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FINANCIAL ADVISORY SUPPORT

Actual or Deemed Dispositions

List of events outside a sale that may trigger taxable capital gains/losses

Typically, you realize a capital gain or loss when you sell securities on a secondary market for cash. If the cash proceeds on the sale of your security are greater or smaller than its adjusted cost base (ACB), a taxable capital gain or loss will result. However, there are other events outside a sale that may trigger an actual or deemed disposition of your securities or other assets for Canadian tax purposes. Therefore, it is important for you to recognize when an actual or deemed disposition may result.

What events will trigger an actual or deemed disposition?

Under certain circumstances, the Canadian tax rules may require that you report your assets as having been sold in the same manner as you would treat an actual sale of those assets for cash. An actual or deemed taxable disposition of assets may result from an event that is not the actual sale of the assets. Therefore, even if you do not receive cash or some other form of consideration for your assets, you may trigger a disposition that you must report on your tax return, and you may have to pay the resulting tax liability.

Here is a non-exhaustive list of common events outside a sale that may trigger an actual or deemed disposition for tax purposes resulting in taxable capital gains or losses:

(Note: The term “spouse” used in this article also refers to common-law partner or same-sex partner.)

Transfer or swap of assets from a non-registered account to a registered account

When securities are transferred in-kind from your non-registered investment account to a registered account such as a Registered Retirement Savings Plan (RRSP), Registered Education Savings Plan (RESP), Registered Disability Savings Account (RDSP), Tax-Free Savings Account (TFSA) or Registered Retirement Income Fund (RRIF), you are deemed to have disposed of the securities for proceeds equal to the fair market value (FMV) of the securities at the time of the transfer to the registered account. In cases where Canadian tax rules permit you to swap securities from your non-registered account to a registered account, you are also considered to have sold the securities in your non-registered account at FMV. A transfer or a swap may trigger a capital gain or loss.

Note that if a capital loss is triggered as a result of the in-kind transfer or swap to a registered account, the capital loss will be denied due to the superficial loss rules, and it will be lost forever. A better strategy to use if your security is in a loss position is to sell it first for cash and then contribute the cash to the registered account. If you intend to repurchase the same security, remember to wait 30 days from the settlement date of the sale to avoid the superficial loss rules.

Transfer of securities to an inter-vivos trust

If you, as the settlor, transfer securities in-kind to a trust (e.g. a family trust or a trust account for a minor), a disposition at FMV will occur. You must report a capital gain or loss on the transfer of the securities. The adjusted cost base (ACB) of the securities transferred to the trust is the FMV on the date of the transfer. Where a disposition results in a capital loss, the loss may be denied under the superficial loss rules if you or your spouse has a majority interest beneficiary of the trust. There are certain exceptions that allow you to transfer assets to a spousal trust, alter-ego trust or joint partner trust without triggering a capital gain or loss. You should consult with your tax advisor to determine whether a disposition will occur and if the superficial loss rules will apply. You should also consider whether the income attribution rules will apply after the transfer.

Transfers from a shareholder to their corporation or from a corporation to a shareholder

If you transfer a security to your corporation, you may trigger a capital gain or loss. If the securities you transfer are in a gain position, a joint income tax election may be available to allow the transfer to be made at an amount that is less than the FMV. It may also be possible to elect an amount, which would result in a complete tax-deferred rollover to your corporation at the ACB.

If these securities are in a loss position, the superficial loss rules prohibit you as the shareholder from claiming a capital loss on the transfer of the securities to a corporation controlled by you or your spouse. When the loss is denied on the transfer of securities, the loss is added to the corporation's ACB of the securities.

A distribution of portfolio securities from a corporation such as a holding company to a shareholder is a taxable disposition and is reported at FMV. The shareholder's ACB will be the FMV of the securities on the date of the distribution. Where the securities are in a loss position, the stop-loss rules will prohibit the corporation from claiming the capital loss until the shareholder ultimately disposes of the securities to an unaffiliated person.

Corporate reorganizations (investments in other corporations)

If your corporation reorganizes, for example through a merger or takeover, you as a shareholder may be considered to have disposed of your shares, resulting in a capital gain or loss. Sometimes the Canadian tax rules allow a tax-deferred rollover or allow you to file a joint tax election with the corporation to allow a tax-deferred rollover at the ACB or some other elected amount that is less than the FMV.

Transfers to an individual other than your spouse

If you gift securities in-kind to anyone other than your spouse, you are considered to have sold the securities for FMV, and you may trigger a capital gain or loss as a result. If you gift property to your spouse or another non-arm's length individual (i.e. individual related by blood), you should consider whether the income attribution rules will apply. For example, the income attribution rules require you to report income earned on gifts made to your spouse or minor child.

If a loss is triggered, the superficial loss rules should also be considered. The transfer of securities in a loss position to your spouse will trigger the superficial loss rules, which will deny you the loss and add the denied loss to the ACB of the securities transferred to your spouse.

Changing ownership of investment accounts from sole to joint ownership

When there is a change in ownership structure of a non-registered investment account from sole ownership to joint ownership with someone other than your spouse and there is a change in legal and beneficial ownership, you are considered to have disposed of a pro-rata share of the account for FMV, which may trigger a capital gain or loss. You should also consider whether the income attribution rules or superficial loss rules apply.

A deemed disposition does not occur when someone other than your spouse is added to a joint account if the intention is to transfer only the right of survivorship and you maintain beneficial ownership. For example, it is possible for a parent to add an adult child to an investment account with the intention of transferring the right of survivorship upon death while the parent retains beneficial interest in the assets during their lifetime. If the parent maintains beneficial ownership of the account, there is no deemed disposition until death, at which point the assets are automatically transferred to the surviving joint tenant (adult child) with no probate required. Further information on this issue is available in the article titled, "Creating Joint Tenancy with Right of Survivorship Accounts Between Parents and Adult Children."

Change in use of property

Due to the Canadian tax rules referred to as "change in use" rules, when the use of property changes from personal use to business or investment use, or vice versa, the property is deemed to be sold at FMV. An example is when your principal residence is converted to a rental property, or your rental property is converted to a principal residence. In certain cases you can make an election to have the change in use rules not apply and thus defer the capital gain that would otherwise be triggered. Alternatively, if you qualify, you may choose to apply the principal residence exemption to offset the capital gain. This area of taxation and planning should be reviewed and discussed with your own personal tax advisor.

Return of capital

A security you own may under certain circumstances have a return of capital distribution that is in excess of the ACB at the end of the year. As a result, the distribution amount less the ACB of your security will be negative, resulting in a capital gain equal to the negative ACB amount.

Worthless securities

Under Canadian tax rules, if at the end of the year a security you own is considered worthless, you may elect to report a deemed disposition of that worthless security on your tax return. You are deemed for tax purposes to have reacquired this security immediately after the year-end. The proceeds of the deemed disposition are zero. This means the amount of the capital loss is equal to the ACB of the worthless security.

Ceasing Canadian residency

If you ceased to be a resident of Canada for tax purposes, you are deemed to have disposed of your property. Therefore, you may incur a tax liability even though you did not actually sell this property. These deemed disposition rules ensure you pay tax on the appreciated value of your property while you were a resident of Canada. There are certain exceptions to the rules and certain property that is excluded. In some cases where capital gains are triggered, your tax liability may be delayed until the property is actually sold, provided adequate security is posted with approval from the Canada Revenue Agency (CRA).

Upon death

When an individual dies, all of their capital property is deemed to have been sold immediately prior to death, unless that property is left to a spouse or spousal trust. Therefore, you may be considered to have disposed of the securities held in your non-registered account for proceeds equal to FMV, and thus, trigger a capital gain or loss even though the property was not actually sold. There are exceptions to these deemed disposition rules where farm property is left to children. There are also special rules concerning the use of capital losses triggered on death.

Summary

The events discussed in this article are examples of situations where an actual or deemed disposition may be triggered resulting in tax implications to you. Since other consequences could result, such as the application of the income attribution rules, the superficial loss rules, possible tax elections that can be made to avoid immediate tax consequences or reduce the tax liability, it is always advisable to speak to your advisor and your tax advisor regarding how these events could apply to you.



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