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Capital Gains and Losses

Calculating your Adjusted Cost Base

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The Adjusted Cost Base (ACB) is the cost of a property or investment calculated according to the Canadian tax rules. According to the Canada Revenue Agency (CRA), the responsibility for the ACB reported on a tax return rests solely with you, the individual whose name is on the top line of the tax return. Although an investment firm may provide cost numbers to their clients, they are strictly provided for information purposes. The firm-provided numbers may not reflect special elections or transactions that a client has undertaken or the need to use the weighted average cost if the same security is held in multiple non-registered accounts.

The Rules

Any sale can be considered to be on account of income or capital. In Canada, it is an argument as old as the tax act. For most investors in stocks, bonds and other financial products, a sale will result in a capital transaction. This article will look at those sales which are considered capital in nature only. If you are unsure if your sale is capital in nature or income in nature, you should seek the guidance of your qualified tax advisor.

CALCULATING YOUR CAPITAL GAIN OR LOSS

Any Capital Gain or Loss is calculated by the following simple formula:

POD – ACB – Fees = Capital Gain or Loss.

Where:

POD = Proceeds of Disposition
ACB = Adjusted Cost Base
Fees = brokerage fees and other outlays incurred to sell the property

In practice, the Proceeds are usually reported net of fees instead of separately on the tax forms. If the answer to the formula is a positive number, you have a capital gain. One-half of the gain is called a taxable capital gain. If the answer is negative, then you have a loss. One-half of the loss is called a taxable capital loss. You are required to subtract your taxable capital losses from your taxable capital gains in the taxation year they happen. A net taxable capital loss in a taxation year can also be carried back and subtracted from net taxable gains reported in the past three years, or carried forward to any future year and subtracted from future taxable capital gains.

THE ADJUSTED COST BASE (ACB)

The basic concept of calculating the ACB is quite simple. You start with your purchase cost and then add or subtract any stock splits, reorganizations, purchases, and sales. **The key to correctly calculating the ACB is to recognize each transaction in the order of their occurrence.**

CRA's guide on capital gains defines an ACB as: "usually the cost of a property plus any expenses to acquire it, such as commissions and legal fees. The cost of a capital property is its actual or deemed cost, depending on the type of property and how you acquired it."

Here are some unique tax events that can impact the calculation of the ACB of any security. Your initial purchase date will determine which, if any of these, will impact your ACB calculation.

DECEMBER 1971 – V-DAY OR VALUATION DAY

Prior to 1972 capital gains were not taxed in Canada. As a result, anyone who owned capital property at the end of 1971 was required to calculate a beginning ACB for their property. Two ways were established for calculating the ACB.

Median Rule Method
For all non-depreciating property, December 31, 1971 was designated as the valuation date. The government established the median rule which is a formula that allows the cost to be the middle figure of the following three amounts:

a) Proceeds of Disposition
b) Valuation Day Value
c) Cost

If any two are equal, they become the ACB.

Valuation Day Method
The last trading day to settle a security trade in 1971 and before taxation of capital gains in Canada was December 22, 1971. There is a published book of the closing stock prices on that day which establishes their V-Day value and represents their starting ACB.

An individual holding publicly-traded stock can choose either method but once they choose the valuation day method, they must use it for all their publicly-traded securities.

In practice, the valuation day value is usually used as it is readily available.

FEBRUARY 22, 1994 – ELIMINATION OF THE CAPITAL GAINS EXEMPTION

A certain dollar limit of capital was always exempt from taxation until February 22, 1994. On this date, the government eliminated the $100,000 lifetime capital exemption. But instead of eliminating it entirely, they allowed an investor to bump up the value of their ACB to their portfolio's Fair Market Value or the $100,000 limit, whichever came first.

If you held a security on that date and you are now disposing of it, you will need to go back and check your 1994 tax return to see if the ACB was bumped up. Late elections were allowed for up to three years, with a penalty, so this election may also be found in your 1995, 1996 or 1997 tax returns.

IDENTICAL PROPERTIES

You may buy and sell the same security at different prices over a period of time. If you do this, you have to calculate the average cost of each property in the group at the time of each purchase to determine your ACB (dispositions of identical properties do not affect the ACB on a per unit basis).

The average cost is calculated by dividing the total cost of identical properties purchased (this is usually the cost of the property plus any expenses involved in acquiring it) by the total number of identical properties owned.

The most common examples of identical properties are shares of the same class of the capital stock of a corporation or units of a mutual fund trust.

Generally, the following properties are not considered identical properties:

- securities acquired under an employee option agreement that are subject to the benefit deferral or are designated and disposed of within 30 days; and
- certain employer shares received by an employee as part of a lump-sum payment upon withdrawal from a deferred profit sharing plan.

- mutual funds of the same style operated independently. For example, RBC Canadian Dividend fund vs. GGOF Dividend Growth fund.

As a result, the ACB averaging rule described above does not apply to these types of securities. Each of these securities will have its own ACB determined in the usual way.

You also use this method to calculate the average cost of identical bonds or debentures you bought after 1971.

A bond, debenture, or similar debt obligation that a debtor issues is considered to be identical to another if:

- the same debtor issues both; and
- all the attached rights are the same.

SUPERFICIAL LOSSES

If you sold a security at a loss and repurchased it within 30 days and held it on the 30th day, your loss could be denied under the superficial loss rules. If your security was subject to the superficial loss rules, the loss that was denied will be added back to the ACB of the security now held. This means that the ACB of the security now held would have the same ACB as the security sold.

STOCK SPLITS

Stock Splits will affect the number of identical properties owned. This will affect the ACB per unit cost of a security but not the total ACB of the security position.

DRIP PROGRAMS

Securities held in a Dividend Reinvestment Program (DRIP) are slightly more difficult to calculate the ACB of because each time the company pays a dividend, the dividend is treated as a purchase. The difficulty in this calculation lies in determining the past dividend history and having to calculate the number of shares owned just before each dividend payment. Further, some DRIPs give a bonus amount either by reducing the purchase share price or providing a premium purchase option.

TRUST UNITS

Trust units are unique in that their value can be reduced to an amount below zero. If the ACB of the trust units is reduced below zero during the taxation year through return of capital distributions, the negative amount is deemed to be a capital gain in the year. The ACB of the trust units is deemed to be zero.

What if I don't know my cost?

Sometimes, you may simply not remember what you paid or you cannot find your original documents. Many times this occurs due to a theft, the shares were inherited, or you are unable to find the necessary records.

In these cases, the principal of reasonableness must be relied upon to determine an estimate of the ACB. To begin, you would need to know, or preferably have some evidence, of when a security was purchased.

If share certificates were purchased, it may be possible to contact the transfer agent to determine when you became the owner of the shares. If shares were purchased through a broker, monthly statements are a great place to start. If they are unavailable, they may be able to be retrieved from storage or archival tapes but there often is a charge associated with this research. Needless to say, the farther back you have to look, the greater the potential cost.

After the time of purchase is determined, an estimate must be made of the cost. Usually this involves going back through a company's history and using published share prices. The price chosen can be a daily close price, weekly, monthly, or annual average and will usually depend on how close to the original day the purchase can be determined. Your qualified tax advisor is the best person to recommend which price to use based on the evidence produced.

Worst Case Scenario

The Canadian tax system is based on the honour system and most times, CRA assesses your return based on the information you provide. However, also under our system, CRA has the right to challenge assumptions on your tax returns. Sometimes this is done because the figures on a return are so dissimilar to others in similar situations, they are targeting a specific area of the return or a return is chosen totally at random. Whatever the reason, if your reporting is challenged by CRA, you should have the best possible support for the position you presented on your return.

If a purchase date cannot be estimated or proof of purchase date simply cannot be found, the safest way to avoid a challenge by the CRA, or a tax audit, is to assume the security has a zero ACB.

Again, your qualified tax advisor is the best person to discuss which of these alternatives is best for you.

Note: The above information is based on the current and proposed tax law in effect as of the date of this article. The article is for information purposes only and should not be construed as offering tax or legal advice. Individuals should consult with qualified tax and legal advisors before taking any action based on the information contained in this article.