

## 1 Lecture 4: Income from Property, Capital gains and Capital Losses

### 1.1 Topics Covered

- This week's lecture looks at the basics of how investments are taxed, i.e. the taxation of interest, dividend and rental income (earned while the investment is held) and the taxation of capital gains and losses (generally earned/realized when an investment is sold)
  - CTP ch. 7 covers property income and expenses, i.e. how dividend income, interest income, rental income and other types of property income are taxed and the expenses that can be deducted against this income
  - CTP ch. 8 covers capital gains and losses, i.e. how the gain on the sale of an investment (including your home) is taxed during your lifetime
  - As before, urls to background materials are included for those who are interested in additional information

### 1.2 Designated problems

- Exercises 7-3, 7-5 to 7-10, self-study problem 7-4
- Exercises 8-1 to 8-3, 8-8 to 8-10 and 8-12

## 2 Property Income [7-2 to 7-5]

- passive income from investments (investment income)
- most interest, dividends, rental income (minus expenses) and some royalties
- In some cases, a corporation's activity of earning property income can be considered an active business, e.g. a corporation earning investment income because of the number of employees (more than 5 full-time employees throughout the year). Discussed further in ADMS 4562
- Most of the rules in subdivision b of Division B of Part I of the ITA apply to both income from business and property

### 2.1 A few significant differences between business and property income:

- You cannot create or increase a property loss on a rental property with CCA
  - For a background note on CCA, see relevant folio at <https://www.canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index/series-3-property-investments-savings-plans/series-3-property-investments-savings-plans-folio-4-capital-cost-allowance/income-tax-folio-s3-f4-c1-general-discussion-capital-cost-allowance.html>
- You cannot deduct travel expenses and convention expenses against property income (only business income)
- Attribution rules apply to property income (and capital gains, in the case of spousal loans and transfers) but not business income
- You cannot deduct home office expenses against property income according to the case law

## 2.2 Interest Expense [7-6 to 7-18]

- The general rule allowing the deduction of interest expense is ITA 20(1)(c). The conditions are as follows:
  - The interest expense must
    - be pursuant to a legal obligation, e.g. a signed agreement
    - meet a purpose test = to produce income from business or property (not capital gains)
    - relate to funds directly used for that income-earning activity

### 2.2.1 Deemed Interest Expense [ITA 80.5]

- The deemed interest benefit on employee loans is deemed to be interest paid for purposes of ITA 20(1)(c) and 8(1)(j)

#### 2.2.1.1 Examples

- The imputed interest benefit on a loan made to an employee to buy company shares is typically deductible (since the shares (can) earn dividend, i.e., property, income)
  - The interest benefit is reported as employment income. The interest (deemed paid) can be deducted as an investment expense under ITA 20(1)(c)
- The imputed interest benefit on a loan to buy a car for employment use is typically partially deductible
  - All of the interest benefit is reported 100% as employment income. The interest (deemed paid) can be deducted partially (i.e., the % used for employment purposes) as employment expense under s. 8(1)(j)

### 2.2.2 Frequently asked questions

- Is home mortgage interest deductible?
  - Home mortgage interest may be deductible if the funds from the mortgage are used directly to earn income from business or property
    - The term “mortgage” means that real estate = collateral for the loan. Funds from most home mortgages are used to buy a house to live in
    - But if part of the house is rented or used for a business, then a portion of the interest may be tax deductible
    - Alternatively if the house is purchased with cash (or the mortgage is paid off) and the house is re-mortgaged and the cash from the bank loan is invested directly to produce income from a business (see Singleton and Ludco cases at 7-19 to 7-22) or property (mutual funds, shares), the interest will be deductible
- Is interest on money borrowed to buy investments deductible?
  - The interest may be deductible if the funds are used directly to earn income from business or property

### 2.2.3 Examples of deductible interest expense, i.e., cases where the money is used to buy:

- Common shares
  - because of the potential to pay unlimited dividends
- Real estate rental property
  - as long as there is a reasonable expectation of profit (excluding capital gains) from the rental property
- Preference shares or interest-bearing investments
  - but the deduction is limited to income earned (grossed-up dividends or interest) because the related income stream is fixed
- Gold bars/commodities/foreign exchange
  - interest is deductible if any profits are reported as business income
  - interest is not deductible if any "profit" is reported as a capital gain because capital gains are not "income from business or property"

### 2.2.4 Examples of non-deductible interest expense; i.e., cases where the money is used to

- Make interest-free loans to family members
  - because not incurred to earn income
- Make an RRSP contribution
  - because ITA 18(11) denies the deduction
- Buy a cottage
  - since it's a personal use property [ITA 18(l)(h)]
- Interest paid on late payments under the ITA is not deductible [ITA 18(l)(t)]

### 2.3 Interest Income [7-38 to 7-45]

- Any interest earned and received during the year is taxed
- Interest earned during a year but not received until after the end of the year is also taxed using an "accrual" method
  - Example: A 2-year \$100,000 term deposit issued and purchased on November 1, Year 1 does not pay interest until the end of the 2 year period (October 31, Year 3). The interest is 5% annually (no compounding). What interest must be accrued in Yr 1? In Yr 2? In Yr 3?
    - by a corporation with a December 31 year end
      - The accrual method for corporations [ITA 12(3)] = normal accounting method
      - The interest that must be accrued by a corporation (assuming that none of the years are leap years) is
        - Yr 1:  $\$5,000 \times 61/365 = \$836$  for the period November 1 to December 31
        - Yr 2:  $\$5,000$  for the period January 1 to December 31
        - Yr 3:  $\$5,000 \times (365 - 61)/365 = \$4,164$  for the period January 1 to October 31

- by an individual
  - The accrual method for individuals = anniversary date method [ITA 12(4)] = simplified method (to allow financial institutions to issue T5s)
  - This method accrues interest to anniversary date
  - Anniversary date [ITA 12(11)] = 1 year after the issue date minus a day, then one year after this day et cetera
  - The interest that must be accrued by an individual is
    - Yr 1: none because the first anniversary date is October 31, Yr 2
    - Yr 2: \$5,000 because the first anniversary date is October 31, Yr 2
    - Yr 3: \$5,000 because the second anniversary date is October 31, Yr 3
- Example at 7-44

## 2.4 Treasury Bills and Commercial Paper

- Treasury bills and commercial paper are short-term investments that do not explicitly bear interest. Instead, they are sold at a discount that reflects going interest rates
- ITA 16 says that this discount is income because it reasonably may be considered to be interest
  - Example: A one year \$1,000 treasury bill issued by the government (or commercial paper issued by a corporation) is purchased by the taxpayer for \$950 today. On maturity, the taxpayer receives \$1,000. What are the tax implications?
    - The additional \$50 received is taxed as interest [ITA 16]. It is not a capital gain

## 2.5 Royalty Income [7-51 to 7-53]

- = payments based on production or use [ITA 12(1)(g)]
  - e.g. book royalties earned by authors
- Royalty income can be business income if the taxpayer is earning a royalty as part of a business (i.e., selling goods or services), or it can be property income if the royalty income is from an investment. This distinction, between business and property income, is more relevant for corporations than for individuals. Royalty income earned by individuals for a work or invention is either “other employment income” or “self-employed”, i.e., business, income

## 2.6 Rental Income [7-54 to 7-65]

- Rental income is net of expenses
- Real estate investments can be viewed as a type of tax sheltered investment because
  - the income can be sheltered (offset) by the deduction of CCA
  - the appreciation of the property is not taxed until sold
  - the appreciation is taxed as a taxable capital gain (1/2 taxable) assuming it meets the common law tests for a capital gain (discussed below)

### 2.6.1 Separate CCA class for each rental building costing \$50,000 or more

- Each rental building costing \$50,000 or more must go into a separate CCA class [Reg. 1101(1ac)]
  - Rationale
    - Effect of separate class rule is to recognize immediate recapture on sale (if applicable)
    - Can't offset recapture with purchase of another building since each building is in its own CCA class
- CCA is claimed at the rate of 4% (Class 1 rate for rental buildings), with the 1/2 net amount rule applying in the year of acquisition
- Do not prorate CCA for short years in the case of property income
- In order to prevent the CCA from being used to shelter other sources of income, CCA is restricted. There is an exception for corporations whose principal business is real estate development and resale [Reg. 1100(11) to (14)]
- If you own several rental properties, you must total up the net rental income (losses) to determine your maximum CCA claim.
- You must include recapture or terminal losses to determine your rental income total
- Do not include taxable capital gains or deduct allowable capital losses to determine your rental income total (since this is not property income)
  - Your CCA claim is limited to this net rental income total  
i.e., you cannot create or increase a net rental loss by claiming CCA
- Read example at 7-64

### 2.7 Canadian Dividend Income

- on integration: read 7-66 to 7-69 and see Fig. 7-1

#### 2.7.1 Canadian Dividends received by an Individual [7-70 to 7-95]

- Non-eligible dividends [see examples at 7-86 and 7-92]
  - 17% gross up (in 2017)
  - federal dividend tax credit = 21/29 of gross up (in 2017)
  - provincial dividend tax credit depends on the province
  - **if** provincial dividend credit rate = 8/29 of gross up
    - dividend tax credit amount =  $(21/29 + 8/29) \times$  gross up
    - dividend tax credit amount = gross up
- Eligible dividends [see example at 7-77]
  - 38% of gross up
  - federal dividend tax credit = 6/11 of gross up
  - provincial dividend tax credit depending on province
  - **if** provincial dividend credit rate = 5/11 of gross up
    - combined dividend tax credit amount =  $(6/11 + 5/11) \times$  gross up
    - combined dividend tax credit amount = gross up

### 2.7.2 Stock Dividends [7-123 to 7-126]

- A stock dividend is a dividend paid in the company's shares rather than cash
- The "amount" of the dividend is deemed to be the increase in the paid up capital of the company's shares on the issuance of the shares (generally the FMV of the shares but sometimes not)
- The "paid up capital increase" will always be given to you in this course
- This amount must be "grossed-up" and included in income if received by an individual
- The amount (i.e., the increase in paid up capital) is the "cost" of the shares. The cost (i.e., ACB) is then averaged with other shares of the same class owned by the taxpayer (to determine the ACB of the shares)

### 2.7.3 Capital dividends [7-121 to 7-122]

- ITA 83(2): These dividends are tax-free
  - It comes out of a special account composed of tax-free amounts like the tax-free half of capital gains
  - Only private corporations can elect to pay a capital dividend

### 2.8 Mutual Funds and Income Trusts [7-96 to 7-120]

- Mutual funds are generally organized as trusts in Canada. A few are organized as corporations.
- Mutual fund trusts issue T3 slips for the year allocating to each unit holder his/her % of income for the year
- The income allocated is generally not distributed
- Instead the income is reinvested in the fund (used to buy more units)
  - There are lots of boxes on the T3 slip to indicate what kind of income is being allocated  
The income may be
    - Canadian interest
    - Foreign income
    - Dividends from taxable Canadian corporations (gross up & dividend tax credit for individuals)
    - Capital gains
    - Other (no special treatment)
- See example at 7-118
- Income trusts
  - Investors buy units in a trust
  - The trust buys an operating business
  - All (or most) cash flows of the operating business are distributed
    - cash-flow distribution > taxable income
    - Income that flows through a trust retains its tax characteristics (e.g., business income stays as business income etc.)

- return of capital is tax-free
- For income trusts (i.e., not personal trusts) other than real estate investment trusts, distributions will be taxable at corporate tax rates. Personal trusts are discussed in Lecture 10.
- For the calculation of ACB of an income trust unit see example at 7-109

## 2.9 Foreign Source Income [7-127 to 7-128]

- There is no gross-up or dividend tax credit for dividends from foreign corporations
- The amount of the dividend is included in income [ITA 12(l)(k)]
- If foreign taxes are withheld, e.g. only \$850 is received because 15% (\$150) was withheld from a \$1,000 dividend; the full \$1,000 must be included in income but \$150 can be claimed as a foreign tax credit under Division E. (A tax credit is a reduction of the Canadian income taxes owing)
- See example at 7-128

## 2.10 Shareholder Benefits [7-131 to 7-133]

- ITA 15(1): Corporate property appropriated by shareholders is included in the shareholder's income
  - An example of this is when a shareholder of a real estate development company arranges for a corporate employee to do repairs to his/her home- the FMV of the services rendered would be included in the shareholder's income
- ITA 15(2): Shareholder loans received are also included in a shareholder's income unless an exemption is met
  - If an exemption is met, the principal of the loan is not included in income but an interest benefit at the prescribed rate must be reported (if the loan is a low interest or interest free loan) [ITA 15(9)]
- A shareholder benefit is fully taxed in the shareholder's hands like salary is (i.e. there is no gross-up and no dividend tax credit) and there is no deduction to the corporation (because, unlike salary paid, the amount is not incurred to earn income). ITA 18(1)(a)

## 3 Capital Gains and Losses [8-1 to 8-10]

- Capital gains and capital losses are, generally speaking, gains and losses on the sale of long-term investments such as shares and real estate
- In Canada, capital gains have always been more lightly taxed than other income but the taxable fraction has changed over the years: see 8-9
- Capital gains are ½ taxable and capital losses are ½ allowable
- \$835,716 lifetime capital gains exemption for sale of QSBC shares (discussed in ADMS 4562) [see 8-6 to 8-8]

### 3.1 General Rules [8-11 to 8-36]

- The computation of capital gains in subdivision c: ITA 38 to 55
- A capital gain or loss will occur when there is a “disposition” of capital property. The term “disposition” is defined and while it includes a sale it also includes other transactions. Technically a disposition is a transaction that entitles the taxpayer to proceeds of disposition. Hence, if an asset is stolen, destroyed or expropriated the taxpayer will typically have a disposition since the taxpayer will have proceeds of disposition in the form of insurance proceeds (if the asset was insured) or proceeds from the government (if the asset was expropriated)
- The common law tests used to distinguish capital gains from business income look at:
  - the holding period of the investment, i.e., whether this type of asset is being traded by the taxpayer (bought and sold frequently);
  - the nature of the asset;
  - the experience of the taxpayer; and
  - the behavior of the taxpayer
- Based on the above tests, if the taxpayer is acting more like an investor selling capital property then the gain (or loss) will likely be a capital gain (or capital loss). If the taxpayer is acting more like a business person, selling inventory, then the gain (or loss) will be business income (or a business loss)
- If the taxpayer intends to sell an (inventory) asset at a profit then this is evidence of business income; whereas, if a taxpayer intends to hold an asset as a capital property and earn investment income (i.e., rent, interest, dividends etc.) then this is evidence of a capital property (the sale of which would give rise to a capital gain or capital loss)
- For example, when you sell a piece of real estate, the gain may be 100% taxable as business income, or one-half taxable as a capital gain, depending on the facts
- A "capital property" is defined as a property that gives rise to a capital gain or loss when it is sold
- For Canadian securities (i.e., Canadian stocks, bonds, mutual funds etc.), you can make a once-and-for-all election under ITA 39(4) that your gains are capital gains and that your losses are capital losses
- ITA 39(5): Stock brokers and other traders cannot make this election. Stock brokers who buy and sell securities on their own behalf will likely be considered to be earning business income (and the security will be considered to be inventory as opposed to capital property)

### 3.2 Superficial Losses [8-29]

- Investors who do tax loss selling in December (i.e., selling capital property that has gone down in value to trigger a capital loss) so that they have allowable capital losses to offset taxable capital gains during the year must watch for superficial losses
- A superficial loss (defined in ITA 54) occurs when:
  - a taxpayer sells a property for a capital loss, e.g. a taxpayer sell some shares for a loss, and

- within 30 days before or after the sale, the same or an identical property is acquired by the taxpayer, his/her spouse or a company controlled by him/her, and
- the taxpayer still owns some of the property at the end of the 30 day period, e.g., he/she buys some more identical shares within 30 days after the initial sale of shares
- Superficial losses cannot be deducted [ITA 40(2)(g)(i)] and for individuals must be added on to the cost of the remaining identical property, e.g. the shares still owned [ITA 53(1)(f)]
- See 8-29

### 3.3 Identical Properties [8-37 to 8-38]

- Taxpayers often acquire their share investments over a number of years
- Shares of the same class of a particular company are considered identical properties
- These rules determine the "cost" of the shares sold
- The rule is that for property purchased after 1971:
  - you use an average cost to determine cost for identical properties (like shares of a particular class of a corporation)
  - you add or subtract the ACB adjustments in ITA 53 to determine ACB [8-27 to 8-30]
- See example at 8-38

### 3.4 Principal Residence Exemption [8-72 to 8-81]

- A principal residence is a house/ apartment etc. owned by the taxpayer and lived in, at some point in the year, by the taxpayer and/or his/her spouse, and/or his/her children
- The Principal Residence Exemption formula in ITA 40(2)(b):
  - gain on the property multiplied by a fraction
    - $\text{gain} = \text{POD} - \text{ACB} - \text{selling costs}$
    - the fraction =  $(1 + \text{no. of years designated}) / \text{no. of years owned}$
- Capital gain = gain - Principal Residence Exemption
- After 1981, each family unit can only designate one principal residence per year
  - a family unit = 2 spouses or common-law partners and minor kids
- The "One plus" rule effectively allows you 2 principal residences for the year of purchase & sale
  - Note that foreign properties qualify if they were ordinarily inhabited by you, your spouse or your minor child, e.g. a Florida condominium. However, only a resident of Canada (for at least part of a year) can claim the principal residence exemption
- This explains why the sale of a home (principal residence) seldom gives rise to a capital gain
- See example at 8-81

#### 3.4.1 Change in Use [8-113 to 8-121] [ITA 45(2) and ITA 45(3)]

- ITA 45(2) allows taxpayer to defer the deemed disposition on the change in use of a personal use property until the actual sale

- If an ITA 45(2) election is made, it allows a rental property to be designated as a principal residence for up to 4 years even though the taxpayer isn't living there
- The one principal residence designation per family unit rule still holds
- ITA 54.1 allows the principal residence designation period to be > 4 years if the taxpayer is transferred by his employer and moves back into the house before it is sold
- ITA 45(3) election: if you convert a rental property to a principal residence
  - The disposition is again deferred to the year of actual disposition and you can designate up to 4 years of rental period as a principal residence. The election is filed in the year of actual sale
- No CCA can be claimed while the property is rented or ITA 45(2) and ITA 45(3) elections are null and void
- You can only claim the principal residence exemption on the personal use portion of the home. Hence if you claim CCA on part of your home, for example if you claim CCA on a room rented out to earn rental income, then you will only get the principal residence exemption on the residential part of your home

### 3.5 Personal Use Property [8-87 to 8-94]

- Personal Use Property (PUP) includes Listed personal property (LPP) and other PUP
  - LPP is a subset of PUP that has a special definition in ITA 54 [see list in 8-92]
- The minimum deemed proceeds and cost for all PUP is \$1,000 [ITA 46(1)]. This means that the ACB of PUP costing less than \$1,000 will be deemed to be \$1,000, and the proceeds of disposition of PUP worth less than \$1,000 will be deemed to be \$1,000
- All PUP losses are denied except for LPP losses [ITA 40(2)(g)(iii)]
- LPP losses can only be used to offset LPP gains (if any)
- LPP losses in excess of LPP gains can be carried back 3 years and/or carried forward 7 years to be used against LPP gains (if any) in these carryover years [ITA 41]
- These rules explain why we seldom have to report capital gains on personal use property (e.g., cars and jewelry) on our tax returns (and why we don't report capital losses on most PUP)
- See example at 8-89

#### **\*\*Becoming an Accountant – Learning the Necessary Skills\*\***

- There are several required competencies that need to be demonstrated before an accounting designation can be obtained. These competencies are tested through the various examinations required in order to become a designated accountant.
- This lecture deals with the taxation of interest, dividend, and rental income, as well as the taxation of capital gains and losses. There are number of problems/issues that can arise in the taxation of these items. It ties directly into the competency map as all candidates are required to identify and diagnose problems and issues in order to develop solutions.
- All course content can be tied back to one or many of the competencies that need to be demonstrated in order to successfully become a designated accountant.