the *Income Tax Act* as follows:[10]

- a print, etching, drawing, painting, or sculpture, or other similar works of art
- jewellery
- a rare folio, rare manuscript, or rare book
- a stamp
- a coin

Any property not listed above that is for personal use and enjoyment is personal-use property.

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• **Financial property** In this category is included all capital property that was acquired primarily to generate a benefit through a financial reward. It includes such items as shares, bonds, loans, land, buildings, equipment, patents, licences, franchises, and vehicles. Only a few capital properties are excluded from this category, the main one being property that qualifies as eligible capital property, as described in Chapter 6.

Clearly, the capital gains provisions encompass a wide range of properties. When examining the disposition of a capital property, it is important to establish it in one of the above categories because, as will be described later in the chapter, certain aspects of transactions are treated differently in each category.

II. Determining Capital Gains and Losses—General Rules

Capital gains and losses were introduced in Chapter 3 as one of the five income categories. You will recall that the aggregating formula, which combines all the types of income to arrive at a taxpayer's net income for tax purposes, includes only the amount by which the total taxable capital gains for the year exceed the total allowable capital losses for the year.[11] Hence, the principle is established that capital losses can be offset only against capital gains and cannot be used to offset other sources of income earned by a taxpayer. (The same restriction is not placed on other sources of income; business losses and property losses can be offset against any other source of income for tax purposes.) The cash-flow implications of this special treatment were discussed in Chapter 3 and are reviewed again later in this chapter; this section restricts itself to establishing the format for calculating the capital gain or loss on each individual asset sold. However, it is important to relate the individual calculation to the aggregating formula in order to establish its effect on the amount of tax payable.

9 ITA 54; IT-332R.
10 ITA 54.
11 ITA 3(b).

A. General Calculation

The capital gain or loss on the disposition of a given capital property is calculated by completing the following simple procedure:[12]

Proceeds of disposition		xxx
less		
Adjusted cost base (ACB)	xx	
Expenses of disposition	x	xx
Capital gain or capital loss		xx

Only *one-half* of the above capital gain is included in net income for tax purposes; it is referred to as "taxable capital gain."[13] Similarly, only one-half of a capital loss is included in the calculation of net income for tax purposes; it is referred to as "allowable capital loss." At the end of each taxation year, the taxable capital gains and the allowable capital losses on all properties are totalled separately and included in the aggregating formula.

Note that the terminology used in the above calculation is different from the normal accounting terminology used in the disposal of long-term assets. The taxation terms "proceeds of disposition" and "adjusted cost base" are much broader than the accounting terms and require special examination.

B. Disposition and Proceeds of Disposition

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Capital gains and losses are recognized for tax purposes only when a disposition of the property occurs.[14] If an investment in shares of a public corporation increases in value during the year, no capital gain is recognized. Similarly, if the investment declines in value, a capital loss does not occur. In comparison, when a bond compounds interest annually but pays nothing for 10 years, the investor who purchased it must recognize accrued interest annually.

Normally, a disposition of property occurs when[15]

(a) property is sold;
(b) property is involuntarily eliminated by theft, destruction, or expropriation;
(c) a share, bond, debenture, note, or similar property is cancelled, redeemed, or settled; or,
(d) a share owned by a taxpayer is converted by amalgamation or merger (see Chapter 14).

When property is sold, the proceeds of disposition is the selling price, whether it is received in cash or is payable at some future time. Property that is sold in exchange for other property has proceeds of disposition equal to the fair market value of the property received in exchange. The proceeds of disposition for an involuntary disposition is the compensation received for stolen, destroyed, or expropriated property.

In some circumstances, property is *deemed* to be disposed, even though no proceeds of disposition are received. A deemed disposition of property occurs in the following circumstances:

1. When property is transferred by way of a gift to another party, the taxpayer is deemed to have sold the property at its fair market value at that time (see Chapter 9).[16]

12 ITA 40(1)(a)(i).
13 ITA 38.
14 ITA 39(1).
15 ITA 54, "disposition" and "proceeds of disposition."
16 ITA 69(1)(b).

2. When the use of property changes from personal use to business or investment use, or when it is changed from business or investment use to personal use, the property is deemed to have been sold at its fair market value.[17]

3. Property is deemed to have been sold at fair market value when a taxpayer ceases to be a resident of Canada for tax purposes.[18] Certain properties, such as real estate situated in Canada, and inventory, eligible capital property, and capital property from a business in Canada are exempted. However, if adequate security is posted, the tax payment can be delayed until the property is sold.

4. On the death of an individual, all of that person's capital property is deemed to have been sold immediately prior to death (see Chapter 9).[19]

The definitions of *disposition* and *proceeds of disposition* are very broad when the concepts of actual disposition and deemed disposition are combined.

C. Adjusted Cost Base

Normally, the adjusted cost base of a property is the original purchase price plus other costs incurred to make the acquisition, such as brokerage fees, installation costs, and legal fees. Sometimes, the original cost is expanded, as described in Chapter 6, when the original cost of depreciable property is increased by the cost of substantial repairs and alterations. There are, however, a number of adjustments to cost for tax purposes that may or may not also be accepted for accounting purposes.[20]

The *Income Tax Act* lists, in section 53, a number of specific additions to and deductions from cost that can be made to arrive at the adjusted cost base of a property. For example, when a taxpayer receives a government grant or subsidy to acquire an asset, the purchase price of the asset is reduced by the amount of the grant to arrive at the adjusted cost base for tax purposes. If the asset is subsequently sold, the capital gain will be determined as the difference between the selling price and the lower cost base, rather than between the selling price and the original cost. The adjustment to the cost base ensures that the grant or subsidy will be taxable as a capital gain if and when it is recovered through an asset sale. The taxable benefits received when shares are purchased under an employee stock-option arrangement are added to the cost of the shares to ensure that the same income is not counted twice (see Chapter 4). These examples demonstrate that the adjustments to cost base are technical and specialized in nature. A detailed review is beyond the scope of this text.

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In some cases, it is possible for the accumulated cost base reductions to be greater than the cost of the asset. When this occurs, the negative balance is considered a capital gain and is recognized in the year in which it occurs.[21] By exception, a negative adjusted cost base of an interest in a partnership normally does not create a capital gain (see Chapter 15).

Special provisions apply to the adjusted cost base of a property that was acquired before 1972 and is still owned by the taxpayer.[22] Before 1972, capital gains were not taxable; to reflect this, the adjusted cost base of property acquired before that year is tied to its fair market value at December 31, 1971.

In some circumstances, property may be acquired without a cost. A person who receives a gift of property has no actual cost. However, as described above, the person who made the gift is deemed to have sold the property at fair market value, and consequently, the recipient of the gift is deemed to have an adjusted cost base of the same amount.[23]

17 ITA 45(1).
18 ITA 128.1; IT-451R.
19 ITA 70(5).
20 ITA 52, 53, 54.
21 ITA 40(3).
22 ITAR 26(3), 26(7), 20; IT-84, IT-139R.
23 ITA 69(1)(c).

D. Expenses of Disposition

Because of the nature of capital property, the owner often requires assistance to complete the sale transaction. All costs incurred to complete the disposition are deductible when arriving at the capital gain or loss; such costs include legal fees to complete the sale agreement, brokerage fees or commissions to agents, advertising, and mortgage discharge fees.[24]

E. Deferred Proceeds

Capital property, by its nature, often commands a relatively high selling price; this often means that the buyer must fund the purchase with a combination of cash reserves and debt financing. In order to facilitate a sale, a vendor may act as the financier for the purchaser by accepting payment in the form of an immediate down payment in cash, with the balance, with interest, to be paid over some future time period. When this occurs, the capital gain rules permit the vendor, subject to a time limitation, to recognize the taxable capital gain over a period of years in proportion to the receipt of the proceeds of disposition.[25] The deferred recognition of capital gains is restricted to a maximum of five years, and a minimum of 20% of the capital gain must be recognized, on a cumulative basis, for each of the five years. This method for recognizing capital gains is optional for each property sold.

It should be noted that the time limit of five years is extended to 10 years when the sale is made to a child of the taxpayer *and* the property sold is shares of a small business corporation, farm property, or an interest in a family farm partnership.[26]

If the taxpayer chooses to use this method, the capital gain calculation referred to previously must be modified, as demonstrated next.

Situation: A taxpayer sold property in 20X0 for $200,000. The property had an adjusted cost base of $130,000, and selling costs of $20,000 were incurred. The selling price of $200,000 is to be paid to the vendor as follows:

Cash on sale (20X0)	$ 80,000
20X1	30,000
20X2	–0–
20X3	90,000
	$200,000

Analysis:

Capital gain:		
Proceeds of disposition		$200,000
less		
Adjusted cost base	130,000	
Expenses of disposition	20,000	(150,000)
Capital gain		$ 50,000
Taxable capital gain (1/2 × $50,000)		$ 25,000

(20X0)	
Capital gain	$50,000
Less deferred portion—capital gains reserve—lesser of:	
(1) $\frac{\$120,000 \text{ (deferred proceeds)}}{\$200,000 \text{ (total proceeds)}} \times \$50,000 = \$30,000$	
(2) 4/5 × $50,000 = $40,000	(30,000)
Capital gain	$20,000
Taxable capital gain (1/2 × $20,000)	$10,000

24 ITA 40(1).
25 ITA 40(1)(a)(iii); IT-236R4.
26 ITA 40(1.1).

Note that the deferred portion of the gain is in the proportion of the unpaid price to the total price. The *capital gain recognized in 20X0 of $20,000* is 40% of the total gain, as 40% of the total proceeds (40% of $200,000 = $80,000) was received in 20X0. Because 40% of the gain is recognized in 20X0, the requirement to recognize at least 20% per year has been satisfied for both 20X0 and 20X1.

(20X1)

Unrecognized gain (prior year's reserve)	$30,000
Less deferred portion—capital gains reserve—lesser of:	
(1) $90,000 (deferred proceeds) / $200,000 (total proceeds) × $50,000 = *$22,500*	
(2) 3/5 × $50,000 = $30,000	(22,500)
Capital gain	$ 7,500
Taxable capital gain (1/2 × $7,500)	$ 3,750

(20X2)

In 20X2, no additional payment is received. However, a portion of the gain must be recognized because the cumulative 20% minimum has not been met. By the end of 20X2, only 55% of the price has been received ($110,000/$200,000 = 55%), but a minimum of 60% (20% × 3 years) must be included in income. The capital gain recognized in 20X2 is 5% × $50,000 = $2,500.

Unrecognized gain (prior year's reserve)	$22,500
Less deferred portion—capital gains reserve—lesser of:	
(1) $90,000 (deferred proceeds) / $200,000 (total proceeds) × $50,000 = $22,500	
(2) 2/5 × $50,000 = *$20,000*	(20,000)
Capital gain	$ 2,500
Taxable capital gain (1/2 × $2,500)	$ 1,250

(20X3)

In 20X3, the full balance of the proceeds is received, and therefore, the balance of the gain must be recognized.

Unrecognized gain (prior year's reserve)		$20,000
Less deferred portion—capital gains reserve—lesser of:		
(1) $0 (deferred proceeds) / $200,000 (total proceeds) × $50,000 = *$0*		
(2) 1/5 × $50,000 = $10,000		(0)
Capital gain		$20,000
Taxable capital gain (1/2 × $20,000)		$10,000
Summarized as follows:		
Total capital gain (above)		$50,000
Less previously recognized:		
20X0	$20,000	
20X1	7,500	
20X2	2,500	(30,000)
Capital gain recognized in 20X3		$20,000
Taxable capital gain (1/2 × $20,000)		$10,000

Deferring the recognition of the capital gain to future years in proportion to the receipt of the proceeds is referred to as a reserve. The reserve is deducted from the capital gain in the year to arrive at the taxable amount. It is important to recognize that claiming the reserve is *discretionary* and that the taxpayer can choose not to defer the recognition of the gain. This may be desirable if the taxpayer has a capital loss in the year to offset the gain or if it is anticipated that tax rates will be higher in the future years. When the reserve is claimed, a formula exists to ensure that the reserve will not exceed the requirement that at least 20% of the gain be included in income on an accumulated basis. The formula states that the maximum reserve in any year is equal to the lesser of

(a) deferred proceeds/total proceeds × gain (as demonstrated above),
or
(b) 80% of the gain in year 1, 60% in year 2, 40% in year 3, 20% in year 4, and zero in year 5.

An alternative formula for calculating the deferred portion of a capital gain is permitted when the property being sold is already encumbered with a debt and when the buyer assumes that debt as part of the purchase obligation.[27] In such cases, the taxpayer can recognize the gain in proportion to receipt of the equity in the property. For example, if capital property has a value of $100,000 but is encumbered by a first mortgage of $40,000, the owner's equity interest is $60,000. If that owner sold the property for $100,000 and the purchaser settled the price by assuming the first mortgage of $40,000, paying cash of $10,000 and owing the balance of $50,000, the deferred taxable capital gain would be calculated as follows:

$$\frac{\$50{,}000 \text{ (deferred proceeds)}}{\$60{,}000 \text{ (equity in property)}} \times \text{gain}$$

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This method permits a greater deferral than the method previously demonstrated, provided that the 20% rule does not limit its application. The obvious benefit of deferring the proceeds of disposition and thereby the related tax is that it permits the owner to reinvest a greater amount of the proceeds on a pre-tax basis by charging interest to the purchaser on the unpaid portion.

This section has developed the general rules for computing the capital gain or loss on the disposal of a single capital asset. With the exception of the rules relating to deferred proceeds, the principles are straightforward and easy to apply. Before examining how the taxation of capital property affects investment and management decisions, it is necessary to review some unique aspects of capital losses and the treatment of special types of property.

III. Unique Aspects of Capital Losses

In accordance with the general rules established in the previous section of the chapter, capital losses are recognized only when a disposition occurs; and as a result of the aggregating formula outlined in Chapter 3, they can be deducted for tax purposes only to the extent that capital gains were realized in the same year. Because of this restriction, a taxpayer who has incurred a capital loss should consider disposing of other capital property that has appreciated in value. Conversely, a taxpayer who is facing a capital gain should consider disposing of property that has declined in value in order to create an offsetting loss.

If a capital loss cannot be used in the current year, it can be carried forward indefinitely and used in the future when a capital gain occurs; or it can be carried *back* to the previous three years provided that capital gains were incurred in those years. This

27 IT-236R4, paragraph 8.

carry-forward and carry-back procedure is not part of the overall net income calculation; rather, it is applied when the net income for the year is reduced to taxable income. This topic will be discussed in detail in Chapter 10.

Normal rules do not apply to certain types of capital losses, some of which are discussed below.

A. Allowable Business Investment Losses

An allowable business investment loss (ABIL) is the allowable capital loss (one-half of the actual loss) incurred on the disposition of a loan to a small business corporation, or on a sale of that corporation's shares (provided that sale is made to an arm's-length party).[28] In general terms, a small business corporation is a *private* corporation that is Canadian controlled and that uses all or substantially all of its assets (valued at fair market value) to conduct an active business.[29] The CRA holds the view that "substantially all" means at least 90% of the assets.

When such a loss occurs, the aggregating formula permits it to be offset against all other sources of income derived by the taxpayer, as an exception to the normal capital loss rules. In this way, the after-tax risk of investing in small business corporations is reduced relative to other capital investments because the tax savings on a loss, if one should occur, are readily usable.[30]

B. Deemed Disposition on Loans and Shares

The rule that a capital loss can be recognized only when the property is disposed of is a burden to taxpayers when a market is not available for the sale of the property. In particular, when an investment in shares of a corporation has declined in value because the corporation has suffered extreme financial problems or when an outstanding loan is uncollectible due to the debtor's inability to pay, the owner may be unable to sell the property and trigger the disposition. In recognition of this problem, property that is a loan or a share of capital stock of a corporation is subject to deemed-disposition rules that permit the loss to be recognized before an actual disposition occurs, as follows:[31]

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1. An outstanding debt is deemed to be disposed of for a value of nil at the time it is established that it is a bad debt.
2. A share of the capital stock of a corporation is deemed to be disposed of for a value of nil at the time the corporation has become legally bankrupt. If the corporation is not legally bankrupt, a deemed disposition may still be permitted if, at the end of the year, the corporation is insolvent, it has ceased operating its business (with no intention to resume), the value of its shares is nil, and the corporation is expected to be dissolved.

It is clear from all this that it is easier to recognize a loss on a bad loan than on a share because in the case of a loan, it need only be established that the loan is uncollectible, whereas with a share, the owner must wait for legal bankruptcy or other specified conditions to occur. Also, the loss from the deemed disposition may be classified as an allowable business investment loss if the loan or the shares are from a small business corporation, as discussed previously.

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28 ITA 38(c), 39(1)(c), 251(1); IT-484R2.

29 ITA 248(1).

30 Also, when an ABIL is incurred, an individual is restricted from claiming the capital gain deduction (see Chapter 10) in future years until taxable capital gains of an equal amount have been included in income. Conversely, if a capital gain deduction has been claimed in a prior year, the ABIL may be restricted.

31 ITA 50(1), (2), 40(2)(g); IT-159R3.

C. Depreciable Property

Under no circumstances can a capital loss occur on the disposition of capital property that is also classified as depreciable property. As described in Chapter 6, the original cost of depreciable property is written off through the capital cost allowance system. Therefore, any actual loss arising when property is sold for a price less than its original cost is automatically reflected in the annual capital cost allowance calculation or the terminal loss or recapture, if any.

For example, suppose that all of the depreciable property of a class originally cost $10,000 and has an undepreciated capital cost of $8,000. If it is sold for $7,000, a terminal loss of $1,000 occurs at the time of sale. The selling price of $7,000 is $3,000 less than the original cost of $10,000; this loss is fully recognized for tax purposes as follows:

Capital cost allowance in previous years	$2,000
Terminal loss on sale	1,000
	$3,000

D. Superficial Losses

When property has declined in value, a taxpayer who has no real intention of ridding himself or herself of the property may dispose of it in an attempt to trigger the recognition of a capital loss; subsequently or before the sale, that person may reacquire the same property. In such circumstances, when the reacquisition occurs within 30 days of the sale of the original property, the resulting loss is classified as a superficial loss and is deemed to be nil for tax purposes.[32] The actual loss is not permanently denied but, rather, is added to the adjusted cost base of the new identical property and will be recognized when the new property is sold.[33]

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Situation: On December 31, 20X0, a taxpayer sold 500 shares of Corporation X for $8,000 that originally cost $10,000. On January 5, 20X1, the taxpayer reacquired 500 shares of Corporation X for $7,500.

Analysis:

(20X0)	
Proceeds of disposition	$ 8,000
less	
Adjusted cost base	(10,000)
Actual capital loss	$ 2,000
Superficial loss deemed to be—	NIL
(20X1)	
Cost of new shares:	
Actual cost of 500 shares	$ 7,500
plus	
Loss previously denied	2,000
Adjusted cost base of new shares	$ 9,500

When the new shares are ultimately sold, the original loss of $2,000 is deducted from the selling price as part of the cost of the new shares sold.

32 ITA 54, 40(2)(g).
33 ITA 53(1)(f).

The same treatment applies when a taxpayer incurs a loss from the sale of property to his or her own corporation or to a corporation controlled by a spouse. In these circumstances, the loss is deemed to be zero.[34] A capital loss is also denied when it results from the transfer of property by an individual to an RRSP.

E. Personal-Use Property

As previously mentioned, personal-use property is capital property from which the owner derives a long-term benefit—that is, personal use and enjoyment.[35] For tax purposes, any loss suffered on the sale of personal-use property is deemed to be nil, even though gains on such property are taxable.[36] Presumably, this policy reflects the fact that the loss on sale is equivalent to the enjoyment received from the use of the property.

This restriction is applied to each item of personal property, which means that the capital loss on one item of personal-use property cannot be offset against a capital gain realized on the sale of another personal-use property.

Personal-use property is further distinguished from other capital property by having a deemed minimum cost for tax purposes of $1,000 and deemed minimum proceeds of $1,000.[37] Therefore, small items of personal-use property will be subject to capital gains treatment only to the extent that the proceeds of disposition exceed the minimum amount of $1,000.

F. Listed Personal Property

Listed personal property was defined previously as personal-use property that has personal value as well as investment value; it is restricted by definition to specific items, such as works of art, rare books, jewellery, stamps, and coins.[38]

Listed personal property is different from personal-use property in this way: a loss from the sale of listed personal property is recognized for tax purposes. However, capital losses from listed personal property can be offset only against capital gains from listed personal property; they cannot be offset against other capital gains or other forms of income.[39] To the extent that capital losses on listed personal property cannot be used in the current year (because there are not sufficient capital gains from listed personal property), the unused loss can be carried back three years or forward seven years and deducted against listed personal property gains, if any, in those years. These carry-overs form part of the calculation of annual net income for tax purposes (see Chapter 3, also Exhibit 10-1 in Chapter 10).

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As is the case with personal-use property, each item of listed personal property that costs less than $1,000 is deemed to have a minimum cost for tax purposes of $1,000. Each property also has a deemed minimum proceeds of $1,000.

IV. Unique Aspects of Specific Capital Properties

Certain specific types of property require special mention either because the tax treatment deviates from the general principles of capital gains or because it is difficult to establish whether or not the property is capital property. Several of these items are discussed briefly in this section of the chapter.

34 ITA 54. Technically, the superficial-loss rules apply where the property is repurchased by the taxpayer, his or her spouse, or an "affiliated" person, 30 days before or after the sale of property on which the loss has occurred.
35 ITA 54; IT-332R.
36 ITA 40(2)(g).
37 ITA 46(1) to (3).
38 ITA 54.
39 ITA 41(1), (2).

A. Identical Properties

Often, several properties of an identical nature are acquired over a period of time and at different costs. For example, an investor may acquire shares of the same corporation over a period of years, with the per-share price different at each time of acquisition. It is difficult in this situation to distinguish one share from another; if some but not all of the shares are sold, this question arises: What is the adjusted base of the shares sold?

The adjusted cost base of each identical property acquired is the weighted average cost of all the identical properties acquired up to the point of sale.[40] This calculation is demonstrated below.

Situation: An investor acquired shares of X Corporation as follows:

Year	*No. of shares*	*Cost per share*	*Total cost*
20X0	100	$ 6	$ 600
20X1	200	8	1,600
20X2	80	10	800
	380		$3,000

In 20X2, the investor sold 150 shares of Corporation X for $9 per share.

Analysis:

Proceeds of disposition (150 × $9)	$1,350
Adjusted cost base of one share: $3,000/380 = $7.89	
Cost base of all shares sold: 150 × $7.89	1,183
Capital gain	$ 167
Taxable capital gain (½ × 167)	$ 84

In the above example, if additional shares are subsequently purchased, they are added to the cost base of the 230 shares (380 – 150) remaining, which now have a total average cost of $1,815 (230 × $7.89).

Shares acquired under an employer stock-option arrangement after February 27, 20X0, that are *eligible to defer* the employment benefit to the year the shares are sold (see Chapter 4) are *not* treated as identical properties.

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B. Convertible Securities

Normally, the exchange of one property for another will result in a disposition for tax purposes. However, when securities, such as shares, bonds, and debentures, are issued and the owner has the right to convert or exchange them for shares of the same corporation, and the owner makes use of that right, a disposition is not considered to have occurred. Instead, the adjusted cost base of the old security becomes the cost base of the new security, and a gain or loss is recognized when the new security is eventually sold.[41]

C. Options and Warrants

In order to secure the opportunity to acquire property at some future time, a taxpayer may pay an amount that grants him or her the right or option to purchase property at a specified price over some limited time period.

40 ITA 47(1), (2); IT-387R2. (Also see proposed ITA 47(3)).
41 ITA 51(1), (2).

From the payer's perspective, this type of transaction has no tax consequences at the time of payment. If, at a subsequent time, the payer exercises the option and purchases the property, the cost of the option is added to the adjusted cost base of the property acquired. On the other hand, if the payer allows the option to expire and does not purchase the property, the full cost of the option is considered a capital loss in the year of expiry.[42]

The tax treatment to the taxpayer who granted the option and received the payment is somewhat different. In this case, the amount received for granting the option is considered a capital gain in the year in which it is received. If, in a subsequent year, the option is exercised, the original option amount received is included as part of the proceeds of disposition in that year, and the original option amount reported as a capital gain in the earlier year is reversed through the filing of an amended tax return.[43]

D. Commodities and Futures Transactions

Commodities and commodity futures cannot, by definition, be classified as capital property because no long-term or enduring benefit can result from their acquisition. Commodities are acquired solely for the purpose of obtaining a gain on resale and are therefore inventory of trade. But in spite of the obvious position of commodity transactions, the CRA has set a policy that allows taxpayers to choose between capital treatment and business-income treatment, provided that the chosen method is used consistently in future years.[44] However, this option is not permitted for taxpayers who are associated with the commodity business or who are taking commodity positions as part of their normal business or trade. For example, farmers who grow wheat must treat commodity transactions in wheat as part of their business income.

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E. Goodwill and Eligible Capital Property

The tax treatment of eligible capital property was described in Chapter 6. Eligible capital property includes goodwill as well as other intangible assets, such as franchises and licences, that do not have a limited legal life. It is important to note that although such properties are capital in nature, they are not usually subject to capital gains treatment for tax purposes. Gains or losses on the sale of eligible capital property are determined as described in Chapter 6 and are treated as business income or business losses.

In comparison, depreciable properties of a limited legal life (class 14), such as buildings, equipment, and franchises, are both depreciable property *and* capital property and, therefore, may have a capital element as well as a business element (see Chapter 6).

F. Principal Residence

A principal residence (which is specifically defined in the *Income Tax Act*) can generally be regarded as a housing unit owned, either directly or through a cooperative, by the taxpayer and ordinarily inhabited for personal use.[45] A principal residence is personal-use property, as previously defined; as such, it may be subject to a capital gain on sale, but it cannot realize a capital loss.

The capital gain realized on the sale of a principal residence is reduced by the following formula:[46]

$$\frac{1 + \text{Number of years designated as principal residence}}{\text{Number of years owned}} \times \text{Gain}$$

42 ITA 54 (disposition).
43 ITA 49(1) to (5).
44 IT-346R.
45 ITA 54; IT-120R6.
46 ITA 40(2)(b), 40(6).

If a taxpayer owns more than one personal residence—for example, a house as well as a summer cottage—only one can be designated for any particular year. Further, only one property can be designated for each family (husband and wife). It is clear from the above formula that if one residence is designated as the principal residence for each year of ownership, the reduction is equal to the full capital gain.

The "+ 1" is included in the formula to cover the year in which two houses are owned as a result of the normal process of selling one house and acquiring a new one.

It is easy to make the principal residence calculation when the individual owns a single residence. However, when more than one residence is owned, the problem of designation is complex because of the nature of the formula. The decision to designate a particular property is made at the time of sale, not when the property is acquired. This is demonstrated below.

Situation: A taxpayer acquired a house in 20X1 for $100,000. In 20X3, the same taxpayer acquired a vacation home for $50,000. In 20X5, both properties were sold: the house for $150,000 and the vacation home for $95,000.

Analysis:

Vacation home:	
Capital gain ($95,000 – $50,000)	$45,000
Exemption:	
$\frac{2+1}{3} \times \$45,000 =$	45,000
Net capital gain	–0–
House:	
Capital gain ($150,000 – $100,000)	$50,000
Exemption:	
$\frac{3+1}{5} \times \$50,000 =$	40,000
Net capital gain	$10,000
Taxable capital gain (½ × $10,000)	$ 5,000

In this example, the house realized a capital gain of $50,000 over five years, or $10,000 for each year of ownership. The vacation home had a capital gain of $45,000 over three years, or $15,000 for each year of ownership.

Because the exemption formula is based on both the period of ownership and the amount of the gain, the summer home will receive an exemption of $15,000 for each year designated, whereas the house exemption will be only $10,000 per year. Therefore, even though the total gain on the house is greater, it is better to emphasize the vacation home. Because of the "+ 1" in the formula, one only needs to designate the vacation home for two years in order to receive the full exemption. This, in turn, permits the house to be designated for three years.

It was mentioned previously that a deemed disposition occurs (at fair market value) when property that has a personal use is altered so that it has a business or investment use. This rule also applies when a principal residence is converted into a rental property. However, an individual can elect to have this rule not apply to a former principal residence for a maximum of four years.[47] This is particularly valuable when that individual rents the home and later resumes using it as a principal residence. In order to qualify for this exception, the owner cannot claim capital cost allowance on the property while it is being rented out.[48]

47 ITA 45(2), (3).
48 ITA 45(4).

Transactions relating to a principal residence are very common and affect a large number of taxpayers. It is unfortunate that the tax rules relating to such transactions are exceedingly complex. This area has been reviewed in a very superficial manner; the more detailed rules are significantly more complex and should be consulted if more than one residence is owned.[49]

G. Real Estate Used to Carry on a Business

Special treatment is provided for the recognition of capital gains on the disposition of real estate (land and buildings) that is used to conduct a business. In such cases, the recognition of the capital gain can be deferred, provided that replacement property is acquired in the same year the property is sold or within one taxation year of the year it is sold.[50] The replacement property must be used for a similar purpose as the original property. The capital gain that would normally have been recognized is used instead to reduce the adjusted cost base of the replacement property acquired; in this way, it is deferred until the replacement property is sold without being similarly replaced. Similar treatment is available for the recapture of capital cost allowance (see Chapter 6).

It should be noted that this exception does not apply to real estate that is used to earn property income from rentals. Nor does it apply to personal-use real estate.

A similar treatment applies to property that has been lost, stolen, destroyed, or expropriated and for which compensation has been received. In such cases, the capital gain can be deferred if replacement property is acquired within two years of the end of the taxation year in which the disposition occurred. The opportunity to defer the recognition of the capital gain is not restricted to business real estate. It also applies to rental properties as well as machinery and equipment.

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H. Mutual Funds

It is common for individuals to invest in mutual funds. When the investment is owned directly by the individual and not through an RRSP, there are a number of possible tax consequences. These are reviewed below.

An investor acquires units of a particular mutual fund at a specified cost. As the units are capital property, the purchase price represents the units' adjusted cost base for tax purposes. The money is pooled with that of other investors and is used to purchase a variety of publicly traded securities, such as shares, bonds, mortgages, treasury bills, and commercial paper. On a regular basis—usually quarterly—the mutual fund distributes its gains to the unit holders. For tax purposes, these distributions retain the source and characteristics of the income earned by the mutual fund—capital gains, dividends, interest, and ordinary income—and are included in each unit holder's income for tax purposes in the taxation year of the distribution. Often, investors choose to reinvest the distribution by acquiring additional units of the mutual fund. When they do, the distribution is still taxable to the unit holder as capital gains, dividends, interest, or ordinary income (as the case may be), and the total amount of the distribution is added to the adjusted cost base of the investment (see the discussion on identical properties on page 252).

A disposition for tax purposes occurs whenever all or some of the units are redeemed for cash or transferred to another mutual fund. The disposition will result in a capital gain or loss to the extent that the redemption price or transfer value varies from the adjusted cost base of the units at the time.

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49 IT-120R6.
50 ITA 44(1), (2); IT-259R4.

I. Eligible Small Business Investments

To improve access to capital for small business corporations, *individuals* who dispose of a small business investment can *defer* the recognition of a limited amount of the related capital gain if the proceeds from the sale are used to make other small business investments.[51] There are a number of qualifications that must be met to be eligible for the deferral. An important qualification is that the new investment be in newly issued *treasury* common shares of a replacement entity. Purchasing shares from an existing shareholder does not qualify for the deferral. This means that the replacement entity is strengthened by the receipt of additional capital resources that can be used to support its growth. The eligible capital gain is deferred until the new investment is eventually sold or the proceeds of its sale are again reinvested in another qualified replacement investment. The concept of the deferral is demonstrated in the following situation:

Situation: In 20X2, an individual sells her shares in Corporation X for $1,000,000. The shares are eligible small business investments having an adjusted cost base of $400,000. Within the qualifying time period, she reinvests $900,000 of the sale proceeds in Corporation Y treasury shares, which are new small business investments. In 20X5, she sells the shares of Corporation Y for $1,200,000.

Analysis: The sale of the Corporation X shares in 20X2 results in a capital gain of $600,000 ($1,000,000 – $400,000). However, because 90% of the proceeds from the sale of Corporation X ($900,000/$1,000,000 = 90%) are reinvested in Corporation Y (a qualified small business investment), she can defer only 90% of the capital gain. Her capital gain recognized in 20X2 is $60,000, as follows:

Capital gain from sale of Corporation X	$600,000
Less amount deferred – 90% × $600,000	(540,000)
Capital gain in 20X2	$ 60,000

The deferred portion of the capital gain ($540,000) reduces the adjusted cost base of the new investment in Corporation Y shares from $900,000 to $360,000 ($900,000 – $540,000). Therefore, when the shares of Corporation Y are sold in 20X5, a capital gain of $840,000 is recognized, as follows:

Proceeds of disposition	$1,200,000
Adjusted cost base	
($900,000 – $540,000 deferred from 20X2)	(360,000)
Capital gain in 20X5	$ 840,000

Note that the 20X5 capital gain of $840,000 includes the deferred gain from 20X2 of $540,000 plus the actual gain of $300,000 from the sale of the corporation Y shares ($1,200,000 – $900,000).

51 ITA 44.1.

Some further qualifications that must be met to be eligible for the deferral are outlined below.

- The deferral is available to individuals only.
- The deferral applies to the capital gains realized from the sale of shares in an eligible small business corporation. Normally, this refers to a Canadian-controlled private corporation with at least 90% of its assets used in active business carried on primarily in Canada. In addition, the corporation's total assets cannot be greater than $50 million immediately after the investment.[52] Corporations that do *not* qualify include professional corporations, specified financial institutions, corporations whose net real estate assets exceed 50% of their total asset value, and corporations whose principal business is the leasing, rental, development, or sale of real property.
- The replacement eligible investment must be purchased at any time during the year of sale of the former shares or 120 days after the end of the taxation year.[53]

V. The Aggregating Formula Revisited

Because the aggregating formula (described in Chapter 3) for determining a taxpayer's net income from all sources imposes special restrictions on capital losses, it would be useful to examine how the various items reviewed in this chapter relate to that formula.

Situation: A taxpayer, in addition to earning business income of $50,000, property income of $18,000, and other sources of income of $4,000, had the following capital transactions in the year:

Property	*Proceeds of disposition*	*Cost base and selling costs*	*Gain or (loss)*
Shares of company X	$60,000	$40,000	$20,000
Shares of company P	17,000	41,000	(24,000)
Art	8,000	6,000	2,000
Boat	9,000	12,000	(3,000)
Grand piano	11,000	10,000	1,000
Stamp collection	18,000	21,000	(3,000)
Shares of small business corporation	8,000	20,000	(12,000)

Analysis: This taxpayer sold property of all three general types—financial property, personal-use property, and listed personal property.

• **Listed personal property** The art incurred a capital gain of $2,000 and the stamp collection a loss of $3,000. Because losses from listed personal property can be offset only against gains from listed personal property, the net gain from this type of property is zero.

52 Applies to transactions after October 17, 2000. A different limit applied to transactions between February 28, 2000 and October 18, 2000.

53 Prior to February 19, 2003, there were restrictions of $2,000,000 for the cost of the shares sold and the amount reinvested.

- **Personal-use property** The loss on the boat is deemed to be zero. The piano had a gain of $1,000, of which $500 (½ of $1,000) is taxable.
- **Financial property** Shares of company X have a taxable capital gain of $10,000 (½ of $20,000).

  Shares of company P have an allowable capital loss of $12,000 (½ of $24,000).

  Shares of the small business corporation are a business investment loss, of which $6,000 (½ of $12,000) is allowable.

Aggregating formula:		
(a) Business income		$50,000
Property income		18,000
Other income		4,000
		72,000
(b) Taxable capital gains:		
Listed personal property	$ –0–	
Piano	500	
Shares of company X	10,000	
	10,500	
Allowable capital loss:		
Shares of company P	$(12,000)	–0–
		72,000
(c) Other deductions		–0–
		72,000
(d) Allowable business investment loss on shares of small business corporation		(6,000)
Net income for tax purposes		$66,000

Note that in part (b) of the formula the net effect of the capital gains and losses is zero, even though the capital losses exceed the capital gains. The excess net capital loss of $1,500 can be carried back three years and forward indefinitely when *taxable income* is computed, provided that sufficient capital gains are available. In addition, the unused listed personal property loss ($3,000 – $2,000 = $1,000 × ½ = $500) can be carried back three years and forward seven years and used in arriving at *net income*, provided that listed personal property gains are available.

Also, note that the allowable business investment loss on the shares of the small business corporation is included in part (d) of the formula and, as a result, is deducted from all other sources of income for the year.

As stated previously, it is important that when applying the normal rules for determining individual gains and losses on capital property, those rules be approached in the context of the aggregating formula. This way, that formula's effect on the tax payable for the particular year can be more readily understood.

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VI. Impact on Investment and Management Decisions

The influence of the tax treatment of capital properties on investment and management decisions centres on the fact that *preferential* treatment is given to capital gains, regarding the amount taxable and the timing of income recognition; whereas *restricted* treatment is given to the utilization of capital losses. Managers must build these fundamental variables into the decision process when forecasting the returns on alternative investment opportunities and also when considering the downside risk if a particular investment is not successful and results in a loss.

A. Return on Investment

The fact that only one-half of a capital gain is taxable at the time of disposition substantially increases the after-tax yield over other forms of investment returns. For example, for a taxpayer in a 45% tax bracket, a $100,000, 20-year investment in a property that will increase in value by 12% annually will provide $411,000 more in after-tax returns over the life of the investment than would an investment of the same amount in property yielding 12% in annual interest.

Capital growth:	
Gross value at end of 20 y:	
$100,000 + (12% × 20 y)	$965,000
Less tax payable in year 20:	
45% × (½) ($965,000 – $100,000)	195,000
Future value after tax	$770,000
Annual interest return:	
The 12% return is taxed annually at 45%, resulting in an after-tax yield of 6.6%. Future value of investment, after tax:	
$100,000 + (6.6% × 20 y)	$359,000
Difference in after-tax yield	$411,000

In most cases, achieving a return by capital growth involves greater risk (example—shares) or greater effort (example—real estate) than is the case with interest-bearing securities. However, one cannot properly assess the importance of additional risk or effort without examining the after-tax yield potential. In the above example, the after-tax returns are so substantial that the concept of risk takes on a different meaning.

The above example compared the decision to invest in property that yields a capital gain with the decision to invest in a venture yielding property income. The impact of tax on capital gains is also relevant when a decision is being made whether to sell one capital property and replace it with another. Because tax must be paid on the sale of the first property, there will be less after-tax value to invest in the second property.

Assume that a taxpayer in a 45% tax bracket owns investment A, which originally cost $10,000 but is now worth $100,000. The taxpayer is contemplating the sale of investment A in order to acquire investment B. If investment A were sold, a tax of $20,250 (45% × ½ [$100,000 – $10,000]) would be payable, leaving only $79,750 for reinvestment in investment B. When a sale of property A to acquire property B is being considered, this question must be asked: Is an investment of $79,750 in property B equivalent in value to the investment of $100,000 in property A? In order to justify acquiring property B, that property would have to be significantly more attractive in terms of its future potential than property A.

The above examples again emphasize the need to examine investment and asset-replacement decisions on an after-tax cash flow basis.

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B. Downside Risk

In addition to considering the tax impact of a given investment, it is important to consider the potential loss in the event that the investment must be sold at a loss. While it is difficult to assess the real risk of an investment, the investor should at least know the potential magnitude of the loss. The real loss is the after-tax loss; therefore, the amount of the loss and the timing of the loss utilization to reduce taxes payable are both vital considerations.

For example, an investment of $100,000 in a capital property by a taxpayer in a 45% tax bracket may incur a loss of only $77,500, calculated as follows:

Maximum loss	$100,000
Less tax saving on utilization of the loss:	
45% × (½) ($100,000)	(22,500)
Net loss after tax	$ 77,500

In this situation, an investment of $100,000 can result in a maximum cash loss of only $77,500; this knowledge may well alter the investor's attitude toward the risk. Unfortunately, in most cases, the ability to utilize capital losses is uncertain because such losses can be offset only against capital gains. This means that a taxpayer who is able to realize capital gains when capital losses occur is at less risk from an investment than an investor who cannot readily utilize the loss.

You will recall that the restrictions on the use of capital losses are relaxed for certain types of property. When this is the case, the downside risk of such an investment is reduced owing to the enhanced ability to generate tax savings through the utilization of losses if they occur. Consider a loan to, or an investment in shares of, a small business corporation. If a capital loss occurs on disposition, one-half of the loss is classified as an allowable business investment loss and can be offset against the investor's other sources of income such as business income, property income, and employment income. Note that a loss on a loan to the corporation is realized for tax purposes when it is established to be uncollectible, whereas a loss on the shares can be realized only when the corporation is legally bankrupt. Therefore, there is less downside risk if the investors in a small business corporation contribute capital to the company primarily by way of loans and less by way of share capital (see Chapter 12).

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VII. Tax Planning Checklist

The following tax planning opportunities were discussed briefly in this chapter:

1. When contemplating an investment opportunity, anticipate the potential tax treatment (capital gain versus business income, capital loss versus business investment loss, and so on). This way, the ultimate after-tax position can be assessed in relation to the risks associated with that investment.

2. Remember that achieving a return via a capital gain delays tax until the property is sold, and even then, only one-half of the gain is taxable. So, be sure to carefully compare investments that have capital growth potential with other types of investments on an after-tax basis, rather than on a pre-tax basis.

3. Review capital properties regularly throughout the year. Consider selling those that will result in a loss in order to offset capital gains that have occurred. As well, consider selling properties that have appreciated in value to trigger a capital gain that can utilize an existing unused loss.

4. When selling one property to obtain funds to acquire a new, higher-yield property, bear in mind that the tax on the sale of the first property will reduce the amount available for reinvestment and that the actual overall return on investment may thus be lower than it was previously.

5. When investing in private corporations, attempt to minimize investments in share capital and maximize shareholder loans. This may speed up any loss recognition if the company should fail or run into severe financial difficulty.

6. Whenever possible, take advantage of the available reserve for deferred proceeds on capital properties in order to delay the recognition of taxable income. Keep in mind that it may sometimes be better not to use the reserve if a tax advantage can be gained by recognizing income earlier (e.g., if current tax rates are lower than those expected in future years or if the taxpayer has accumulated losses). However, before accepting an agreement to defer proceeds on a sale, be sure there is sufficient cash available to meet the tax obligations as they come due.
7. Capital gain reserves are optional, which means that the reserve provisions constitute an opportunity to shift income from one time period to another within specified limits.
8. When selling a security for a loss, remember to consider the superficial loss rules if contemplating a reinvestment in that property.
9. When investing in Canadian securities, consider electing capital gains treatment on those and future properties. However, keep in mind that capital losses can be offset only against capital gains. A similar decision must be made when investing in commodity futures.
10. When replacing properties in order to defer the related capital gain, be aware of the time limits—one year for business real estate after a voluntary disposition and two years for assets destroyed, stolen, or expropriated. Eligible small business share replacements also have time limits.
11. When investing in shares of a private corporation, regularly review its dividend policy. When a corporation does not declare a dividend, the value of its shares increases and so does the potential capital gain. The greater the dividend a corporation declares, the lower are the share value and potential capital gain.

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VIII. Summary and Conclusion

Capital gains and losses occur when property that was acquired for the purpose of providing the owner with a long-term or enduring benefit is disposed of. It is the *intended purpose* of acquisition that establishes its capital nature, not the nature of the asset itself. The tax authorities, in an attempt to determine "purpose," examine the owner's course of conduct with the property over the period of ownership; this process may or may not substantiate the owner's claims regarding intended purpose. Owners should be aware of the subjective nature of the definition and look on this as part of the overall risk when making investment decisions.

In relation to the overall scheme of income determination for tax purposes, capital gains have preferential treatment because

(a) only one-half of the gain is taxable; and,
(b) the gain is included in income only when a disposition of the property occurs.

Because capital gains are given preferential treatment, capital losses are treated in a restrictive manner compared with other types of losses.

A capital gain or loss on a property is calculated as the difference between the proceeds of disposition and the sum of its adjusted cost base and selling expenses. This formula is simple but also limited. Note that no deductions are available for the costs associated with maintaining the property or financing its acquisition. If the property is of a financial nature and provides long-term benefits from business revenues,

interest, dividends, or rent, expenses associated with the property can be deducted against those sources of income. However, if the property is personal-use property, the related expenses are ignored for tax purposes.

The reader may be aware that individuals, but not corporations, are exempt from a certain amount of capital gains through the capital gain deduction. This deduction, which applies in limited situations for individuals, forms part of the calculation that converts net income for tax purposes to taxable income and will be discussed in Chapter 10.

The impact of capital gains and losses on decisions involving investment and—for businesses—capital expansion and replacement is tied to the special tax treatment afforded to capital property transactions. Investors and business managers faced with long-term investment decisions should recognize that these tax preferences are continually being debated in the political arena. There are those who argue that capital gains should not be taxable at all, especially if the proceeds of disposition are reinvested in capital expansion. (This concept already applies, in a limited manner, to real estate used to conduct an active business.) Others argue that it is unfair to tax only a portion of capital gains, which are earned by a small minority of taxpayers, when the great majority of low- and middle-income taxpayers, who are unable to invest in capital property, are fully taxable on their normal sources of income. Because investment in capital properties is a long-term process, decision makers must be cognizant of the debate and consider its possible outcome. Capital gains were not taxable at all before 1972. Beginning that year, 50% of capital gains were taxable. In 1990, this was increased to 75%. In 2000, the inclusion rate was reduced to 50%. What may it be in the future?

Visit the Canadian Income Taxation Web site at **www.mcgrawhill.ca/college/buckwold9** to view any updated tax information.

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Reading List

***Income Tax Act* References**

	Section
Income for taxation year (capital gains)	3(b)
Adjusted cost base	54
Capital property	54
Disposition of property	54
Listed personal property	54, 41(1) to (3)
Personal-use property	54, 46(1) to (3), 40(2)(g)
Principal residence	54, 40(6), 40(2)(b)
Proceeds of disposition	54
Superficial loss	54, 40(2)(g), 53(1)(f)
Election: disposition of Canadian securities	39(4) to (6)
General rules (calculation of capital gain)	40(1)(a)
Taxable capital gain	38(1)(a)
Allowable capital loss	38(1)(b)
Allowable business investment loss	38(1)(c), 39(1)(c)
Small business corporation	248(1)
Meaning of capital gain or loss	39(1)
Gifts	69(1)(b)
Property with more than one use	45(1) to (4)
Deemed disposition—ceased to be resident	128.1
Death of a taxpayer	70(5)
Negative adjusted cost base	40(3)
Assets owned in 1971	ITAR 26(3), (7)
Deemed cost of property received as gift	69(1)(c)

Deferred proceeds—reserve	40(1)(a)(iii)
Deferred proceeds—reserve (property to child)	40(1.1)
Arm's length	251(1)
Bad debts and shares of bankrupt corporations	50(1)
Identical properties	47(1), (2)
Convertible property	51(1), (2)
Options	49(1) to (4), 54
Exchanges of property	44(1), (2)

Canada Revenue Agency Publications

IT-459	Adventure or concern in the nature of trade
IT-218R	Profit, capital gains, and losses from the sale of real estate, including farmland and *conversion* of real estate from capital property to inventory and vice versa
IT-102R2	Conversion of property (other than real estate) for or to inventory
IT-479R	Transactions in securities
IT-95R	Foreign-exchange gains or losses
IT-236R4	Reserves—disposition of capital property
IT-259R4	Exchanges of property
IT-332R	Personal-use property
IT-84	Capital property owned at December 31, 1971—median rule
IT-139R	Capital property owned at December 31, 1971—fair market value
IT-484R2	Allowable business investment losses
IT-159R3	Capital debts established to be bad debts
IT-239R2	Deductibility of capital losses from guaranteeing loans
IT-387R2	Meaning of "identical properties"
IT-451R	Deemed disposition and acquisition on ceasing to be or becoming a Canadian resident
IT-346R	Commodity futures and certain commodities
IT-120R6	Principal residence
IT-264R	Part dispositions

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Major Court Decisions

California Copper Syndicate Ltd. v. Harris (1904), 5 DTC 159—Business income versus capital gain

Regina Shoppers Mall Ltd. v. The Queen, 89 DTC 5483—Establishing a taxpayer's intention

Regal Heights Ltd. v. MNR, 60 DTC 1270—Intention

Racine v. MNR, 65 DTC 5098—Secondary intention

Gairdner Securities v. MNR, 54 DTC 1015—Relationship of transaction to taxpayer's business

Demonstration Questions

QUESTION ONE

Teresa Sereti, a resident of Halifax, Nova Scotia, has requested your tax advice regarding a number of financial transactions that occurred in 20X5. Information relating to these transactions is outlined below.

1. In 20X0, Sereti purchased shares of Pluto Inc., a Canadian-controlled private corporation, for $20,000. After several years of financial problems, the corporation recently ceased operations and is insolvent. When operations ceased, all of Pluto's assets were being used in an active business.

2. In 20X3, Sereti purchased, for $30,000, a three-hectare parcel of land in a rural area. In 20X5, two of the three hectares were sold separately for $20,000 per hectare. She used the proceeds to construct a greenhouse on the remaining land. She will use the greenhouse to grow and sell vegetables in her spare time. Sereti could have acquired a one-hectare site in 20X3 but opted for the larger property in the hope that she could sell part of the property at an increased value and raise funds to help pay for the cost of constructing the greenhouse. Sereti paid property taxes of $500 per year on the three-hectare site.

3. Sereti's previous employer, Seaco Ltd., a public corporation, provided her with options to acquire shares. Information relating to these options is outlined below.

	1st option	*2nd option*
# of shares	1,000	1,000
Date option granted	May 20X1	June 20X2
Option price	$12.00	$13.00
Value at date granted	$12.40	$13.20
Date acquired by Sereti	September 20X3	July 20X4
Value at date acquired	$13	$16

   In December 20X5, Sereti sold 500 of the Seaco shares for $20 per share.

4. In 20X4, Sereti invented a board game and incurred $6,000 in legal fees to obtain a patent. She had intended to manufacture and market the game herself, but a feasibility study showed that she did not have the necessary financial resources or management expertise. As a result, she sold the patent and the distribution rights to a marketing company in 20X5 for $36,000 plus an annual royalty on sales. Her 20X5 royalty receipts totalled $12,000.

5. Sereti's mother had died several years ago and left her a house valued at $90,000 and a gold bracelet worth $600. Sereti's brother is using the house until it is sold.

   In 20X5, a land developer paid Sereti $6,000 for an option to purchase the house. As of December 31, 20X5, the option had not been exercised. Also, in 20X5, Sereti sold the gold bracelet for $2,000. Sereti's 20X4 tax return shows an unused listed personal property loss of $400 carried forward from the previous year.

6. Sereti sold the following other properties in 20X5:

1937 classic automobile	$25,000
Camper trailer	7,000
Shares of Tex Inc., a public corporation	6,000

Sereti purchased the classic automobile, which she drove only on warm summer days, in 20X0 for $8,000; restoration costs for it were $6,000. She had acquired the camper trailer in 20X1 for $16,000, and the Tex Inc. shares that same year for $60,000.

7. In 20X5, Sereti earned a salary of $85,000. She contributed $2,000 to her employer's registered pension plan and also made an allowable contribution of $7,000 to her RRSP.

Required:
Determine Sereti's net income for tax purposes for the 20X5 taxation year.

Solution:
Each transaction is discussed below before net income is calculated for tax purposes.

The shares of Pluto Inc. are deemed to have been sold for nil because the corporation has ceased to carry on business and is insolvent. The result is a capital loss of $20,000. The shares are qualified small business corporation shares because the company was a Canadian-controlled private corporation that used all of its assets in an active business. Consequently, the capital loss is also classified as an allowable business investment loss.

Part of the farmland was purchased with the intention of selling it at a profit; therefore, the profit is considered to be income from business. The property taxes on the two hectares of vacant land that were sold cannot be deducted from annual income, except to the extent of any incidental income earned on the property. The property taxes are, however, added to the cost of the land (see Chapter 5—interest and property taxes on vacant land).

When Sereti acquired the shares of Seaco Ltd. under the stock-option agreement, she earned employment income equal to the difference between the value of the shares at the date of acquisition and the purchase price. The recognition of the stock option employment benefit could not be deferred to the year when the shares were sold because the value of the shares was greater than the option price at the date the options were granted (see Chapter 4—stock options). The adjusted cost base (ACB) of the shares is increased by the amount of employment income, resulting in the ACB being equal to the shares' market value at the acquisition date. The two acquisitions in 20X3 and 20X4 are identical properties, and therefore the ACB is determined as the weighted average of the two purchases.

The patent on the board game is a capital property because it was developed with the intention of generating a long-term benefit. Its adjusted cost base is the cost of registering the patent.

The house is a capital property having an ACB of $90,000 (the market value at the time of her mother's death). It does not qualify as Sereti's principal residence because she does not occupy it. The receipt of the option results in a capital gain in the year of receipt. If the option is subsequently exercised, the capital gain will be the amount by which the selling price plus the option proceeds of $6,000 exceed the ACB of $90,000. The capital gain from the option received in 20X5 can then be eliminated by filing an amended tax return for that year. If the option expires, the capital gain of $6,000 in 20X5 stands.

The gold bracelet that Sereti received from her mother's estate is listed personal property (jewellery), or LPP. Its ACB would normally be $600, but as LPP, it has a deemed minimum ACB of $1,000. The unused LPP loss from her 20X4 tax return must have occurred because an LPP loss exceeded the LPP gain in a previous year. Unused LPP losses can be carried back three years and forward seven years, and can be deducted from LPP gains only. This carry-over is deducted in arriving at net income for tax purposes, unlike other types of losses (net capital losses and non-capital losses), which are deductible after net income for tax purposes in arriving at taxable income (see Chapter 10).

The classic automobile and the camper trailer are both personal-use properties. The ACB of the automobile is $14,000 (original cost of $8,000 plus the $6,000 for restoration). The camper trailer incurred a loss, but as personal-use property, the loss is deemed to be nil.

Re

Net income for tax purposes:		
(a) Employment income:		
Salary		$ 85,000
Registered pension plan		(2,000)
		83,000
Business income:		
Sale of farm land—proceeds	$ 40,000	
Less—cost (2/3 × $30,000)	(20,000)	
—property taxes on vacant land		
2/3 ($500 × 3 y)	(1,000)	19,000
Property income—royalties		12,000
		114,000
(b) Taxable capital gains:		
Seaco shares:		
Proceeds—500 × $20	10,000	
ACB 1,000 @ $13 = $13,000		
1,000 @ $16 = 16,000		
2,000 $29,000		
Average—$29,000 ÷ 2,000 = $14.50 × 500 shares	(7,250)	
	2,750	
Taxable—1/2 × $2,750	1,375	
Patent—1/2 ($36,000 – $6,000)	15,000	
Option—1/2 ($6,000)	3,000	
Classic automobile—1/2 ($25,000 – [$8,000 + $6,000])	5,500	
Camper trailer—loss deemed to be nil	–0–	
Net gain on LPP:		
Bracelet—1/2 ($2,000 – deemed cost of $1,000) – loss		
carry-over of 1/2 ($400)	300	
	25,175	
Allowable capital loss:		
Tex Inc.—1/2 ($6,000 – $60,000) = $27,000		
Limited to taxable capital gains	(25,175)	–0–
		114,000
(c) Other deduction:		
RRSP contribution		(7,000)
		107,000
(d) Loss:		
Pluto shares—allowable business investment loss		
1/2 ($20,000)		(10,000)
Net income for tax purposes		$ 97,000

QUESTION TWO

In 20X3, in anticipation of retirement, Philip Portnoy sold several properties. Information relating to these transactions is outlined below.

1. In 20X1, Portnoy purchased a recreational parcel of land for $20,000 near a mountain resort, with the intention of building a cottage for personal use. The cottage was never built because of Portnoy's declining health. The land was sold in 20X3 for $21,000. A commission of 10% of the selling price was paid to a real estate broker.

2. On November 30, 20X3, he sold all of his 1,000 shares of TR Ltd. (original cost—$21,000) for $18,000. He also sold a bond for $62,000 (including accrued interest of $200) that he

had purchased in January 20X3 for $64,000 (including $600 accrued interest). Prior to these sales, he had received bond interest of $2,800. On December 15, 20X3, on the advice of his broker, he purchased another 500 shares of TR Ltd. for $8,000.

3. In 20X0, Portnoy had sold shares of Hazel Ltd. (a Canadian-controlled private corporation) for $50,000, with the proceeds payable over several years. The original cost of the shares was $10,000. By the end of 20X3, $15,000 of the $50,000 selling price remained unpaid. Portnoy's 20X2 tax return shows that he claimed a capital gain reserve of $12,000.

4. On December 31, 20X3, Portnoy sold a rental property for $120,000 (land $50,000, building $70,000). He had acquired the property seven years earlier for $90,000 (land $10,000, building $80,000). At the end of the previous year, the building had an undepreciated capital cost of $58,000. A net rental loss of $6,000 was incurred in 20X3 after a deduction of $2,000 for amortization/depreciation. Portnoy intends to purchase a new rental property in early 20X4 for $300,000.

5. Portnoy bought and sold commodity futures in 20X3 and made a profit of $15,000. He first traded commodities in 20X2, incurring a loss of $23,000, which he fully deducted against his employment earnings for that year.

6. During 20X3, Portnoy sold shares of PC Ltd., a Canadian-controlled private corporation operating a small manufacturing business, for $30,000. He had acquired the shares in 20X0 for $40,000. He paid legal fees of $1,000 to draw up the sale agreement. At the time of the sale, PC Ltd.'s balance sheet had total assets of $600,000 (equal to their fair market value) as follows:

Current assets	$220,000
Manufacturing equipment	215,000
Government of Canada bonds	165,000
	$600,000

7. Portnoy's only other income in 20X3 was his salary of $80,000.

Required:
Calculate Portnoy's net income for tax purposes for the 20X3 taxation year. Also, what are the tax implications if Portnoy purchases a new rental property in 20X4?

Solution:
Each transaction is discussed before the net income is calculated for tax purposes.

The cottage property results in a capital loss of $1,100 (proceeds of $21,000 less the adjusted cost base of $20,000 and the selling commission of $2,100 [10% × $21,000]). However, for tax purposes, the property is classified as personal-use property, and the loss is deemed to be nil.

The sale of the TR Ltd. shares would normally result in a capital loss of $3,000 ($18,000 – $21,000). However, because 1,000 shares were sold on November 30, 20X3, and 500 shares were repurchased within 30 days on December 15, 20X3, a superficial loss results with respect to the 500 shares replaced. The allowable capital loss for 20X3 is, therefore, $750, calculated as follows:

Proceeds of disposition	$18,000
Adjusted cost base	(21,000)
	3,000
Deemed superficial loss:	
500 shares/1,000 shares × $3,000	(1,500)
Capital loss	$1,500
Allowable capital loss—½ ($1,500)	$ 750

Re

The superficial loss of $1,500 that was denied recognition in 20X3 is added to the adjusted cost base of the newly acquired shares, giving them a total adjusted cost base of $9,500 ($8,000 + $1,500). The loss will be recognized when the new shares are eventually sold.

The bond proceeds include accrued interest of $200, which must be included in property income. Similarly, the purchase price of the bond includes accrued interest of $600, which must be deducted from property income. The allowable capital loss on the bond is $800 (½ × [($62,000 – $200] – [$64,000 – $600)]). Property income from the bond is $2,400 ($2,800 plus the sale of accrued interest of $200 minus the purchase of accrued interest of $600).

The shares of Hazel Ltd. were sold in 20X0, resulting in a capital gain of $40,000 ($50,000 – $10,000). Because some of the proceeds are being paid over several years, Portnoy has been claiming a capital gain reserve and deferring the recognition of the gain. In 20X2, a reserve of $24,000 was claimed, and this amount must be included as a 20X3 gain, from which a new reserve can be deducted. As 20X3 is the fourth year from the date of sale, this year's reserve cannot exceed 20% of the gain (a minimum of 20% of the gain must be recognized each year, which means that 80% must be recognized by the end of 20X3). The taxable capital gain for 20X3 is $8,000, calculated as follows:

Inclusion of 20X2 reserve	$24,000
Less 20X3 reserve—lesser of:	
⅕(20%) × $40,000 = $8,000	
$15,000/$50,000 × $40,000 = $12,000	(8,000)
Capital gain	$16,000
Taxable capital gain (½ × $16,000)	$ 8,000

The rental property income of $8,000 is calculated as follows:

Net rental loss	$(6,000)
Amortization/depreciation not deductible	2,000
Recapture of capital cost allowance on the building ($70,000 – $58,000)	12,000
	$ 8,000

The disposition of land results in a taxable capital gain of $20,000 (½ × [$50,000 – $10,000]). Note that there is no capital loss on the building, even though it was sold for $70,000, which is less than its original cost of $80,000. This loss of $10,000 has been fully deducted as capital cost allowance in prior years. The undepreciated capital cost of the building at the end of 20X2 was $58,000, indicating that $22,000 of capital cost allowance had been deducted to that time. The sale for $70,000 resulted in income from the recapture of capital cost allowance of $12,000 ($70,000 – $58,000); this left a net deduction over the years of $10,000 ($22,000 – $12,000).

The gain of $15,000 from the trading of commodity futures appears to be business income. In the previous year, a loss of $23,000 was fully deducted against employment income, indicating that a choice was made not to treat the transaction as a capital item. Therefore, Portnoy's tax treatment for the 20X3 transaction must be treated in the same manner.

The sale of shares of PC Ltd. results in an allowable capital loss of $5,500 (½ × [$30,000 – $40,000 – 1,000]). The shares are not qualified small business corporation shares because all or substantially all of the corporation's assets at the time of the sale were not used in an active business. The corporation does carry on an active business, but 28% of its assets ($165,000/$600,000) are invested in bonds. Therefore, the loss cannot be classified as an allowable business investment loss. Here, it is of no consequence because there are sufficient taxable capital gains from which the capital loss can be deducted.

Net income for tax purposes:		
(a) Employment income—salary		$ 80,000
Business income—commodity trading		15,000
Property income:		
Net rentals	8,000	
Interest on bond	2,400	10,400
		105,400
(b) Taxable capital gains:		
Rental property land	20,000	
Shares of Hazel Ltd.	8,000	
	28,000	
Allowable capital losses:		
Shares of TR Ltd.	(750)	
Bond	(800)	
Shares of PC Ltd.	(5,500)	20,950
Net income for tax purposes		$126,350

The purchase of a new rental property in 20X4 will have no tax effect on Portnoy's 20X3 income. If the land and building sold in 20X3 had been used for business purposes, rather than to earn income from property, the capital gain and recapture of capital cost allowance realized in 20X3 could have been deferred if a replacement property had been acquired within one taxation year from the end of the 20X3 taxation year.

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Review Questions

1. A capital gain or capital loss is the gain or loss realized from the disposition of capital property. What is meant by the term "capital property," and how is it different from other types of property?
2. Is it necessary for property to provide a long-term benefit to its owners in order for the gain or loss on sale to be considered a capital gain or capital loss?
3. When it is unclear whether a gain or loss on a sale of property is of a capital nature, what factors are considered when judging the transaction?
4. An investor acquired a residential high-rise apartment as an investment. The property has now been owned for 11 years and annually has provided reasonable net rental income. This net rental income has been reinvested in other types of properties as well as in improvements to the apartment building. The owner is considering either selling the property to another investor or dividing the property into separate condominium units that will be marketed to existing tenants and to the public. Explain how a gain on sale will be treated for tax purposes under each alternative.
5. Distinguish among financial property, personal-use property, and listed personal property. Which of these three categories is (are) subject to capital gains treatment?
6. Distinguish between a capital gain and a taxable capital gain and between a capital loss and an allowable capital loss.
7. Explain why the tax treatment of capital gains is often described as preferential, while the treatment of capital losses is often considered unfair.
8. "A capital gain or loss can be recognized for tax purposes only when capital property is sold." Is this statement true? Explain.

9. A corporation acquires a licence that permits it to manufacture a patented product for 10 years in exchange for the payment of a royalty. Describe the tax treatment that will occur if the taxpayer sells the licence for more than its cost or less than its cost to another party before the 10-year term expires. Would the tax treatment be the same if the licence had an unlimited life?
10. What advantage can a taxpayer achieve by incurring a capital gain on property and permitting the purchaser to pay for the property over a number of years?
11. Because of the tax treatment, an investment in shares of a small business corporation may present less risk than an investment in shares of a public corporation. Explain why.
12. What difference does it make when the sole shareholder of a corporation provides $10,000 of additional capital to the corporation as a loan (shareholder's loan), rather than in return for additional share capital?
13. "The sale of a warehouse building used by a taxpayer to operate a business can result in a capital gain but not a capital loss." Is this statement true? Explain.
14. Explain how the tax treatment of personal-use property deviates from the normal tax treatment of capital property.
15. When an investor buys some shares of a corporation at one price and later buys more shares of the same corporation at another price, how does the investor determine the cost for tax purposes when some, but not all, of the shares are eventually sold?
16. When an investor acquires a commodity or a contract to purchase a commodity in the future, what type of property does that investor own? Can a gain or loss on the sale of commodities or futures contracts result in a capital gain or loss?
17. An investment in capital property that appreciates in value at 10% per year is more valuable than an investment in capital property that provides an annual return, such as interest, of 10%. Explain why.

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Problems

PROBLEM ONE

Jennifer Farmer farmed for 36 years. She has recently sold her farm assets. Her primary crop was asparagus, and 20 of Jennifer's 25 hectares of land were devoted to growing this vegetable.

The land had cost her $10,000 in 1967. She has sold it for an all-inclusive price of $175,000 that includes an unharvested asparagus crop that is 70% mature.

Asparagus is a perennial plant consisting of a strong root stock which, when planted, remains in the soil for many years and requires little annual maintenance. Every year, the root stock provides two or three asparagus crops, which are harvested at little cost and sold directly to a food wholesaler.

The sale agreement for $175,000 included a cash down payment of $35,000 and a first mortgage of $140,000 held by Farmer. The mortgage is to be paid in seven annual instalments of $20,000. Interest of 12% will be charged on the unpaid balance.

Farmer has sought your advice concerning the tax implications of the sale.

Required:

1. Describe to Farmer how the preceding transaction will be treated for tax purposes.
2. What additional information will you require to determine the actual amount of income for tax purposes created by the transaction?

PROBLEM TWO

Murray George is a professional musician and composer. For 15 years, he has made a good living from this profession. He derives his income from concert appearances (for substantial fees) and from royalties on original musical compositions.

As of 20X0, George has been internationally famous in the classical music field. In 20X1, the Canadian National Music Library agreed to purchase a number of documents from him. These documents included

(a) 26 of George's original manuscripts, written in his own hand;
(b) a box containing 15 of his youthful works, including first drafts and final versions; and,
(c) a copy of George's personal diary, to be exhibited to the public only after his death.

For these items, he received $50,000, to be paid in the amount of $30,000 in 20X1 and $20,000 in 20X2. Over the years, the compositions (other than his youthful works) had generated income from royalties, which George had declared as professional income for tax purposes.

The Canadian National Music Library is not a commercial enterprise. It is a registered charitable foundation.

Before filing his 20X1 tax return, George obtained the CRA's advice on how the receipt of $50,000 should be handled. Their response was that the $50,000 clearly represents business revenue and should be added to his professional earnings in 20X1.

Required:
State whether you agree or disagree with the CRA's advice, and provide reasons for and against your position.

PROBLEM THREE*

R.M. Inc. (RMI) manufactures earth-moving and excavation equipment. RMI is owned and managed by Ross Meister.

It is now February 15, 20X2. Meister has asked you to help the company deal with a tax problem. The CRA is questioning the capital gains treatment of a 20X1 sale of land by RMI; it believes that the full amount of the gain should have been included in income. Meister wants to know what arguments the CRA will likely present and how RMI can counter them. Also, he wants to know what the tax consequences will be if the CRA succeeds in making an adjustment. Details of the land transaction are offered below.

RMI purchased 50 hectares of vacant land in an industrial park on December 2, 20X0, for $1.35 million. The purchase was financed, in part, by a five-year first mortgage of $500,000 with interest at 12%. At first, Meister intended to move RMI from its current location to the new location just north of Toronto. He knew that even if he decided later not to move from his current premises, he had purchased the land at a bargain price and would be able to make a profit if he sold it.

On April 1, 20X1, RMI accepted an offer of $3.68 million for 40 hectares of the vacant land. RMI took back a $685,000 first mortgage, repayable at $30,000 per year, with the balance due in 20X6. In RMI's 20X1 corporate tax return, the land disposition was recorded as a capital gain. The remaining 10 hectares of land were retained by RMI. Meister decided to build RMI's new warehouse on the 10-hectare site. RMI will retain its current location as a garage for storing and servicing construction equipment.

RMI is subject to a 45% tax rate on all of its income.

Required:
Prepare a brief report that answers Meister's questions.

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PROBLEM FOUR

In 20X0, Kiranjit Dhillon acquired 1,000 shares of Pluton Ltd. (a Canadian public corporation) at a cost of $21,000 plus a brokerage commission of $600. During 20X0, she received cash dividends of $1,200. In 20X1, Pluton failed to pay the cash dividend owing to a cash-flow shortage; instead, it issued a stock dividend, whereby Dhillon received an additional 100 shares. At the time of the stock dividend, the share value was $18 per share.

On December 15, 20X1, with the company's financial position continuing to decline, Dhillon sold all of her shares of Pluton for $15,000. She felt relieved when the share values declined further over the next two weeks. She incurred brokerage fees of $300 on the sale.

Early in the new year, Pluton apparently solved its financial crisis by selling an unprofitable subsidiary. Dhillon's broker recommended that she again invest in Pluton's shares. On January 11, 20X2, she purchased 1,000 shares at a cost of $12,000 plus brokerage fees of $200.

In June 20X2, she gifted all of her shares in Pluton to her son, who was about to attend university. At that time, the shares were valued at $20,000.

Required:
Calculate the amount by which Dhillon's net income for tax purposes will be affected by the above transactions for the years 20X1 and 20X2.

PROBLEM FIVE

For the year ended August 31, 20X0, Zefer Ltd., a Canadian-controlled private corporation, reported a net income before income taxes of $485,000. The statement of income is summarized as follows:

Income from operations	$380,000
Other income:	
Interest	5,000
Net gain on sale of assets	100,000
	$485,000

The net gain on the sale of assets consists of the following amounts:

• **Gain on sale of franchise—$40,000** The franchise to operate a retail store was acquired seven years previously at a cost of $110,000. It was sold in 20X0 for $140,000. The sale proceeds included a cash down payment of $20,000, with the balance payable in seven annual instalments of $20,000 plus interest beginning in 20X1. The franchise, which qualified as a class 14 asset, had an undepreciated capital cost of $92,000 at the time of the sale and was the only asset in its class.

• **Gain on sale of warehouse property—$80,000** In July 20X0, a warehouse property was sold for cash proceeds of $430,000 (land $180,000, building $250,000). The property had an original cost of $370,000 (land $60,000, building $310,000). The building, which was the only asset in class 1, had an undepreciated capital cost of $290,000. After the sale of the warehouse, temporary premises were leased until a new, larger warehouse was constructed. New land was purchased in January 20X1 for $200,000. Construction of the new warehouse would be completed by July 20X1.

• **Loss on sale of shares of subsidiary—$20,000** Zefer sold shares of a subsidiary corporation for cash proceeds of $450,000. The shares were acquired five years ago for $470,000. Legal fees of $2,000 were paid to draw up the sale agreement and were charged to the legal expense account.

Required:

1. Calculate Zefer's net income for tax purposes for the 20X0 taxation year.
2. What are the tax implications relating to the construction of the new warehouse in 20X1?

PROBLEM SIX

Charles Bartello intends to leave Canada and start a new life in southern Florida. Before leaving, he intends to dispose of all his property so that he will have sufficient capital to acquire a business in the United States.

Bartello has provided the following information:

1. He currently owns 40% of the shares of a Canadian small business corporation, which are valued at $70,000. The shares were purchased four years ago for $100,000. Bartello is employed by the corporation and anticipates that his salary up to the date of departure will be $75,000.
2. At the beginning of the current year, he purchased a rental property as an investment. To date, the property has provided rental revenue of $14,000; however, Bartello has incurred cash expenses for property taxes, maintenance, interest, and insurance of $17,000. At the same time, the property has appreciated in value by $12,000. When he purchased the property, Bartello was not yet thinking of leaving Canada.
3. Three years ago, Bartello loaned $10,000 to a small business corporation owned by a friend. The business has suffered serious losses, and he has little hope of being repaid. In addition, no interest has been paid on the loan, although in the past two years Bartello has included interest in income for tax purposes on the anniversary dates. The total interest included is $2,000.
4. His home is worth $180,000 (original cost, $150,000.) He has owned the home for eight years and has lived in it all that time.
5. Bartello owns the following additional properties:

	Cost	*Value*
Motorboat	$ 14,000	$ 10,000
Furniture	21,000	6,000
Shares of public corporation X	10,000	14,000
Shares of public corporation Y	50,000	15,000
Corporate bond	100,000	102,000
Art collection	15,000	17,000
Stamp collection	20,000	16,000
Grand piano	10,000	14,000

Required:
Determine Bartello's net income for tax purposes for the year in which he leaves Canada.

PROBLEM SEVEN

The following financial information is provided for the 20X0 taxation year of Virginia Couture:

Interest income	$20,000
Net loss from retail store for the year ended December 31, 20X0	(7,000)
Gain on sale of public corporation shares	8,000
Loss on sale of shares of a CCPC qualified as a small business corporation	(10,000)
Dividends from foreign corporations, net of $300 withholding tax	2,700
Loss on sale of land that was originally purchased to build a rental property. The project was cancelled after a rezoning application was lost.	(38,000)
Gain on sale of an oil painting	4,000
Director's fees for attendance at corporate meetings	6,000
Loss on sale of personal jewellery	(5,000)

In 20X0, Couture gifted shares of a Canadian-controlled public corporation (CCPC) to her 16-year-old son. The shares, which originally cost $8,000, had a value of $10,000 at the time of the gift.

Also, in 20X0, Couture had a rental loss of $3,000 (before amortization/depreciation and capital cost allowance). The property was originally purchased for $70,000 (land $9,000, building $61,000). The class 1 building had an unamortized capital cost of $50,000 at the end of the previous year. On the last day of 20X0, Couture sold the property for $100,000 (land $12,000, building $88,000). She intends to purchase a new rental property in early 20X1 for $200,000 (land $20,000, building $180,000).

In the previous year, by agreement, Couture obtained the exclusive licence to distribute a certain product in Canada. In 20X0, she divided the country into six sales territories and sold 10-year sub-licences to individuals in each territory. Total proceeds were $24,000.

Required:

1. Calculate Couture's income for tax purposes for the 20X0 taxation year in accordance with the aggregating formula of section 3 of the *Income Tax Act*.
2. What are the tax implications if Couture acquires the new rental property in 20X1?

PROBLEM EIGHT

Cindy Tse retired in April 20X9 and moved from Thunder Bay to Vancouver Island. During her retirement she plans to accept the occasional small consulting contract. Her financial transactions for 20X9 are summarized below.

1. Tse sold her home in Thunder Bay for $240,000. She paid a real estate commission of $8,000 and legal fees of $2,000 to complete the sale. Tse had purchased the home in 20X3 for $110,000.

   In 20X6, she purchased a summer cottage for $74,000. She sold it in 20X9 for $175,000. She paid a legal fee of $1,000 to draw up the sale agreement. Tse had used the summer cottage regularly for summer vacations.

2. Tse's gross salary from January 1, 20X9, to her date of retirement was $30,000.

3. Three years ago, Tse purchased 20% of the shares of T Ltd. and 15% of the shares of Q Ltd. Both are Canadian-controlled private corporations. T's assets consist entirely of investment properties, including shares, bonds, and rental properties. All of Q's assets are used to operate an active business. Tse sold her shares in both corporations in 20X9. Details of the transactions are outlined below.

	T Ltd.	*Q Ltd.*
Cost	$30,000	$40,000
Selling price	63,000	28,000

Tse received $9,000 in cash for the T Ltd. shares, with the balance payable at the rate of $9,000 annually for the next six years. The Q Ltd. shares were sold for cash.

4. A local farmer has been trying to purchase Tse's hobby farm land. Tse purchased the land in 20X2 for $69,000. In July 20X9, Tse received $2,000 from the farmer, for which she granted him an option to purchase the land. The option is open for two years and allows the farmer to purchase the land for $100,000.

5. In February 20X9, Tse paid an investment counsellor $300 for investment advice. The same month, she purchased 5,000 units of ABC mutual fund for $10 per unit. An additional 3,000 units were purchased in April 20X9, at $14 per unit. On October 31, 20X9, ABC fund distributed $1,500 of taxable Canadian dividends, which Tse reinvested in the fund, thereby acquiring another 100 units. On December 3, 20X9, Tse sold 2,000 units of ABC at $16 per unit. At year end, the fund units were valued at $18.

6. To obtain the funds to complete the purchase of the ABC mutual fund units, Tse increased the mortgage on her house by $20,000. She incurred interest of $500 on this amount before paying off the mortgage when the house was sold.

7. In 20X8, Tse invested in a real estate project with her friend, a real estate agent and part-time developer. Together, they purchased a parcel of land and constructed four town homes at a cost of $500,000. In 20X9, the four town homes were sold for $580,000 to a single buyer, who planned to use them as rental properties. Tse's share of the gain was 40%. No cash was invested in the project, which had been funded entirely with bank financing.

8. Tse sold shares of X Ltd. (a public corporation) for $18,000 during the year. She had acquired the shares in 20X4 for $25,000.

9. Most of Tse's investments have been in blue-chip shares that pay dividends. Recently, she has decided to invest and trade in speculative Canadian mining shares and commodity futures. Before she does so, she wants to know the tax implications of gains and losses on such trading.

Required:

1. Calculate Tse's minimum net income for tax purposes for the 20X9 taxation year in accordance with the aggregating formula of section 3 of the *Income Tax Act*.
2. Explain to Tse the potential tax consequences of gains and losses realized on trading speculative Canadian mining shares and commodity futures.
3. What will be the tax consequences to Tse if the option on the farmland is exercised the following taxation year?

PROBLEM NINE

Sheila Ram is a professional engineer. In 20X7, she sold her consulting business and retired. Her financial information for the year 20X7 is outlined below.

1. On January 1, 20X7, Ram sold her engineering consulting business to a senior employee. The business had been operated as a franchised proprietorship with a December 31 fiscal year end. The following assets were sold:

	Original cost	*Price*
Goodwill	38,000	40,000
Franchise	40,000	50,000
Library	2,000	1,000
Office equipment	12,000	4,000

The sale agreement called for cash proceeds for all assets, except the franchise, which required a down payment of $20,000 at closing, with the balance payable on June 30, 20X8.

The accounts receivable of $90,000 were not sold but were retained by Ram for collection. During 20X7, Ram collected $82,000 of the receivables. The remainder is uncollectible.

On August 15, 20X7, Ram paid $4,000 to a former employee for a bonus awarded on December 31, 20X6.

A review of Ram's 20X6 income tax return showed the following:

Undepreciated capital cost:	
Class 8	$ 6,800
Class 14	24,000
Cumulative eligible capital	20,460
Reserve for bad debts	10,000
Unused listed personal property loss	800

2. In January 20X7, Ram sold her home for $230,000. She had acquired the house in 20X0 for $200,000. In May 20X7, she sold her Ontario vacation home, which she had acquired in 20X3 for $50,000, for $140,000. She also sold an oil painting for $1,400 that originally had cost $600.

3. Also, in 20X7, she received $30,000 from the sale of her 10% interest in Q Ltd., a Canadian-controlled private corporation. She had purchased the shares in 20X0 for $50,000. Q operates a small manufacturing business, and at the time of sale, its assets were appraised as follows:

Working capital	$200,000
Manufacturing assets	300,000
Goodwill	100,000
Government bonds (three-year term)	200,000

4. In 20X7, Ram withdrew $45,000 from her RRSP.

Required:
Determine Ram's net income for tax purposes for the 20X7 taxation year.

PROBLEM TEN

Simon Shansky is about to sell his shares in a private corporation for $100,000. He has owned the shares for many years, having originally acquired them at a cost of $20,000. Shansky intends to invest the proceeds from the sale in interest-bearing securities yielding 10%.

Two potential purchasers have made offers on the shares. One purchaser has offered to pay the full purchase price in cash. The other has offered to pay $40,000 at the date of sale and the balance of $60,000 in three annual instalments of $20,000, plus interest of 10% on the unpaid balance. The unpaid balance would be secured with adequate collateral. Shansky is subject to a 45% tax rate.

Required:

1. Which option should Shansky accept?
2. Calculate the amount of funds that Shansky will have after three years under each option.
3. What rate of return would have to be earned on the invested proceeds of sale under the full cash payment option to provide the same capital value as under the deferred payment option after three years?
4. Indicate, without providing detailed calculations, whether your answer to question 2 would be different if Shansky were selling a building for $100,000 that originally cost $80,000 and had an unamortized capital cost of $35,000.

PROBLEM ELEVEN

Jordana Lea has accumulated a substantial portfolio of investments in bonds and shares of public corporations. She selects shares that provide low dividends and maximum long-term growth but is risk averse and will purchase only shares of corporations in secure industries. Currently, all of her investments are achieving capital growth but her investment in shares of Cory Corporation is providing the lowest yield. This year, her share value in Cory increased to $50,000, a 10% increase (i.e., from $45,000) over the previous year. Cory has consistently maintained this growth rate. The shares were purchased several years ago at a cost of $20,000.

Lea's investment counsellor has recommended that she sell her shares in Cory and use the proceeds to purchase shares in J2 Industries Ltd. J2 is in the same industry as Cory but has recently achieved industry dominance. There is strong evidence that the shares of J2 will maintain a growth rate of 13% annually for the next five years.

Lea has high earnings from her annual salary, and her marginal tax rate is 45%.

Required:

1. Should Lea dispose of the Cory shares and use the proceeds to acquire the J2 shares?
2. What rate of return on the J2 shares is required to justify the exchange of securities?

PROBLEM TWELVE

Sharon Sutherland owned a home in Toronto, Ontario, a ski chalet in Whistler, BC, and a condominium in Florida, USA until June 15, 20X6 when she sold all three properties and moved into a seniors' residence. She provided the following information with respect to the properties:

Property	*Year Acquired*	*Cost*	*Selling Price (net of commission and other selling costs)*
Home	20X1	$400,000	$460,000
Condo	20X2	$200,000	$245,000
Chalet	20X4	$300,000	$336,000

For the years that Sharon owned each property, she ordinarily inhabited it at some time in the year. She tended to spend the winter in Florida, the summer in Toronto, and the fall in Whistler.

Required:

1. Determine the minimum taxable capital gain to be reported by Sharon on the sale of the three properties.
2. How would the answer change if Sharon had moved out of the Toronto home in 20X3 when it was worth $410,000 and earned rental income from the Toronto home from that date until she sold it in 20X6?

Cases

CASE ONE The Concorde Theatre Ltd.

The Concorde Theatre Ltd., a local company owned by J. Bleet, operates a small neighbourhood cinema. The business is usually profitable, but this year, because of unusual events, a net loss has occurred. The income statement for the year ended December 31, 20X1, is summarized in the table below.

The company does not usually invest in real estate. The land and building that was sold for a gain of $70,000 was acquired seven months before its sale. An acquaintance of Bleet who ran into some serious financial difficulties required immediate cash to stop bankruptcy proceedings and asked Bleet to purchase his real estate. Bleet had no money to invest in real estate and was not in the market for such an investment. However, the acquaintance pleaded with Bleet to help him out and kept reducing the purchase price to provoke an immediate cash sale.

Bleet, watching the price drop to below what he felt was the fair market value, finally gave in. Concorde Theatre borrowed 100% of the purchase price and bought the property. The loan from the bank was payable on demand.

Sales	$ 600,000
Cost of sales	400,000
Gross profit	200,000
Operating expenses	170,000
Operating income	30,000
Other:	
Gain on sale of land and building	70,000
Loss on sale of land	(110,000)
Net loss	$ (10,000)

Four months later, the company received an offer from a local real estate investor to buy the property for $65,000 above the original purchase price. The same day, the original owner, who had improved his financial situation, asked if he could buy the property back. He was upset when Bleet agreed only if the price was $70,000 above the original price. Reluctantly, the acquaintance agreed to pay that much, provided that the closing date was delayed to three months hence.

The land, the sale of which resulted in a $110,000 loss, had been purchased three years earlier. The land was across the road from the theatre, and Bleet had intended to turn it into a parking lot for theatre patrons. However, because of the traffic patterns on the street, the city refused to grant vehicle access for the property. After a long battle, Bleet gave up and posted the land for sale. After six months without an offer, he finally accepted a reduced price to free up needed cash.

Bleet has just met with his accountant, who has informed him that the company will have to pay income tax of $45,000 for the year ended December 31, 20X1. Bleet knows that the corporate tax rate is 45% on income but cannot believe that a tax of $45,000 is payable on a net loss of $10,000.

Bleet asks his accountant to explain how such a result is possible and asks whether there is any possibility of a more logical result.

Required:
As the accountant, outline your response to Bleet.

CASE TWO Pan Li Ltd.

Pan Li Ltd. is a Canadian private corporation owned 100% by David Benjamin. The corporation operates an active business. Its most recent statement of financial position is summarized in the table below.

PAN LI LTD.
Statement of Financial Position

Assets:		
Current assets		$ 100,000
Land		50,000
Building	400,000	
Equipment	700,000	
	1,100,000	
Accumulated depreciation	(400,000)	700,000
Goodwill, at cost		200,000
		$1,050,000
Liabilities and shareholders' equity:		
Liabilities		$ 600,000
Common shares	20,000	
Retained earnings	430,000	450,000
		$1,050,000

Benjamin purchased the shares of Pan Li seven years ago from the previous shareholders at a cost of $100,000. He is considering retirement and has let it be known that the business is for sale. Recently, he received an offer of $700,000 for the shares of the corporation.

A second potential group of buyers has indicated that it would like to buy the business but does not want to buy the shares of the corporation. Instead, it wants to purchase the individual assets (current assets, land, building, equipment, and goodwill). Benjamin knows that certain of the corporate assets are worth more than their stated value on the financial statement and has asked his advisor to provide an appraisal. If he sold to the asset-buying group, the buyers would assume the corporation's liabilities of $600,000 as part of the purchase price.

Both potential buyers have indicated that they have sufficient cash resources to pay only 70% of the purchase price and that the remaining 30% will have to be paid over three years, with appropriate interest.

Benjamin does not understand the tax implications of selling the shares, rather than the assets. Once the business is sold, he intends to use the funds to buy investments that will provide an annual return to supplement his retirement income.

Required:

1. Keeping in mind Benjamin's objectives, explain to him the general tax implications of selling the shares of Pan Li, rather than the company's individual assets.
2. What difference does it make to the purchasers whether they acquire the shares from Benjamin or the individual assets from Pan Li?