Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Capital gains reserve

When you dispose of capital property, you may realize a capital gain or loss equal to the difference between the proceeds of disposition and the adjusted cost base (ACB) of the property. You will generally need to pay tax on the capital gain in the year of disposition, even if you're not fully paid in the year. However, you may be able to defer a portion of the capital gain and the associated taxes by claiming a capital gains reserve when you receive the proceeds over a number of years.

Who can claim a reserve?

Generally, you can claim the reserve when you dispose of capital property and you haven't received all of the proceeds of disposition, unless you:

- were not a resident of Canada at the end of the tax year, or at any time in the following year;
- were exempt from paying tax at the end of the tax year, or at any time in the following year; or
- sold the capital property to a corporation that you control in any way.

How do you calculate the capital gains reserve?

The capital gains reserve reduces the amount of the capital gain you report as income in a particular year. As such, you first calculate your capital gain, then you reduce the capital gain with the reserve you would like to claim in the year. Generally, the maximum period over which most reserves can be claimed is four years, which allows you to spread the capital gain over a maximum of five years. There is an exception, as will be discussed. In the year after you claimed a reserve, you must include the reserve in the calculation of your capital gains. You may then claim a recalculated reserve amount.

Generally, you may calculate the capital gains reserve as follows:

The lesser of:

a) $\text{Capital gain} \times \frac{\text{Proceeds payable after the end of the year}}{\text{Proceeds of disposition}}$

b) $\text{Capital gain} \times \frac{(4 - \text{number of preceding tax years ending after disposition})}{5}$

Under this formula, you can't take more than four-fifths of the gain as a reserve in the year you dispose of the capital property. Each year, you repeat the calculation to determine the amount of the reserve. As a result, you can spread the capital gain over a maximum of five years. If the purchaser pays you the purchase price over a period longer than five years, for example, an eight-year period, you must still recognize the capital gain in full over a period of five years.

You must recognize the capital gain in full by the year in which you receive the final payment. So, if the purchaser pays you 50% of the purchase price in the year of sale and the remaining 50% in the following year, you could recognize up to 50% of the original capital gain in the year of sale and the remaining 50% would have to be recognized in the following year.

Numerical example

For example, let's assume you sell your cottage to your children at fair market value for $400,000. The ACB of the cottage is $100,000. You would normally declare a capital gain of $300,000. However, your children can only afford to pay you $100,000 in the year of the sale, so you agree to take back a note for the remaining $300,000. In this case, you can claim a capital gains reserve for tax purposes for a portion of the $300,000 capital gain. You can recognize a portion of the $300,000 capital gain in the year of the sale and defer a portion of this gain to a future tax year, since you've not received all of the proceeds in the year of the sale. The calculation of the capital gains reserve you can claim would be the lesser of:

a) $\$300,000 \times \frac{\$300,000}{\$400,000} = \$225,000$

b) $\$300,000 \times \frac{(4 - 0)}{5} = \$240,000$

Therefore, you can defer up to $225,000 of the capital gain to future tax years. You would, in this case, only have to recognize a capital gain of $75,000 ($300,000 –$225,000), in the year of the sale. In the following year, you would include the $225,000 as a capital gain in your income and you would repeat the capital gains reserve calculation.

If you donate non-qualifying securities, other than an excepted gift, to a qualified donee which results in a capital gain, you may be able to claim a reserve to postpone the inclusion of the capital gain in income.

Nine-year reserve period for certain types of capital property

You may be able to spread the capital gain you realize over a maximum period of ten years if you are transferring certain types of capital property to a child who's a resident of Canada at the time of transfer. Your children include any of the following:

- a person of whom you or your spouse or common-law partner is the legal parent;
- your grandchild or great-grandchild;
- your child's spouse or common-law partner; or
- another person who is wholly dependent on you for support and who is, or was immediately before the age of 19, in your custody and under your control.

The following property qualifies:

- family farm or fishing property (which includes shares of a family farm or fishing corporation, an interest in a family farm or fishing partnership, and land or depreciable property in Canada that you, your spouse or common-law partner, your parent or any of your children used in a farming or fishing business); or
- shares of a qualified small business corporation (QSBC).

Lifetime capital gains exemption (LCGE)

A capital gain that you bring into income in the year following the year you claim a reserve may still qualify for the LCGE. In order to qualify, the original capital gain must qualify for the LCGE. Generally, you qualify for the LCGE if you dispose of shares of a QSBC or qualified farm or fishing property.

Reserve for a gift of non-qualifying securities

This section does not apply to you where you're gifting a share to a qualified donee with whom you deal at arm's length. The qualified donee cannot be a private foundation. This is referred to as an "excepted gift," explained later on in this section.

If you donate non-qualifying securities, other than an excepted gift, to a qualified donee which results in a capital gain, you may be able to claim a reserve to

postpone the inclusion of the capital gain in income. Your reserve in each year cannot be more than the amount of the capital gain you realized from making the gift.

Examples of a non-qualifying security include (but is not limited to):

- a share of a corporation with which you do not deal at arm's length after the donation is made;
- an obligation of yours, or of any person or partnership, with whom you do not deal at arm's length after the donation is made;
- any other security issued by you or by any person or partnership with whom you do not deal at arm's length after the donation is made.

An excepted gift is a gift of a share you made to a qualified donee with whom you deal at arm's length. The donee cannot be a private foundation. If the donee is a charitable organization or public foundation, it will be an excepted gift if you deal at arm's length with each director, trustee, officer and official of the donee.

You can claim a reserve for any tax year ending within 60 months of the time you donated the security. However, you cannot claim a reserve if the donee disposes of the security, or if the security ceases to be a non-qualifying security before the end of the tax year. If this happens within the 60 months, you will receive a donation tax receipt and will be considered to have made a charitable donation in that year. Therefore, you can claim the charitable donation tax credit.

The qualified donee, which is an organization that can issue official donation receipts, would not issue a donation tax receipt for a gift of a non-qualifying security and you cannot claim a charitable donation tax credit unless, within 60 months of the donation, the non-qualifying security ceases to be a non-qualifying security or has been disposed of in exchange for property that's not another non-qualifying security.

If the non-qualifying security is not disposed of by the qualified donee within the 60-month period, you will not be required to bring the reserve back into income in the year following the end of that period.

Other considerations

When deciding if you should claim the reserve, you'll want to consider your current and future marginal tax rate. The deferral of the capital gains can be especially advantageous if you expect to be in the same tax bracket or a lower tax bracket over the next four years.

Another benefit of claiming the capital gains reserve is the ability to match the cash flow from the proceeds of sale to the income tax payment.

> If you're selling your property with accrued gains and will not be receiving all of the proceeds in that year, the capital gains reserve may help you defer or reduce taxes.

If you receive certain income-tested benefits, bear in mind that deferring recognition of capital gains can be a potential disadvantage. This is because when you include portions of the capital gain in your income in future years, the amount of certain benefits to which you may be entitled (e.g. Old Age Security) may be reduced.

As the capital gains inclusion rate is applied to the reserve, any potential change to this inclusion rate could impact your ultimate tax liability.

In addition, in the year of death, you cannot claim a reserve. Any remaining deferred capital gain must be included in your final return and your estate is responsible for the related tax liability.

Conclusion

If you're selling your property with accrued gains and will not be receiving all of the proceeds in that year, the capital gains reserve may help you defer or reduce taxes. Speak to a qualified tax advisor for more information.

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Wealth Management

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