A REVIEW OF THE INCOME TAX ACT
RELATED TO NON-CORPORATE REAL ESTATE HOLDINGS

by

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Business Administration and Commerce

We accept this thesis as conforming
to the required standard

The University of British Columbia
April 1975
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ABSTRACT

The purpose of this thesis is to examine the impact of the new Canadian Income Tax Act on real estate investments and real estate investors. Effective January 1, 1972, this new Act instituted many changes to provisions of the old Act which had been in effect for twenty years, and introduced substantial new tax provisions which will have a significant influence on the overall profitability of most real estate investments. Those provisions of the new Income Tax Act which will have the greatest effect on real estate investments are examined in this thesis, and, wherever possible, these provisions are contrasted with those of the old Act. Also, numerous examples are presented to demonstrate the impact of the various provisions on real estate investments and investors.

Each chapter in this thesis examines, analyzes and makes a conclusion as to the effect of the various income tax provisions on real estate investments and real estate investors. Chapter 1 provides a background of the history, structure, and administration of the income tax system in Canada. Who is taxable, what income is taxable and how is this income taxed are questions answered in this chapter. Chapter 2 examines the tax treatment of income derived from the ownership and operation of real property. Capital cost allowance, tax shelters, disallowable expenses and hobby farms are discussed. Chapter 3 is devoted to an examination of the most revolutionary new income tax provision -- the taxation of capital gains. The new rules are discussed which categorized the property yielding the capital gain into capital property, depreciable property, or personal-use property, all of which have different rules for the computation of the taxable gain or loss. Included in this chapter, also is the examination of the transitional provisions for capital gains on property owned prior to the enactment of the new
Income Tax Act. Chapter 4 examines the special provisions relating to involuntary dispositions, options, non-arm's length transactions and tax free rollovers.

Overall, the conclusion of the thesis is that the new Income Tax Act has eliminated or greatly restricted many of the tax provisions which provided great benefits to real estate investors in the past. The tax shelter aspects of the capital cost allowance provisions have been mainly eliminated. Capital cost allowance that is recaptured on rental buildings costing $50,000 or more can no longer remain tax free in capital cost allowance pools. The new capital gains provisions have made gains on property appreciation no longer free from income taxes. These gains are frequently substantial in a country where continual inflation and population growth have stimulated a rapid rise in real property values. Provisions which enabled a taxpayer to transfer property, which has appreciated in value, to related persons, without incurring tax on the capital gain or on prior capital cost allowance claimed, no longer exist except for transfers by a taxpayer to his spouse. A taxpayer can temporarily defer the taxation of capital gains by transferring his property to a controlled corporation or his spouse, however all capital gains and capital cost allowance recaptures will eventually be subject to income taxes upon the death of the taxpayer or his spouse.

Under the new Income Tax Act, the real estate investor must face fewer deductible expenses, fewer tax shelters, and eventually much higher taxes.
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CHAPTER 1
INCOME TAXES IN CANADA
HISTORY

Canada's first introduction to income tax legislation at the federal level occurred in 1917 with the passage of the Income War Tax Act designed principally to assist the country to finance the war effort. Prior to that time, the federal government was relying upon customs and excise taxes to provide taxation revenue.

Under the provisions of the Income War Tax Act, corporations were taxed at 4% and personal income was taxed on a graduated scale of 4% to 25%. By 1919, the rates had risen to 10% for corporations and 4% to 65%, graduated, for individuals.

Each year various modifications were added, creating an unwieldy body of amendments, so that by 1945 the need for revised tax legislation was recognized. In 1948, Parliament passed the Income Tax Act which codified the old act as well as introducing major amendments.

Modifications to the new act continued each year and in 1952 the Income Tax Act was revised again.

By 1962, with the recognition of continuing defects in the income tax system, a Royal Commission on Taxation (Carter Commission) was established to investigate the entire field of taxation. The Commission's findings were published in 1967 in a six volume report recommending extensive revisions to the Canadian income tax structure. Working on the basis of the report and subsequent submissions by the public, the government published the White Paper on Tax Reform on November 7, 1969, which stated the government's proposed changes to the income tax system.

Following numerous public hearings and submissions causing modifications to the proposed tax legislation, it was presented to the House of Commons on June 30, 1971 as
Tax Reform Bill C-259, an Act to amend the Income Tax Act. After several legislative changes, the bill was given Royal Assent on December 23, 1971 and thereby became the new Canadian Income Tax Act.
ADMINISTRATION OF THE INCOME TAX SYSTEM

In Canada, the federal government and the ten provincial governments have been granted the authority under the British North America Act of 1867 to impose a direct tax on income. Section 91.3 of the British North America Act grants to the Parliament of Canada the exclusive authority in Canada on all matters coming within "the raising of money by any mode or system of taxation". Section 92.2 of the same Act grants the provincial legislatures the powers to make laws in relation to matters coming within "direct taxation within the province in order to the raising of a revenue for provincial purposes". The provinces have all imposed income taxes, but, with the exception of Ontario's corporation income tax and Quebec's corporation and personal income tax, the provinces have delegated the responsibility of administering and collecting their income taxes to the federal government.

The federal government agency which administers the Income Tax Act is the Taxation Division of the Department of National Revenue. This Division which is headed by a Deputy Minister has its head office in Ottawa and has 28 district offices headed by District Directors across Canada. These District Offices administer the income tax returns filed in their area and negotiate with the taxpayers in their jurisdiction.

The Income Tax Act constitutes only part of the law which governs the application of income taxes in Canada. Section 221.1 of the new Income Tax Act stipulates that the Governor in Council may make regulations which facilitate the carrying out of the purposes and provisions of the Act. These regulations expand and clarify the sections of the Income Tax Act. A further important
body of law relating to income taxes is judicial law embodied in decisions made by the courts of the land. These judicial decisions can not take priority over the statutory law of the Income Tax Act and the Income Tax Act Regulations but they are important in interpreting the meaning of these statutory laws. Decisions rendered by the Department of National Revenue - Taxation against a taxpayer must conform to the Income Tax Act and the Income Tax Act Regulations as interpreted by the judicial system.
STRUCTURE OF THE NEW INCOME TAX ACT

The new Income Tax Act which became effective January 1, 1972 is a comprehensive federal statute which is divided into 17 parts which are in turn divided into 257 sections as is shown in Table 1.1.

Part I of the Income Tax Act contains the general tax provisions which stipulate who is taxable, what income is taxable, how income taxes are calculated, and the manner in which income taxes are paid in Canada. Parts II to IX describe special taxes which are imposed on corporations. Parts X to Xlll describe the tax treatment of special types of income. Provisions for an additional tax on corporations is contained in Part XlV. Parts XV to XVll describe the administration, interpretation and enforcement provisions of the new Income Tax Act.
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LIABILITY FOR TAX

According to Section 2.1 of the new Income Tax Act, income taxes shall be levied upon the taxable income of every person resident in Canada. This taxable income includes income for the year from all sources inside and outside Canada and includes income from all businesses, property, offices, employments, and net taxable capital gains (3)\textsuperscript{1}. A person is defined in the Act to include individuals and corporations and the legal representatives of these entities (248.1).

An individual is deemed to be a resident of Canada if he sojourned in Canada during the year for 183 days or more or was an employee of the government or of certain prescribed international organizations (250.1). A corporation is deemed to be a resident of Canada if incorporated in Canada after April 26, 1965 or has carried on business in Canada (250.4).

A non-resident person is subject to Canadian income taxes on his taxable income earned in Canada if he was employed in Canada, carried on business in Canada, or disposed of a taxable Canadian property at any time in the year or a previous year (2.3).

\textsuperscript{1} Indirect reference to specific sections of the new Income Tax Act in this paper will be made by including the number of the section in parentheses at the end of the passage. References to sections of the old Act will be done in the same manner except that the section number will be preceded by the letters O.A.
TAXABLE INCOME

Taxable income of a taxpayer for a taxation year is his income for the year minus certain deductions permitted by the Income Tax Act. The basic format for determining taxable income is shown in Table 1.2. The Canadian tax system computes taxable income in two stages. The first stage determines "income for the year" which is the aggregate of income from all sources less special deductions allowed by the Act and less those losses which are not restricted by the Act. The resulting "income for the year" is then used as the basis from which certain prescribed deductions may be taken in order to arrive at the "taxable income" for the year. Deductions, exemptions, and the treatment of losses available to a taxpayer vary greatly according to the source of the income and the nature of the taxpayer who earns the income.

The source of income is often important in determining which expenses or deductions from income will be allowable under the Income Tax Act. The new Act differentiates between five sources of income as follow:

Income from - 1.Office  
2.Employment  
3.Business  
4.Property  
5.Taxable capital gains

Income from office or employment is usually easy to segregate in that it includes salaries, wages, and other remuneration received by a taxpayer for occupying an office or acting as an employee for others (5.1). Differentiating between business and property income is usually much more difficult.
Table 1.2
Basic Flow Chart for Determining Taxable Income

Add: Income from-
   Business and property
   Office and employment

   Excess of taxable capital gains over allowable capital losses

Less: Special Deductions

Less: Losses from-
   Business and property
   Office and employment

Equals: Income for the Year

Less: Charitable donations,
   medical expenses, etc.

Less: Losses from other years

Less: Personal Exemptions

Equals: Taxable Income
Business and Property Income

A taxpayer who actively manages a rental property that he owns would usually be deemed by the taxing authorities to be earning business income from a property owned and actively managed by him. Whereas a taxpayer who engages a property manager to operate his property and who only receives the net income from his property would be deemed to be earning property rather than business income. The tax treatment afforded the taxpayer who is earning business income from rental property could be very different from that accorded a taxpayer who only receives property income. Due to the difficulty in differentiating between property and business income, the courts have been called upon frequently to determine whether or not a taxpayer's income is from a business or from property.

Generally however, Section 248.1 defines income from a business to be income derived from "a profession, calling, trade, manufacture or undertaking of any kind whatever and includes an adventure or concern in the nature of trade but does not include an office or employment". Business income includes the revenue generated by the business less those expenditures which must be incurred to earn that revenue and which are allowable under the provisions of the Act. Under normal circumstances, the business expenses which are allowable under the Act correspond to the common business and accounting interpretation of business expenses. Thus, wages and salaries of employees, advertising, promotion, and office expenses of the business are normally deductible in full. Depreciation on capital property used in the business is also deductible to the extent permitted by the capital cost allowance regulations.

Property is defined by Section 248.1 to mean "property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes a right of any kind whatever, a share
or a chose in action, and unless a contrary intention is evident, money". Property income includes the revenue earned by property less those expenditures which must be incurred to generate that revenue and which are allowable by the Act. Property income is differentiated from business income by the fact that property income is derived basically from the employment of capital property whereas business income is normally derived from the employment of both labor and capital. Labor intensive expenses which would qualify as allowable business expenses may not qualify as allowable expenses incurred to earn property income. Thus a salary paid to the owner of a revenue property which is managed by others would undoubtedly be disallowed as an expense of the property.

Taxable Capital Gains

The last major source of taxable income is from taxable capital gains. The taxation of capital gains is the most significant income tax change included in the new Act. Prior to the new Act, capital gains were not subject to income taxes. Basically the new Act subjects one half of all capital gains to the normal rates of taxation except for certain windfall gains like winnings from sweepstakes and games of chance which continue to be exempt from tax (40.2.f). However, since capital gains enjoy preferential tax treatment, it will still be important to a taxpayer to be able to designate that portion of his income which is a capital gain.

The tax free status of capital gains in the past has resulted in frequent judicial cases in order to determine whether or not a taxpayer's income has been derived from capital gains or from some other source of income like business or property. Since the new Act has only changed the tax status of a capital gain and not its definition, this extensive judicial law will continue to be used in determining whether or not income is from a capital gain. The expectation
of capital gains has been a prime motive for many taxpayers to invest in real estate and many of the cases relating to capital gains have involved real estate transactions. The importance of capital gains to real estate investors and the lack of a universal definition of a capital gain necessitates an examination of several judicial cases in order to generally understand the nature of capital gain.

An important distinguishing feature of a capital gain transaction is the intention of the taxpayer in the purchase and/or sale of a property. If it is apparent that the taxpayer purchased a property to earn rental income or for some other reason then to dispose of it for a capital gain, then a gain on the subsequent disposition will be deemed a capital gain. For example, a taxpayer was judged to have realized a capital gain which arose from his acceptance an unsolicited offer for an apartment house that he had constructed for investment purposes.²

The intention must however be supported by the entire course of conduct of the taxpayer in buying, holding and eventually selling the property in addition to the taxpayer's statement of his intention in acquiring the property. Thus, a taxpayer who bought 32 acres of land to build his home on part of it and who subsequently subdivided the remainder of his property into lots was held not to have realized a capital gain. Irregardless of his original intention in acquiring the land, the subsequent course of conduct of the taxpayer showed that his intention had changed to one of an adventure in the nature of trade which earns taxable income and not capital gains.³

² B.C.W. Investments, 64 D.T.C. 4.
A secondary intention of a taxpayer may however prevent a gain on disposition from being deemed a capital gain. Thus if the courts decide that a taxpayer, in acquiring a property for investment also had a secondary intention of selling the property for a gain, then such a gain would not be deemed a capital gain. For example, in 1952 Bayridge Estates Ltd. purchased a parcel of land for a motel and service station which they intended to hold as an investment. Financial difficulties prevented the company from achieving its investment objective so the property was sold for a gain. The court decided that since the company in acquiring the property had also considered that its sale for a gain was an alternative course of action to development deemed the gain not to be a capital gain.4

A second distinguishing characteristic of a capital gains transaction is the relationship of the transaction to the taxpayer's business. A taxpayer who realizes a gain from a transaction which requires the skill and knowledge that he uses in his business is unlikely to be deemed a capital gain. Thus a contractor with extensive experience in real estate who bought a poultry farm which he subdivided into three parcels after unsuccessfully operating the farm for several months was not deemed to have realized a capital gain.5

The amount of the taxpayer's time and effort required to complete a transaction may also be considered by the courts in determining whether or not a capital gain has been realized. Thus a retired school teacher who purchased lakeshore property and who sold lots for a summer cottages over a period of 20 years was held to have earned a taxable income - not capital gains.6

Finally, the nature of the transaction may determine whether or not a gain is a capital gain. The gain on a transaction which appears to be an adventure or concern in the nature of trade will not be deemed a capital gain. Thus if a taxpayer frequently engages in much the same type of transaction, it is likely that such transactions will be considered as trading transactions which are taxable at the normal rates. Thus, a dealer in milk and livestock who purchased a farm and then engaged in a continuous series of real estate transactions including buying, selling, exchanging, sub-dividing and building was held to be earning taxable income - not capital gains. However, even a single transaction which is carried out in the same way as a transaction of an adventure in the nature of trade may result in the gain on the transaction being deemed taxable income. For example, a taxpayer who purchased a farm for his own use was held to be earning taxable income when he systematically sub-divided the farm and sold the lots.

SUMMARY

The income tax system in Canada applies a direct tax on the income of every person resident in Canada. The Income Tax Act, the Income Tax Act Regulations and the tax cases of the judicial system provides the legal framework upon which the income tax system is based. Income taxes have been instituted by the federal government and the ten provincial governments but the federal government, through its Department of National Revenue - Taxation, administers the income tax system for all of Canada except Quebec and corporations in Ontario.

Income taxes are applied to the taxable income of a taxpayer. Taxable income includes all the income of a taxpayer from property, businesses, offices, employments, and taxable capital gains. Depending of the source of the income, certain expenses and deductions are permitted to be taken from income by the taxpayer in order to ascertain his taxable income.
CHAPTER 2
INCOME PROPERTY INVESTMENTS

A major reason that individuals invest in real property is to earn a regular income from their invested capital. Unlike other income producing investments, real property is a more tangible investment which requires considerably more management and entrepreneurial effort on the part of the investor. In addition, real property investments are subject to many unique provisions of the Income Tax Act. This chapter will examine those tax provisions which have the greatest effect on the income and ownership of income property.
PROPERTY INCOME

Income earned on property is subject to the normal rates of taxation. Property income for tax purposes generally corresponds with the property profit determined in accordance with normal business and accounting practices. Revenue earned by the property is recognized for tax purposes in the year that it is deemed to have been earned whether or not actual receipt occurs in that year (12.1). Expenses which have been incurred for the purpose of gaining or producing that revenue are allowable deductions for tax purposes (18.1.a). Allowable expenses therefore normally include the following:

- salaries and wages of employees operating property
- repairs and maintenance
- property taxes
- interest on borrowed money (20.1.c)
- reserve for doubtful receivables (20.1.1)
- landscaping the grounds (20.1.aa)

Reserves for expected repair and maintenance expenditures are not allowable for tax purposes until the actual repair is made (18.1.e). Although expenditures made to repair and maintain the property are allowable in the year of incurrence, expenditures which improve or extend the life of a property, called capital expenditures, are not allowable expenses of that year (18.1.b). These capital expenditures must be added to the capital cost of the property.

The most important difference between property income for tax purposes and the businessman's concept of income occurs with the tax treatment of depreciable assets. Buildings and other improvements to land are wasting assets which physically deteriorate and become functionally obsolete over time. The systematic allocation of their cost
against the revenue earned by these assets is accounted for by depreciation expense in the business accounts. However this depreciation expense used for book purposes is not an allowable expense for tax purposes. Specific provision has been made in the income tax legislation whereby the cost of depreciable property is allocated to the revenue earned by it through the capital cost allowance provisions of the Act and its Regulations. The Regulations divide depreciable assets into 26 different classes. Each class contains assets of a similar nature and designates a particular rate at which the assets may be claimed as a deduction for tax purposes. For most classes, the rate, a fixed rate of percentage, is applied to the declining or diminishing balance in that particular class. This amount is the maximum capital cost allowance that the taxpayer may claim for that asset class in a given year. As the undepreciated capital cost (U.C.C.) of the class declines over time, the absolute amount of capital cost allowance (C.C.A.) that can be claimed in any year also declines as is shown in Example 2.1.

Example 2.1
Calculation of Capital Cost Allowance

Assumptions:
Cost of rental property:
  Land $100,000
  Building (Class 6 - 10%) $250,000
$350,000

Calculation of capital cost allowance:

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<th>Year 3</th>
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<td>U.C.C., beginning of year</td>
<td>$250,000</td>
<td>$225,000</td>
<td>$202,500</td>
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<tr>
<td>Maximum C.C.A. claimed (10%)</td>
<td>25,000</td>
<td>22,500</td>
<td>20,250</td>
</tr>
<tr>
<td>U.C.C., end of year</td>
<td>$225,000</td>
<td>$202,500</td>
<td>$182,250</td>
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It is important to note in Example 2.1 that capital cost allowance is only taken on the cost of the building which
is the depreciable portion of the rental property. Land is never considered a depreciable asset for tax purposes.

The capital cost allowance classes which are most relevant to income property are as follows:

<table>
<thead>
<tr>
<th>Class</th>
<th>Types of Structure</th>
<th>C.C.A. Rate</th>
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<tr>
<td>3</td>
<td>Stone, steel, concrete or brick structures</td>
<td>5%</td>
</tr>
<tr>
<td>6</td>
<td>Log, stucco, frame, galvanized or corrugated iron structures</td>
<td>10%</td>
</tr>
<tr>
<td>8</td>
<td>Furniture and equipment</td>
<td>20%</td>
</tr>
</tbody>
</table>

Provided that it is within the maximum amount authorized, the amount of capital cost allowance which may be claimed in any one year is at the discretion of the taxpayer. The taxpayer may reduce the amount claimed from time to time, and in any one year, he may take no capital cost allowance should it be advantageous to him.

Apart from the special capital cost allowance provision of the Act and certain restrictive provisions relating to such items as reserves for repairs and maintenance, property income for tax purposes is basically the same as the business-men's concept of property profit. Example 2.2 demonstrates the technique by which a statement of property income is converted to a statement of taxable property income.

Income taxes must be paid on the income for tax purposes of Pacific Apartments of $500 even though the income for book purposes was $7,000. As can be seen in example 2.2, the difference between the income for book purposes of $7,000 and the income for tax purposes of $500 is mostly due to the difference between the capital cost allowance claimed of $12,500 and the depreciation expense of $5,000.
Example 2.2
Pacific Apartments
Statement of Income for Tax Purposes
1972

Rental revenue $ 50,000

Expenses:

Mortgage interest $ 20,000
Property taxes 5,000
Utilities 4,000
Caretaker 3,000
Management 1,600
Insurance 400

Reserve for repairs and maintenance 4,000
Depreciation (2% of cost per year) 5,000 43,000

Income for book purposes 7,000

Add: Reserve for repair and maintenance 4,000
Depreciation 5,000 9,000

Less: Outlays for repairs and maintenance 3,000
Capital cost allowance claimed 12,500 15,500

Income for tax purposes $ 500

Capital Cost Allowance Schedule:

U.C.C., beginning of year $250,000
Less: C.C.A. claimed (Class 3 - 5%) 12,500
U.C.C., end of the year $237,500
AN IMPORTANT CAPITAL COST ALLOWANCE RESTRICTION

Under the provisions of the old Income Tax Act, the undepreciated capital cost of the properties of the same class were pooled together into one undepreciated capital cost account. The capital cost allowance rate was applied to this aggregate amount irregardless of whether or not the properties originally composing the undepreciated capital cost account continued to be owned by the taxpayer as long as he still owned at least one of the properties. The undepreciated capital cost account of each class of depreciable assets was increased or decreased in the following manner:

1. The capital cost of depreciable assets were added to the pool of undepreciated capital cost of their particular class in the year of purchase.

2. In a year of disposal, the proceeds of disposition of each depreciable asset were deducted from their class pool. If however the proceeds exceeded the original capital cost of the depreciable asset, then this excess, called a capital gain, was excluded from the proceeds that were deducted from the pool.

3. If all of the depreciable assets of a particular class have been sold or no longer exist, then the remaining undepreciated capital cost of that class would be completely deductible as a terminal loss of the taxpayer.

Example 2.3 demonstrates the accounting treatment of the capital cost allowance system under the old Act and highlights the following characteristics of that system.

1. The maximum capital cost allowance could be claimed on additions acquired during the year irregardless of when they were acquired. Thus, even if an asset...
Example 2.3
Accounting for Capital Cost Allowance under the old Act

<table>
<thead>
<tr>
<th></th>
<th>Class 6(10%) Assets</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Bldg A</td>
<td>Bldg B</td>
<td>Bldg C</td>
</tr>
<tr>
<td><strong>Year 1:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.C.C., beginning</td>
<td>$250,000</td>
<td>$250,000</td>
<td></td>
<td>$300,000</td>
</tr>
<tr>
<td>Additions</td>
<td>300,000</td>
<td>250,000</td>
<td></td>
<td>300,000</td>
</tr>
<tr>
<td>Less: C.C.A. claimed</td>
<td>55,000</td>
<td>25,000</td>
<td></td>
<td>30,000</td>
</tr>
<tr>
<td>U.C.C., end of year</td>
<td>$495,000</td>
<td>$225,000</td>
<td></td>
<td>$270,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Year 2:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.C.C., beginning</td>
<td>$495,000</td>
<td>$225,000</td>
<td></td>
<td>$270,000</td>
</tr>
<tr>
<td>Additions</td>
<td>400,000</td>
<td>225,000</td>
<td></td>
<td>400,000</td>
</tr>
<tr>
<td>Proceeds of disposition</td>
<td>(250,000)</td>
<td>225,000</td>
<td>20,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Less: C.C.A. claimed</td>
<td>64,500</td>
<td>22,500</td>
<td></td>
<td>2,000</td>
</tr>
<tr>
<td>U.C.C., end of year</td>
<td>$580,500</td>
<td>$202,500</td>
<td></td>
<td>$18,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Year 3:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.C.C., beginning</td>
<td>$580,500</td>
<td>$202,500</td>
<td></td>
<td>$18,000</td>
</tr>
<tr>
<td>Proceeds of disposition</td>
<td>(250,000)</td>
<td>(47,500)</td>
<td></td>
<td>18,000</td>
</tr>
<tr>
<td>Less: C.C.A. claimed</td>
<td>33,050</td>
<td>1,800</td>
<td></td>
<td>36,000</td>
</tr>
<tr>
<td>U.C.C., end of year</td>
<td>$297,450</td>
<td>($42,750)</td>
<td></td>
<td>$16,200</td>
</tr>
</tbody>
</table>

was acquired the last day of the year, the maximum capital cost allowance could be claimed in that year.

2. In year 2, Building B was sold for $250,000 which was $20,000 less than its undepreciated capital cost of $270,000. This $20,000 however remained in the class pool to be subjected to capital cost allowance of future years.

3. In year 3, Building A was sold for its original capital cost of $250,000 which was $47,500 above its undepreciated capital cost of $202,500. This $47,500 of recovered capital cost allowance continued to remain as a reduction in the class pool balance and would be amortized over future years.

4. As a result of the pooling of depreciable assets of the same class, the undepreciated capital cost of the class 6 properties is $297,450 in year 3 even though the undepreciated capital cost of the only existing property (Building C) in that class is $324,000.

Generally, the system of aggregating depreciable properties into pools for capital cost allowance purposes is continued under the provisions of the new Act. However one change in the provisions has had a major effect on real estate investors. The new provision of the Act states that each depreciable property costing $50,000 or more whose prime purpose is to earn rental income must be segregated into a separate capital cost allowance class. Consequently capital cost allowance that is recaptured through sales proceeds in excess of undepreciated capital cost in the year of disposition will now be subject to income taxes in that year rather than being carried forward in a capital cost allowance pool. The comparative effect of this new
income tax provision can best be demonstrated in Example 2.4 by applying it to the circumstances described in Example 2.3.

Each rental building in Example 2.4 has a capital cost of $50,000 or more. Consequently, each of the rental buildings constitutes a separate undepreciated capital cost account. Buildings which are sold during the year must have their undepreciated capital cost accounts eliminated for tax purposes in the following manner:

1. Where proceeds of disposition are less than the undepreciated capital cost of a building, a terminal loss results. Rental Building B in Example 2.4 had a terminal loss of $20,000 in year 2. This terminal loss is deductible in full from the taxpayer's income for that year.

2. Where proceeds of disposition exceed the undepreciated capital cost of a building, recapture of previously claimed capital cost allowance occurs.

In Example 2.4, Rental Building A resulted in a $47,500 recapture of capital cost allowance in year 3. The amount of this recapture must be included in the income of the taxpayer in the year of disposition. The owner of Rental Building A would have his taxable income increased by $47,500 in year 3.

3. If the proceeds of disposition exceed the original capital cost of the building, then the amount of the excess which is a capital gain is excluded from the proceeds which are deducted from the undepreciated capital cost of the building. This capital gain is accounted for separately for income tax purposes.

This capital cost allowance restriction over rental buildings which cost $50,000 or more applies to such buildings acquired by a taxpayer after 1971 except where
construction of the building commenced prior to 1972. Again, it is important to reiterate that this restriction applies only to depreciable property whose primary purpose is to earn rental income. Buildings owned by their occupants and used to earn income other than rental income are not affected by this restriction under the new Act.
# Example 2.4

**Accounting for Capital Cost Allowance under the new Act**

<table>
<thead>
<tr>
<th>Year</th>
<th>Rental Bldg A</th>
<th>Rental Bldg B</th>
<th>Rental Bldg C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year 1:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.C.C., beginning of year</td>
<td>$250,000</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td>Additions</td>
<td>250,000</td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td>Deduct: C.C.A. claimed (10%)</td>
<td>25,000</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>U.C.C., end of year</td>
<td>$225,000</td>
<td>$270,000</td>
<td></td>
</tr>
</tbody>
</table>

| Year 2: |               |               |               |
| U.C.C., beginning of year | $225,000 | $270,000 | $400,000 |
| Additions |             | (250,000) |               |
| Proceeds of disposition |             |             |               |
| Terminal loss |             | $20,000 |               |
| Deduct: C.C.A. claimed (10%) | 22,500 | 40,000 |               |
| U.C.C., end of year | $202,500 | $360,000 |               |

| Year 3: |               |               |               |
| U.C.C., beginning of year | $202,500 | $360,000 |               |
| Proceeds of disposition | (250,000) |             |               |
| Recapture of C.C.A. | $47,500 |             | $360,000 |
| Deduct: C.C.A. claimed (10%) |             |             | 36,000 |
| U.C.C., end of year |               | $324,000 |               |
This restriction over the claiming of capital cost allowance will have a major impact on the decisions of investors who own or are about to acquire depreciable rental property. With inflation and real property appreciation, a depreciable rental property can have a market value far in excess of its undepreciated capital cost over a period of a few years as Building A in Example 2.4 demonstrates. The owner of Building A must consider the fact that his current year's income would be increased by $47,500 if he sells the Building in Year 3. The higher income taxes that he will have to pay will reduce his cash available for another investment. In fact, he would not have sufficient cash after income taxes to buy a similar building with the same terms of purchase. Thus the owner of a depreciable rental building or an investor contemplating such a purchase must be prepared for the eventual prospect of paying a significant portion of the cash return resulting from the sale of the property as the income tax on the recaptured capital cost allowance. Consequently, owners of depreciable rental property may find themselves locked-in to retaining such properties because the income returns that they could expect on their residual cash investment after disposition would be less than the income generated by their currently held properties. Under the old Act, the capital cost allowance pools would often completely conserve the cash received upon the disposition of a depreciable property thereby enabling the acquisition of more or larger properties.

In addition to being locked-in to the continued ownership of depreciable rental buildings, an investor may be under a financial incentive to demolish his older rental buildings because of this new capital cost allowance restriction. If land values have risen rapidly, an owner of rental property may find that the land upon which the building is situated has a value which is close to the value of the property as a whole. If this was the case with the owner of Building B in Example 2.4, he could demolish the building and claim a
a terminal loss of $270,000 in Year 2. The tax savings which would result could more than compensate the owner for the loss of the income which would have been earned from the old rental building. Under the old Act, the undepreciated capital cost of the demolished building would have remained in the capital cost allowance pool to be amortized slowly over many future years. The immediate tax relief provided by the new Act by demolishing older buildings which occupy underutilized sites will likely accelerate the redevelopment of many urban areas even though the existing developments are structurally and economically sound. Thus, this new tax provision will likely stimulate a higher and better utilization of land especially land located in urban centres, but the new developments will require much greater revenues than were generated by the older developments. Consequently, the rental rate structures of an area will be greatly increased as the older buildings are replaced by newer and more expensive structures.

In conclusion, the restriction over claiming capital cost allowance on buildings costing $50,000 or more will likely deter many taxpayers from disposing of properties which have appreciated in value and will stimulate taxpayers to demolish the buildings which occupy underutilized sites.
REAL ESTATE INVESTMENTS AS A TAX SHELTER

A controversial aspect of the old Income Tax Act was that its provisions enabled taxpayers to reduce the income tax liability on their employment and business income by creating paper losses for tax purposes on their property investments. By claiming capital cost allowance in excess of rental income, a property loss for tax purposes was created even if the property had generated a cash income for the year. This paper loss was then used to reduce other taxable income and therefore the income taxes of a taxpayer. According to the provisions of the new Income Tax Act, this avenue of tax reduction is to be closed. Losses created by claiming capital cost allowance on rental property will no longer be deductible from non-rental income of an individual taxpayer. The impact of this new tax provision is demonstrated in Example 2.5.

Example 2.5 demonstrates that under the provisions of the old Act, a taxpayer could shelter his other income from income taxes to the extent of $22,500 - the amount of the rental loss for tax purposes. In so doing, a taxpayer in a high marginal tax rate of 60% could reduce his overall tax liability by a substantial $13,500. The apartment which yielded a nominal before tax cash return of only 2.5% is an attractive real estate investment to a taxpayer in a 60% tax bracket in that his cash return after taxes from the apartment was 16% under the old Act. Under the new tax provisions, a capital cost allowance on rental properties can not be used to create losses which reduce non-rental taxable income. In Example 2.5, capital cost allowance of only $2,500 can be claimed which reduces rental income to zero but does not create any deductible losses for tax purposes.
Example 2.5
Tax Shelter Provisions
under the old and new Acts

Assumptions:
1. Marginal tax rate of taxpayer is 60%.
2. Taxpayer's equity in an apartment is $100,000.
3. Undepreciated capital cost of apartment building is $250,000.
4. Rental income of the apartment before claiming capital cost allowance is $2,500.

<table>
<thead>
<tr>
<th></th>
<th>Old Act</th>
<th>New Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental loss for tax purposes:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rental income before claiming C.C.A.</td>
<td>$2,500</td>
<td>$2,500</td>
</tr>
<tr>
<td>C.C.A. claimed</td>
<td>25,000</td>
<td>2,500</td>
</tr>
<tr>
<td>Rental loss for tax purposes</td>
<td>$22,500</td>
<td>Nil</td>
</tr>
</tbody>
</table>

Taxpayer's cash return for the year:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental income before C.C.A.</td>
<td>$2,500</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

Application of rental loss for tax purposes against other income of the taxpayer reduces the overall income tax liability of the taxpayer:

- 60% of $22,500: 13,500
- 60% of Nil: Nil

Cash return for the year:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash return for the year</td>
<td>$16,000</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

Cash return to owner's equity of $100,000:

- 16%: 16,000
- 2.5%: 2,500
Although losses created by claiming capital cost allowance on rental properties can not be used to reduce non-rental taxable income, they may however be used to reduce the taxable income of other rental properties as is shown in Example 2.6.

In Example 2.6, the rental loss of $15,000 of Building A, which was caused in part by claiming capital cost allowance, can be used to reduce the taxable rental income of Building B and Building C. Generally, the capital cost allowance that can be claimed on a taxpayer's rental buildings is limited by the established capital cost allowance rates as well as being limited to the net rental income from those buildings prior to claiming capital cost allowance. This provision prevents the utilization of rental losses created by capital cost allowance to eliminate other rental income and then using actual rental losses to reduce other non-rental income.

In Example 2.6, the actual rental loss of $5,000 of Building A can not be preserved by utilizing the additional $5,000 of capital cost allowance which could otherwise be claimed on Building A. However, if Building A had been the only rental property of the taxpayer, then without claiming any capital cost allowance, the taxpayer could have used the actual rental loss of $5,000 to reduce his non-rental taxable income.
Example 2.6
Application of Rental Losses to Rental Income

Assumption:
1. Taxpayer owns 3 buildings which he uses to earn rental income.

<table>
<thead>
<tr>
<th></th>
<th>Bldg A</th>
<th>Bldg B</th>
<th>Bldg C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental revenue</td>
<td>$30,000</td>
<td>$50,000</td>
<td>$60,000</td>
<td>$140,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>35,000</td>
<td>40,000</td>
<td>45,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Rental income (loss)</td>
<td>(5,000)</td>
<td>10,000</td>
<td>15,000</td>
<td>20,000</td>
</tr>
<tr>
<td>C.C.A. claimed</td>
<td>10,000</td>
<td>5,000</td>
<td>5,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Rental income (loss) for tax purposes</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$ (15,000)</td>
<td>$ 5,000</td>
<td>$10,000</td>
<td>Nil</td>
<td></td>
</tr>
</tbody>
</table>

Undepreciated capital cost of buildings $300,000 $100,000 $100,000

Maximum C.C.A. allowable (5%) $15,000 $5,000 $5,000
The elimination of this tax shelter will have a major effect on real estate investors who earn high non-property income and on some forms of real estate. Under the old Act, real estate investors like doctors, lawyers and executives who earned high employment or business incomes found certain forms of real estate like frame apartments to be highly attractive investments, not because of their ability to generate income, but because of the savings in income taxes which resulted from claiming capital cost allowance on them. As was shown in Example 2.5, a high income taxpayer could earn an excellent cash return from an otherwise poor investment because of the tax provisions of the old Act. Under the new Act, this tax shelter has effectively been eliminated for all real estate investments. Consequently high income taxpayers will direct their financial resources into other investments which may continue to provide some form of tax shelter like some classes of machinery and equipment used in manufacturing or into those forms of real estate which earn good returns. The forms of real estate which provided substantial tax shelters in the past, like frame apartments, will be much less attractive investments until they generate substantially higher incomes. Thus over the short term, real estate which created tax shelters will undergo a relative decline in market value and new construction will be greatly reduced. The lack of construction of new frame rental apartments in 1972 and 1973 demonstrates this effect. Over the long term, the economic forces of supply and demand will raise the incomes of these formerly tax shelter investments to competitive levels in order to stimulate new construction. The rise in rental income and therefore rents of some forms of real estate like frame apartments could be substantial. For example, if a competitive return for the apartment in Example 2.5 is 12.5% on the owner's equity of $100,000, then the annual rental income must rise by $10,000.
If this apartment had an annual gross rental income of $40,000, then its rents must rise by 25% to provide a competitive return to this apartment.

In conclusion, the elimination of this income tax shelter has redirected the investment capital of many high income individuals away from certain forms of real estate especially frame apartments. Over the short term, the market value of these forms of real estate will likely decline because of the lack of investor interest. Over the long term, the forces of supply and demand for these forms of real estate will cause rental rate increases of a sufficient magnitude to make these properties attractive once again to investors.
RECAPTURED CAPITAL COST ALLOWANCE

Extensive income taxes can be deferred by a taxpayer over the years by claiming capital cost allowance on his depreciable property at or near the maximum allowable rate each year. Since the amount of capital cost allowance claimed does not have to reflect the actual decline in value of a property, the maximum rate of allowance can be claimed irregardless of the actual decline, if any, in value. It therefore follows that the undepreciated capital cost bears no relation to economic value.

However the avoidance of income taxes by claiming capital cost allowance is only temporary. Upon disposition of the property, any excessive capital cost allowance claimed in the past is fully taxable in the year of disposition. Example 2.7 demonstrates the income tax consequences of recaptured capital cost allowance.

Over the 10 years, the taxpayer in Example 2.7 has been able to reduce his taxable income by $10,000 each and every year by claiming excessive capital cost allowance. If the taxpayer had a marginal tax bracket of 50%, he has been able to defer $50,000 of income taxes over the 10 years which would have been payable otherwise. However disposition of the building in year 10 has resulted in a recapture of $100,000 of capital cost allowance which is taxable in full in year 10. Adding $100,000 to the taxpayer's income in year 10 may however put him into a marginal tax bracket of perhaps 70% which means that income taxes of $70,000 would have to be paid on the recapture in year 10 even though only $50,000 of income taxes were deferred. In order to alleviate the tax burden on such substantial capital cost allowance recaptures, special provisions were made in the old Act and have also been included in the new Act.
Example 2.7
Recapture of Capital Cost Allowance

Assumptions:
1. On January 1 of year 1, taxpayer acquires apartment building for $250,000.
2. Taxpayer claims maximum capital cost allowance each year which is $10,000 more than the actual decline in value.
3. Apartment building is sold on December 31 of year 10 for $200,000.

Recapture of Capital Cost Allowance:

\[
\begin{align*}
\text{U.C.C., beginning of year 1} & \quad \$250,000 \\
\text{C.C.A. claimed over 10 years} & \quad 150,000 \\
\text{U.C.C., end of year 10} & \quad 100,000 \\
\text{Proceeds of disposition} & \quad 200,000 \\
\text{Recapture of C.C.A.} & \quad \$100,000
\end{align*}
\]
Under the old Act, many capital cost allowance recaptures could be protected by the capital cost allowance pooling system. Capital cost allowance was based on the undepreciated capital cost of a class of assets so that the disposition of one of the assets for proceeds in excess of its undepreciated capital cost would only reduce the capital cost of the class. Recapture would not occur unless the capital cost of the class became a negative balance. An expanding real estate investment program could avoid income taxes on its recaptures for years under the old Act. However if circumstances did result in a substantial recapture of capital cost allowance which was currently taxable, then Section 43 of the old Act permitted this recapture to be averaged over a maximum of 5 previous years. Instead of being taxed at the high marginal tax rates, the recapture was taxed as if it had been realized in equal portions over the preceding 5 years. The resulting tax rate on the recapture would only be slightly higher than the taxpayer's normal marginal rate.

Under the provisions of the new Act, a taxpayer has three averaging options for the tax treatment of recaptured capital cost allowance. These provisions will be utilized to a much greater extent than the averaging provision under the old Act. The reason for this is that taxable recaptures are likely to be much more prevalent under the new Act because depreciable rental properties that cost $50,000 or more must be segregated into separate capital cost allowance classes. Recaptured capital cost allowance which results from the disposition of these rental properties will no longer be allowed to be buried in class pools. The averaging provisions for recaptured capital cost allowance under the new Act are as follows:
1. The technique of averaging the recapture over a maximum of 5 years which existed under the old Act can still be elected to be used by a taxpayer until 1975 (I.T.A.R. 42). Only individual taxpayers may utilize this transitional provision.

2. The new Act introduces a general averaging formula which is available to every Canadian resident individual whose income in a particular year is at least 10% greater than that of the immediately preceding year and at least 20% greater than the average of his income over the 4 preceding years (118). The income in excess of these qualifying limits will be taxed as though it had been earned over 5 years. The calculation of this general averaging formula will be automatically computed each year by the Tax Department. As a result of this general averaging provision, an individual with an inordinate rise in taxable income in any one year caused by a recapture of capital cost allowance will automatically benefit from averaging. However, an important exception to this general averaging results if the transitional provision described in 1 above is selected. In that case, general averaging will not be applicable.

3. Section 61 of the new Act provides a further means of averaging certain unusual income amounts including recaptured capital cost allowance. The tax on these amounts can be deferred by the purchase of a special income averaging annuity contract that meets certain conditions. The contract must be purchased from an authorized company and must be paid for by a single lump sum payment. An annuity payment must be made at least once a year and the first payment
must be made within 10 months of the contract
date. The term of the annuity can be either for the
life of the taxpayer or a guaranteed term not in
excess of 15 years. Finally, the guaranteed term
can not extend beyond the taxpayer's 85 birthday.
As the annuity payments are received, they must
be included in the income of the taxpayer. Thus,
this averaging provision enables the taxpayer to
spread the income tax liability of a capital cost
allowance recapture over many years. Also, the
election of this provision does not preclude the
application of the automatic averaging provision
described in 2 above. This provision can be very
advantageous to a taxpayer who is approaching
retirement. The proceeds of a recapture which are
otherwise taxable at high marginal rates due to the
taxpayer's high employment or business income
can be used to purchase an annuity whose future
payments will be taxable at the much lower rates
applicable to the taxpayer's retirement income.
Other taxpayers may not derive very much benefit
from this provision. To benefit from this provision,
a taxpayer must invest the entire amount of a taxable
recapture in the income averaging annuity.
Since this annuity may earn a relatively unattractive
return when compared to real estate investments, it
may not be a feasible alternative to an investor
who desires to maximize his investment returns.
Although provisions of the new Income Tax Act still enable a taxpayer to spread the income tax liability of a recapture of capital cost allowance over a number of years, the major advantage of the old Act of deferring the tax on a recapture by reducing the undepreciated capital cost of a pool of assets is no longer available to rental properties costing $50,000 or more under the new Act. Under the old Act, an expanding real estate investment portfolio could avoid paying any taxes on a recapture for years. The cash which would have been required to pay the tax could therefore be used over and over again to acquire more real estate and to earn more income. Under the new Act, income taxes incurred on a recapture of capital cost allowance must be paid immediately upon disposition or over a period of a few years as provided under the Act. In order for an investor to earn the same income from his investment capital, he will have to earn a higher rate of return on his cash equity since he is no longer able to earn a return on the cash which must be paid as income taxes on his recaptures of capital cost allowance. Therefore, real estate investments which benefited by this income tax deferral under the old Act must generate more income in order for them to be as attractive as investment under the new Act as they were under the old Act.
Land vs. Buildings Controversy

Recaptured capital cost allowance and the income taxes thereon can be very substantial for properties held for many years or where rapid appreciation of property values has occurred. Since most real estate investments consist of a non-depreciable component - land, and a depreciable component - buildings and equipment, the amount of recapture is dependent upon the allocation of the sales proceeds of the property between the depreciable and non-depreciable components. Income tax considerations are very significant when it is realized that land appreciation may be taxed as a capital gain whereas building appreciation may consist of fully taxable recaptured capital cost allowance. Upon disposition of a property which includes land and buildings, the taxpayer must make a reasonable allocation of the consideration received for his property between the depreciable property and the property that is not depreciable. This creates two major problems for most taxpayers when they sell their property. The first problem is that a reasonable allocation is often very difficult to make. The second problem is that the incentive to save tax dollars by minimizing the value of the depreciable property is very strong so that irregardless of how reasonable the allocation may be it is often disputed by the Tax Department.

The separation of the value of a building and the land upon which it is situated is often very arbitrary under the best of circumstances. An apartment has a certain value because of its physical structure and appearance, its age and its location. The value of the apartment as a
whole can often be well substantiated by many comparable apartments which are of a similar size, age and location. However, what portion of that value is attributable to the size, shape, exposure and location of the apartment site and what portion is attributable to the physical depreciable apartment is often only conjecture. A common technique of separating the value of the building from its land is to determine the value of the land as if it was vacant and then subtract this value from the value of the property as a whole. A major shortcoming of this residual method is that there is rarely very many vacant building sites with the same size, shape, exposure and location. Various valuation techniques are used to eliminate differences between comparable building sites but their application is often disputed even among experts. Because of the complexity of allocating consideration received for a property between its depreciable and non-depreciable components, a taxpayer would be well advised to consult a professional property appraiser whose expertise and well documented research will provide strong support for the taxpayer's allocation.

The second allocation problem is that due to the strong incentive for the taxpayer to undervalue the depreciable part of the property the Tax Department is likely to be suspicious of a taxpayer's allocation of consideration received for his property. Even with the allocation of the sales proceeds being implicitly stated in a contract between arms' length parties, the Tax Department will often require substantial evidence that the apportionment is borne out by facts. Often one of the arms' length parties may not be as concerned as the other party over the allocation of the sales proceeds. For example, the buyer of an apartment may not need to claim very much capital cost allowance in future years
so that understating the acquisition cost of the apartment building may not be important to him whereas the seller may save substantial amounts which would otherwise be payable as income taxes on recaptured capital cost allowance by undervaluing the building and overvaluing the land. In such a case, the Tax Department would likely require substantial evidence that the agreed upon allocation was reasonable. Generally however, a negotiated allocation by a seller who wishes to reduce the portion of the consideration paid for the depreciable property and by a buyer who wishes to maximize the amount of capital cost allowance which can be claimed in the future will likely be accepted by the Tax Department. Substantial evidence supporting an allocation will be required where the allocation is not part of an agreement or where the parties did not deal at arms' length. It is especially important that the taxpayer has substantial evidence and expert testimony supporting his allocation in order to counter evidence provided by the Tax Department.

In conclusion, a taxpayer is required by the Income Tax Act to allocate consideration received for a property between its depreciable and non-depreciable components. The impact of income taxes is often much more severe when the consideration is mostly allocated to the depreciable property because of the recapture of capital cost allowance. This allocation is often arbitrary and vulnerable to Tax Department criticism because the value of land and buildings is difficult to separate and there is a strong monetary incentive to undervalue the depreciable property. Therefore, a taxpayer is well advised to include an allocation clause as part of the agreement to sell his property and to be prepared to provide substantial evidence to support the allocation to the Tax Department and possibly to the courts which may have to adjudicate the dispute.
PROPERTY TAXES AND INTEREST ON UNDEVELOPED LAND

Section 18.2 of the new Act restricts the amount of interest and property taxes that can be deducted as expenses from revenue earned from undeveloped land. Interest and property taxes which can be expensed for tax purposes are limited to the amount of gross revenue from the land after all other carrying costs have been deducted. The purpose of this provision is to prevent a taxpayer from using interest and property taxes to create property losses which are used to reduce the tax liability on other income of the taxpayer, and then have the taxpayer claim a capital gain on disposition of the property which was tax free under the old Act and partially taxable under the new Act. Therefore, to prevent the carrying cost of owning property from being used to reduce income subject to the normal rates of taxation, this restrictive provision was enacted.

Section 18.2 applies to all undeveloped land except for land which is used as follows:
- part of the inventory of a business
- held for the purpose of carrying on a business
- held for the primary purpose of earning income therefrom
- used to support a building or in conjunction with a building (parking lot).

Interest and property taxes which can not be expensed for tax purposes may be added to the cost base of the land (53.1.h). Consequently, these disallowed carrying costs can be used to reduce the amount of any taxable gain or increase the amount of an allowable capital loss which arises from disposition of the land. The tax treatment afforded interest and property taxes on undeveloped land is demonstrated in Example 2.8.
**Example 2.8**  
**Interest and Property Taxes on Undeveloped Land**

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Rental revenue</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>General expenses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$200</td>
<td>$900</td>
<td>Nil</td>
</tr>
<tr>
<td><strong>Less: Interest</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Property taxes</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,500</td>
<td>2,000</td>
<td>3,000</td>
</tr>
<tr>
<td></td>
<td>300</td>
<td>500</td>
<td>600</td>
</tr>
<tr>
<td><strong>Rental losses</strong></td>
<td>$2,000</td>
<td>$2,900</td>
<td>$2,600</td>
</tr>
</tbody>
</table>

**Distribution of rental losses:**

- Rental losses not caused by interest and property taxes to be deductible from other income -  
  - $200 | $400 | Nil

- Rental losses caused by interest and property taxes to be added to cost base of the land -  
  - 1,800 | 2,500 | $2,600

**Distribution of rental losses**  
- $2,000 | $2,900 | $2,600
Example 2.8 shows that expenses of undeveloped land other than interest and property taxes may still create property losses which can be deducted from other income of the taxpayer. Thus, the taxpayer in the example may deduct $600 from his other taxable income. However, the remainder of the property losses which have been caused by interest and property taxes of $6,900 must be added to the cost base of the undeveloped land.

This new provision which greatly restricts the deductibility of the costs of carrying vacant land will have a major impact on land speculators. In the past, a land speculator who had a marginal tax rate of 50% had, in effect, his costs of carrying his speculative land reduced by 50%. For example, interest and property taxes on ten acres of land that cost $100,000 could be $12,000 a year. However, the after tax cost of holding this land to a taxpayer in the 50% marginal tax bracket under the old Act would have been only $6,000 a year. If the speculator sold the land after 5 years for $150,000 then his profit would be approximately $20,000 over and above the cost of $100,000 and 5 years of holding costs of $6,000 a year. Under the new Act, the annual cost of holding the land cannot be reduced so it will remain at $12,000 a year. The speculator upon selling the land after 5 years for $150,000 will incur a loss of $10,000 because the cost base of the land will then be $160,000. Thus, the effect of this new tax provision is to greatly increase the cost of speculating in vacant land. Consequently, it will be much less profitable in the future for land speculators to hold back the development of their lands in order to extract a higher price from the market.
HOBBY FARMING

A common real estate investment of high income individuals has been the purchase of rural land which is then used for carrying on a limited farming operation. In addition to having a home in the country and the future expectation of appreciating land values, these individuals were able to derive benefits from the income tax system. Under the old Act, these individuals were able to expense many of the costs of holding and improving the land since they were deemed to be carrying on a limited farming operation. As a result, interest, property taxes, land clearing, drainage, and soil tillage expenditures were able to be deducted from the farm income. If these expenses exceeded the farm income, then the resulting farm loss, under limited conditions, could be used to reduce the other taxable income of the taxpayer.

The old Act in Section 13.1 provided that where a taxpayer's chief source of income for a taxation year was neither farming nor a combination of farming and some other source of income then allowable farm losses would be deemed to be the lesser of:

(a) amount of the farm loss or
(b) $2,500 plus \( \frac{1}{2} \) of the farm loss in excess of $2,500 to a maximum of $5,000

Thus in any one year, a hobby farmer could create an allowable farm loss which could be used to reduce other taxable income to a maximum of $5,000, by incurring a farm loss to a maximum of $7,500 ($2,500 plus \( \frac{1}{2} \) of $7,500 - $2,500). Farm losses in excess of $7,500 and the portion of the farm loss which was not allowable against other income could not be used to reduce other taxable income of the current or any other year under the old Act.

The income tax provisions relating to hobby farmers under the new Act are similar to those under the old Act.
Farming is defined in the same general terms as including:
"tillage of the soil, livestock raising or exhibiting, maintaining of horses for racing, raising of poultry, fur farming, dairy farming, fruit growing and the keeping of bees" (248.1).

Costs of holding and improving the hobby farm including interest and property taxes can still be expensed for income tax purposes. Section 31.1 of the new Act defines an allowable loss of a hobby farmer to be the lesser of the farm loss, or $2,500 plus \( \frac{1}{2} \) of the farm loss in excess of $2,500 to a maximum of $5,000. However the disallowed farm loss, called a "restricted farm loss", can now be applied against farm income of the immediately preceding year or the following 5 years (111.1.c). Also, interest and property taxes which are included in these restricted farm losses and which are not applied against farm income of other years can now be added to the cost base of the land (53.1.i).

Example 2.9 demonstrates the tax treatment of the farm losses of a hobby farmer. In this example, the taxpayer can reduce his other taxable income for years 1973 to 1975 by the allowable farm losses of $5,000, $4,000, and $2,500 respectively. Since he has made a cash profit on his hay operations, these losses consist entirely of those expenditures which are necessary to hold the land (interest and property taxes) and to improve it (land clearing). Since in all likelihood these costs will be recaptured by land appreciation, these farm losses are likely to be only losses for tax purposes. Even if the restricted farm losses of 1973 and 1974 can not be used to reduce farming income of other years, they can be added to the cost base of the land since both losses consist of interest and property tax expense.

In conclusion, hobby farm investments are likely to continue to be favourable investments of high income taxpayers.
who can continue to obtain income tax savings while having the pleasure of a home in the country. Consequently, the pressure around the urban centres to sub-divide large acreages into small hobby farms will continue. In so doing, economical farming units will be broken down into uneconomical ones and the cost of expanding urban centres into these hobby farms areas will continue to escalate because of the high cost of reassembling and developing small acreages.
### Example 2.9
Farm Losses of a Hobby Farm

<table>
<thead>
<tr>
<th></th>
<th>1973</th>
<th>1974</th>
<th>1975</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hay sales</td>
<td>Nil</td>
<td>$2,000</td>
<td>$4,000</td>
</tr>
<tr>
<td><strong>Expenses:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hay cutting contract</td>
<td>Nil</td>
<td>900</td>
<td>1,600</td>
</tr>
<tr>
<td>Land clearing</td>
<td>$5,000</td>
<td>3,000</td>
<td>1,400</td>
</tr>
<tr>
<td>Interest</td>
<td>3,500</td>
<td>3,400</td>
<td>3,300</td>
</tr>
<tr>
<td>Property taxes</td>
<td>200</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td><strong>Farm loss</strong></td>
<td>$8,700</td>
<td>$5,500</td>
<td>$2,500</td>
</tr>
</tbody>
</table>

**Calculation of allowable farm loss:**
Lesser of:

- a. farm loss (as above) $8,700 $5,500 $2,500
- b/ $2,500 plus 1/2 of excess (maximum of $5,000) $5,000 $4,000 $2,500

**Allowable farm loss** $5,000 $4,000 $2,500

**Distribution of farm losses:**

- Allowable farm loss $5,000 $4,000 $2,500
- Restricted farm loss (difference) 3,700 1,500 Nil
- **$8,700** $5,500 $2,500
CONCLUSION

The new Income Tax Act and its Regulations have a significant bearing on the overall profitability of income property investments. Provisions having the greatest effect on property income are those which relate to depreciable property, rental losses, interest and property taxes on undeveloped land, and hobby farms.

Capital cost allowance regulations stipulate what costs must be capitalized for tax purposes as well as the rate at which these costs can be written-off against income. A difference in capital cost allowance rates can have a major effect on the after tax profitability of a property since a high rate may protect the cash income of a property from income taxes for many years whereas a low rate will expose the cash income to high rates of taxation immediately. Upon disposition of a property, substantial income taxes can be incurred on recaptured capital cost allowance since the full amount of the recapture must be added to the taxpayer's income in the year of disposition. Under the old Act, payment of this tax could be deferred for many years due to the recapture being a part of a much larger capital cost allowance pool. Under the new Act, this tax deferral provision no longer exists for rental buildings costing $50,000 or more, since these buildings must each comprise a separate capital cost allowance account, and therefore a recapture on any one account must be taken into income immediately. Consequently, the substantial tax liability which can result from the disposition of a rental building will strongly deter an investor from selling his building since the expected return on his residual cash equity invested elsewhere will likely be less than the income generated by his rental building. In addition to locking a taxpayer into his present real estate holdings, this new $50,000 tax rule will stimulate the taxpayer to take terminal losses by demolishing those buildings located on land which has a value close to the value of the property
as a whole. As a result, better utilization will likely be made of land in urban centres but many low rental buildings which house low income earners and small businesses will be eliminated.

The problem of allocating the sales proceeds of a property between its depreciable and non-depreciable components continues under the new Act since capital gains are taxed much less than recaptured capital cost allowance. The vulnerability of a taxpayer to reassessment and much higher taxes from the sale of a property necessitates the taxpayer to collect substantial evidence to support his allocation of the consideration between depreciable and non-depreciable property.

Rental losses created by the capital cost allownace provisions can shelter income from income taxes. Under the old Act, a high income individual could reduce the tax liability on his rental and non-rental income by claiming capital cost allowance in excess of his rental income. Consequently, many properties, like frame apartments, which earned a relatively poor return were often very attractive to high income taxpayers who could use the excess capital cost allowance to reduce the taxes on their other income. Under the new Act, the amount of capital cost allowance that can be claimed in a year is limited to the lesser of the maximum rates for the class or the taxpayer's rental income and therefore it cannot be used to shelter any of his non-rental income. This income tax change has caused many high income individuals to redirect their investment capital away from many forms of real estate, like frame apartments, which earned a nominal income but provided substantial tax savings to their owners. Consequently, the construction and value of these formerly tax shelter
properties has declined over 1972 and 1973. New construction of these properties will only be resumed when the rental rates have risen to levels which compensate the investor for his formerly tax shelter benefits. These rental increases are likely to be substantial.

The interest and property tax expenses of holding non-productive land are now limited by the new Act to the extent of the income generated by the land. In the past, these expenses usually caused property losses which could be used to reduce the taxes on other income of the taxpayer. Upon disposition of the non-productive land, a capital gain would be claimed which was not taxable under the old Act, and is only partially taxable under the new Act. Although the unclaimed interest and property taxes can be added to the cost base of the land under the new Act which will reduce a future capital gain, a major tax advantage has been lost by non-productive land investors who will now have to incur the full cost of holding the non-productive land. By substantially increasing the costs of holding unproductive land, this new tax provision reduces greatly the ability of land speculators to withhold their land from development.

Finally, the tax advantages of being a hobby farmer have continued to survive under the new Act. In addition to having a home in the country and being able to benefit from land appreciation, the hobby farmer can get tax relief for his non-farm income by continuing to incur those expenses of holding and improving land, such as interest, property taxes, and land clearing. Consequently, the new Income Tax Act continues to stimulate the forces which segment the rural areas around urban centres into small uneconomical hobby farm units. In so doing, the Act has further perpetuated the problem of declining productive farmland and the rising costs of urbanizing suburban areas.
CHAPTER 3
CAPITAL GAINS AND THE REAL ESTATE INVESTOR

The prospect of making a capital gain has been a prime motivating force which has made real estate a very attractive investment for many people. The pressure of population in our expanding cities has resulted in a continuous and often high rate of real property appreciation. In the past, these gains were often tax free which made real property investments even more attractive. Under the new Income Tax Act which became effective January 1, 1972, these capital gains became taxable. However, since these gains are only subject to one half of the normal rates of taxation, capital gains on real estate will continue to be very attractive to most investors.

This chapter examines the income tax implications for real property which is held for the purpose of realizing a capital gain. Since the new Act differentiates between non-depreciable capital property, depreciable capital property, and personal property, the income tax treatment of each form of property will be examined separately in this chapter.
CAPITAL GAINS TERMINOLOGY

In order to minimize any possible confusion over similar but unique terms used in the income tax legislation, some of the more important terminology will be defined here before progressing with the examination of the implications of income taxes on real property held for the purpose of realizing a capital gain.

The new Act differentiates between three forms of real property as follows:

1. **Capital property** of a taxpayer means-
   - any depreciable property of the taxpayer, and
   - any property (other than depreciable property), any gain or loss from the disposition of which would, if the property were disposed of, be a capital gain or a capital loss, as the case may be, of the taxpayer (54.b).

2. **Depreciable property** of a taxpayer means property upon which the taxpayer is allowed to claim capital cost allowance in computing his income for the year (13.21.b).

3. **Personal-use property** of a taxpayer includes property owned by him that is used primarily for the personal use or enjoyment of the taxpayer or for the personal use or enjoyment of one or more individuals each of whom is - the taxpayer
   - a person related to the taxpayer, or
   - where the taxpayer is a trust, a beneficiary under the trust or any person related to the beneficiary (54.f.i).

The following terms which relate to the gains and losses on disposition of property have their own unique meaning in the new Act.

1. A **capital gain** of a given taxation year is the gain realized from the disposition of property in the year
which would not otherwise be included in income (39.1.a).

2. A **taxable capital gain** for a given taxation year from the disposition of property is \( \frac{1}{2} \) of the capital gain for the year from the disposition of that property (38.a).

3. A **capital loss** for a taxation year is the loss incurred from the disposition of property in that year (other than depreciable property) which would not be deductible in computing income (39.1.b). Losses incurred on the disposition of depreciable property are provided for under the capital cost allowance provisions of the new Act.

4. An **allowable capital loss** for a taxation year from the disposition of property is \( \frac{1}{2} \) of the capital loss for the year from the disposition of that property (38.b).
NON-DEPRECIABLE CAPITAL PROPERTY

A capital gain results from the disposition of non-depreciable capital property whenever the proceeds of disposition exceed the adjusted cost base of the property plus any outlays or expenses associated with the disposition. The adjusted cost base of the property is normally the cost of acquisition that is adjusted for amounts specifically allowed by the Act. One half of this capital gain, called the taxable capital gain, is added to the income of the taxpayer in the year of disposition and is then subjected to the normal rates of taxation. In Example 3.1, a taxpayer who is in a 60% marginal tax bracket and who realizes a capital gain of $2,000 must pay income taxes of $600 on a taxable capital gain of $1,000. In effect, the taxpayer's investment return which is in the form of a capital gain is reduced by $600 which is 30% of his capital gain of $2,000. In order for the taxpayer to earn the same return under the new Act, as was possible under the old Act, he would have to incur a capital gain of almost $3,000 in order to have an after tax return of $2,000. Consequently, investments like real estate which were attractive under the old Act because of their ability to generate capital gains will be less attractive under the new Act because a significant portion of the capital gain must be paid as income taxes. Furthermore, investors who have earned a substantial but unrealized capital gain on their properties will be deterred from disposing of them because of the substantial income taxes which will be incurred upon disposition.

A taxpayer incurs a capital loss from the disposition of a non-depreciable property whenever the adjusted cost base of the property and the related costs of disposition exceed the proceeds of disposition. One half of this capital loss can be deducted from the taxable capital gains of the taxpayer. If these allowable capital losses
Example 3.1  
Taxable Capital Gains

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds of disposition</td>
<td>$13,000</td>
</tr>
<tr>
<td>Deduct:</td>
<td></td>
</tr>
<tr>
<td>Adjusted cost base (acquisition cost)</td>
<td>$10,000</td>
</tr>
<tr>
<td>Outlays and expenses of disposition</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>11,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$2,000</td>
</tr>
<tr>
<td>Taxable capital gain (1/2)</td>
<td>$1,000</td>
</tr>
<tr>
<td>Income taxes payable by a taxpayer in a 60% bracket - .60 x $1,000 =</td>
<td>$600</td>
</tr>
</tbody>
</table>
in a year exceed the taxable capital gains of a taxpayer, then these net capital losses can be applied against taxable capital gains of the taxpayer in the immediately preceding year or in any future year of the taxpayer (111.1.b). In addition to this provision, taxpayers who are individuals can apply a maximum of $1,000 of the net capital loss against other income of the current, immediately preceding, or any future year (111.1.b). Example 3.2 demonstrates the tax treatment of the net capital losses of a taxpayer who is assumed to have personal exemptions of $2,000. Net capital losses are applied to income after non-capital losses have been considered. In Example 3.2, the $10,000 net capital loss incurred in 1973 has eliminated the $6,000 of taxable capital gains of years 1972, 1974 and 1975. The remaining $4,000 of net capital loss has been applied in amounts of $1,000 to the other income of years 1972 to 1975. It is important to note that only $1,000 of a net capital loss can be applied to the other income of a taxpayer in the year that the loss is incurred even if the net capital loss exceeds the taxpayer's other income as was in the case in Example 3.2.

These provisions differ greatly from the old Act where capital losses were never deductible. Being deductible from taxable capital gains, realized capital losses will become attractive to taxpayers who have realized taxable capital gains. Consequently, many taxpayers will be under an incentive to dispose of those properties which have incurred capital losses in order to apply these losses against realized taxable capital gains.
Example 3.2
Application of Net Capital Losses

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net capital loss</td>
<td>$(10,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable capital gains</td>
<td>$2,000</td>
<td>$1,000</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>Ordinary income</td>
<td>$8,000</td>
<td>$8,000</td>
<td>$8,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>Income for year</td>
<td>$10,000</td>
<td>$8,000</td>
<td>$9,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>Less: Personal exemptions</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Taxable income before application of net capital loss</td>
<td>$8,000</td>
<td>$6,000</td>
<td>$7,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>Application of net capital loss:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-to taxable cap. gains</td>
<td>$2,000</td>
<td>$1,000</td>
<td>$3,000</td>
<td></td>
</tr>
<tr>
<td>-to other income</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Net capital loss applied</td>
<td>$3,000</td>
<td>$1,000</td>
<td>$2,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Revised taxable income</td>
<td>$5,000</td>
<td>$5,000</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
</tbody>
</table>
Adjustments to Cost Base of Non-Depreciable Capital Property

The cost base of non-depreciable capital property is normally the acquisition cost of the property. However, certain adjustments to the cost base have been specifically allowed by the new Act. The excess of interest and property taxes over the income generated by vacant or low income producing property can be added to the cost base of the land (53.1.h). Similarly, interest and property taxes related to land owned by a hobby farmer may be added to the cost base of the land provided that these expenses were not deducted in computing income nor deducted as part of a restricted farm loss in computing income of other years (53.1.i).

Adjustments which are allowed to reduce the cost base of non-depreciable property include grants or subsidies which are received by the taxpayer from a government and which are specifically related to the acquired property (53.2.k). Also if part of a property is disposed of, the cost base of the property must be reduced to an amount which can reasonably be attributable to the remaining property (43). This latter situation would easily arise where land is sub-divided and sold in parcels.

Non-Depreciable Capital Property Owned at December 31, 1971

The provisions of the new Income Tax Act do not apply to capital gains and capital losses that have arisen prior to January 1, 1972 (I.T.A.R. 26.1). Taxable capital gains and allowable capital losses must arise as the result of valuation changes occurring after December 31, 1971. Therefore to determine the amount of gains or losses subject to the new tax provisions, it is necessary to ascertain a base value for all capital property as at
December 31, 1971. The new Act provides that an individual taxpayer may utilize one of two techniques to determine a December 31, 1971 valuation base for his non-depreciable capital property held on that date. These techniques are as follows:

1. tax free zone method (I.T.A.R. 26.3)
2. fair market value method (I.T.A.R. 26.7)

One of these methods must be selected by a taxpayer in the year that he first disposes of capital property held on December 31, 1971, and once this selection is made, this method must be used for all subsequent disposals.

Tax Free Zone Method

The tax free zone method utilizes three valuations of a property in determining the valuation base to be used for calculating a taxable capital gain or an allowable capital loss. These three property valuations are as follows:

1. Pre 1972 cost of acquisition
2. Fair market value on December 31, 1971.

If the property is sold for an amount in excess of acquisition cost (1) or fair market value on December 31, 1971 (2), then the valuation base used for calculating the capital gain will be the higher of (1) or (2). If the property is sold for less than either of these two values, then the valuation base will be the lesser of (1) or (2). If the proceeds of disposition lie between (1) and (2), then neither a capital gain nor a capital loss results. This range between the cost of acquisition and the fair market value on December 31, 1971 is the tax free zone from which this method derives its name. Example 3.3 summarizes the tax free zone method and Example 3.4 demonstrates its application to an acre of land purchased in 1971 for $10,000 and sold for varying amounts subsequent to that time.
**Example 3.3**
*Calculation of Capital Gains (Losses)*

**Tax Free Zone Method**

<table>
<thead>
<tr>
<th>Amount of Proceeds</th>
<th>Capital Gain (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greater than both original cost and December 31/71 value.</td>
<td>Capital gain = proceeds minus greater of cost or Dec. 31/71 value.</td>
</tr>
<tr>
<td>Between original cost and December 31/71 value.</td>
<td>No capital gain nor capital loss.</td>
</tr>
<tr>
<td>Less than both original cost and December 31/71 value.</td>
<td>Capital loss = proceeds minus lower of cost or Dec. 31/71 value.</td>
</tr>
</tbody>
</table>
Example 3.4
Application of the Tax Free Zone Method

<table>
<thead>
<tr>
<th></th>
<th>Case A</th>
<th>Case B</th>
<th>Case C</th>
<th>Case D</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Pre 1972 cost</td>
<td>$10,000</td>
<td>$10,000*</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>2. Market value 12/31/71</td>
<td>12,000*</td>
<td>8,000</td>
<td>8,000*</td>
<td>12,000</td>
</tr>
<tr>
<td>3. Proceeds of disposition</td>
<td>14,000</td>
<td>14,000</td>
<td>6,000</td>
<td>11,000*</td>
</tr>
</tbody>
</table>

Calculation of capital gain:

<table>
<thead>
<tr>
<th></th>
<th>Case A</th>
<th>Case B</th>
<th>Case C</th>
<th>Case D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds of disposition</td>
<td>$14,000</td>
<td>$14,000</td>
<td>$6,000</td>
<td>$11,000</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dec. 31/71 value base(*)</td>
<td>12,000</td>
<td>10,000</td>
<td>8,000</td>
<td>11,000</td>
</tr>
<tr>
<td>Capital gain (loss)</td>
<td>$2,000</td>
<td>$4,000</td>
<td>$(2,000)</td>
<td>Nil</td>
</tr>
</tbody>
</table>

Composition of actual gain (loss) on disposition:

<table>
<thead>
<tr>
<th></th>
<th>Case A</th>
<th>Case B</th>
<th>Case C</th>
<th>Case D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain (loss) above$ 2,000</td>
<td>$2,000</td>
<td>$4,000</td>
<td>$(2,000)</td>
<td>Nil</td>
</tr>
<tr>
<td>Pre 1972 gain (loss)</td>
<td>$2,000</td>
<td>Nil</td>
<td>$(2,000)</td>
<td>$1,000</td>
</tr>
<tr>
<td>Actual gain (loss)</td>
<td>$4,000</td>
<td>$4,000</td>
<td>$(4,000)</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

* December 31, 1971 valuation base for calculating capital gains or losses under the tax free zone method (see Example 3.3).
Fair Market Value Method

The fair market value method of determining a valuation base for calculating post 1971 capital losses is available only to individual taxpayers. Under this method, all property held by the taxpayer at December 31, 1971 is valued at its fair market value as of that date. Generally, this method would only be advantageous to a taxpayer whose property at December 31, 1971 is worth more than its cost but the post 1971 proceeds of disposition are likely to be less than the December 31, 1971 valuations. Under the tax free zone method, allowable capital losses would be based on the lower valuation (cost) rather than the higher December 31, 1971 valuations. Example 3.5 demonstrates the situation where a taxpayer would benefit more from the fair market method than the tax free zone method.

In Example 3.5, election of the fair market value method by the taxpayer would result in $5,000 of capital losses being available to offset capital gains of the taxpayer. Election of the tax free zone method would only have resulted in $1,000 of capital losses being available to reduce capital gains. The higher capital loss of the fair market value method is due to the fact that the aggregate market value of the properties held at December 31, 1971 is $29,000 whereas the proceeds of disposition aggregate only $24,000. It is important to note in this example that the capital losses are only losses for tax purposes since there was no actual gain or loss on disposition (proceeds of disposition equal acquisition cost of $24,000).

Either the tax free zone method or the fair market value method must be elected by the taxpayer in the first year that properties held on December 31, 1971 are disposed. Once elected, a valuation method cannot be revoked and
### Example 3.5
Comparison of the Fair Market Value Method and the Tax Free Zone Method

<table>
<thead>
<tr>
<th>Case</th>
<th>Pre 1972 Cost</th>
<th>Market Value 12/31/71</th>
<th>Proceeds of Disposition</th>
<th>Capital Gains (Losses):</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Case A</strong></td>
<td>$10,000*</td>
<td>12,000</td>
<td>8,000</td>
<td>under F.M.V. method $(4,000) under tax free zone $(2,000)</td>
</tr>
<tr>
<td><strong>Case B</strong></td>
<td>$6,000</td>
<td>10,000</td>
<td>7,000</td>
<td>NIL (2,000)</td>
</tr>
<tr>
<td><strong>Case C</strong></td>
<td>$8,000*</td>
<td>7,000*</td>
<td>9,000</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$24,000</td>
<td>29,000</td>
<td>24,000</td>
<td>$(5,000)</td>
</tr>
</tbody>
</table>

* December 31, 1971 valuation base under the tax free zone method.
applies to all further dispositions of properties held prior to 1972. A prudent policy regarding disposition of such properties is to avoid disposition of small properties in order to extend the period of election for as long as possible.

Regardless of which valuation day method is utilized by the taxpayer, it is important that the taxpayer be able to provide substantial evidence of the market value of his properties as at December 31, 1971. Capital gains realized prior to January 1, 1972 remain tax free but those realized after that date are taxable. As the years pass, it will become much more difficult and expensive to ascertain the market value of a property as of December 31, 1971. The Tax Department with its vast resources will have substantial evidence to support its valuation of the taxpayer's property so that the taxpayer will also have to have extensive support for his valuation in order to minimize the amount of his taxable post 1971 capital gain.
DEPRECIABLE PROPERTY

Depreciable property falls into the category of capital property. The income tax treatment of capital gains derived from the disposition of depreciable property is basically the same as those derived from capital property. However, because depreciable property is normally expected to decline in value over time through physical deterioration and economic obsolescence, provision has been made in the Income Tax Act to allocate the cost of this depreciable property against the income generated by it. If on disposition the proceeds exceed the undepreciated cost of the property, part or all of this excess represents the cost of the property which was permitted by the Act to be written-off against income. Therefore, for purposes of calculating a capital gain on the disposition of depreciable property, the undepreciated capital cost of the property cannot be used as the cost base of the property. Consequently, a capital gain on depreciable property is defined as the excess of the proceeds of disposition over the capital cost of the property. Proceeds of disposition which are in excess of the undepreciated capital cost but equal to or less than the capital cost of the property constitute a recapture of capital cost allowance which is taxed at the normal rates.

In Example 3.6, Building B has been sold for $20,000 in excess of its original capital cost of $100,000. This $20,000 is a capital gain realized from the disposition of depreciable property of which one half will be subject to the normal rates of taxation of the taxpayer. The recaptured capital cost allowance of $30,000 will be subject to the normal rates of taxation (Chapter 2). Building A has been sold for $10,000 less than its original capital cost, but since the capital cost allowance provisions provide for this decline in value at the time of disposition, no special tax treatment is afforded
Example 3.6
Calculation of Capital Gain on Depreciable Property

<table>
<thead>
<tr>
<th></th>
<th>Bldg A</th>
<th>Bldg B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assumptions:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital cost - 1973</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Undepreciated capital cost - 1977</td>
<td>70,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Proceeds of disposition - 1977</td>
<td>90,000</td>
<td>120,000</td>
</tr>
</tbody>
</table>

Calculation of capital gains:

|                        |           |           |
| Proceeds of disposition | $ 90,000  | $120,000  |
| Less: Capital cost      | 100,000   | 100,000   |
| Capital gain (1/2 taxable) | Nil       | $20,000   |

Recapture of capital cost allowance:

|                        |           |           |
| Lesser of proceeds or capital cost | $ 90,000  | $100,000  |
| Undepreciated capital cost       | 70,000    | 70,000    |
| Recapture (fully taxable)        | $ 20,000  | $ 30,000  |
this decline in value. However since the proceeds of disposition of Building A exceed its undepreciated capital cost of $70,000, there is a recapture of capital cost allowance of $20,000 which is subject to tax.

Cost Base of Depreciable Property

The cost base used to determine capital gains on the disposition of depreciable property is normally the acquisition cost of the property. In the purchase of an existing building, the acquisition cost would consist of the purchase price applicable to the depreciable property plus a proportionate share of the legal, commission, and other expenses incurred by the purchaser. A common problem in the acquisition of depreciable property is that it is part of a package containing both depreciable and non-depreciable property (buildings and land). The vendor who wishes to minimize any recapture of capital cost allowance usually wants as little as possible of the purchase price to be allocated to the depreciable property. The purchaser on the other hand who wants to maximize the amount of future capital cost allowance to be claimed wants as much of the purchase price as possible to be allocated to the depreciable property. The purchase price allocated to the depreciable property by an agreement between the vendor and the purchaser will normally be accepted by the Tax Department as the proper cost base of the depreciable property. In cases where the taxpayer uses a different cost base, where no allocation agreement was made or where the vendor and purchaser did not deal at arm's length, then the purchase price allocated to the depreciable property must be reasonable in order for it to be acceptable to the taxing authorities.

The cost base of depreciable property constructed by the taxpayer consists of all outlays and expenses incurred
by the taxpayer which relate directly to the depreciable property. The cost of all materials included in the depreciable property and the wages and salaries of all those workers who developed, planned, and constructed the property are to be included in the cost base of the depreciable property. Expenditures not directly related to the depreciable property under construction would not generally be included in the cost base of the property but would be written-off for tax purposes in the year of occurrence. These indirect expenditures would include general and administrative costs of the taxpayer-builder, property taxes on the property, and interest on borrowed monies used to finance construction. The fact that these indirect expenses can be written-off for tax purposes in the current year or carried to other years as part of a business loss is generally of greater benefit to a taxpayer than increasing the cost base of the property. However, the taxpayer has the option of electing to capitalize the cost of borrowed money used to finance the construction of depreciable property (21). This election would be beneficial to the taxpayer when there is some doubts as to whether these financing expenses can be utilized as deductions from income. By increasing the cost base, a greater amount of capital cost allowance can be taken and any future capital gains, and the income taxes thereon, will be less.

Depreciable Property
Owned December 31, 1971

Capital gains which have accrued to depreciable property prior to 1972 are not taxable under the provisions of the new Act (I.T.A.R. 26.1). However capital gains arising on depreciable property subsequent to 1971 are taxable, therefore it is necessary to determine a base value for
all depreciable property owned by a taxpayer at December 31, 1971. Because of the inherent nature of depreciable property and the capital cost allowance provisions of the Act, neither the tax free zone nor the fair market value method can be used for determining a December 31, 1971 valuation base for depreciable property. Therefore, the new Act stipulates that capital gains realized on depreciable property owned at December 31, 1971 will be the excess of proceeds of disposition over the original capital cost of the property (54.a). However in order to exempt from tax those capital gains which have accrued to the property prior to 1972, the proceeds of disposition of property owned at December 31, 1971 are deemed to be the sum of the following (I.T.A.R.20.1):

1. the capital cost of the depreciable property plus
2. the excess of the proceeds of disposition over the fair market value of the property as at December 31, 1971.

Example 3.7 demonstrates the calculation of a capital gain realized on the disposition of depreciable property that was owned by the taxpayer at December 31, 1971.

In Example 3.7, the deemed proceeds of disposition include the capital cost of the property of $60,000 plus the post 1971 capital gain of $20,000. As a result, the capital gain which is subject to tax is only $17,000 after disposition costs, rather than the actual gain of $37,000. It is important to note that the costs of disposition are first applied against the capital gain that is taxable rather than the tax free pre 1972 capital gain.

Under the old Act, the taxpayer would realize a tax free capital gain of $37,000 in Example 3.7. A capital gain of $37,000 realized since January 1, 1972 would increase the taxpayer's taxable income for the year of disposition by $18,500 (1/2 of $37,000). Assuming a marginal tax rate of 50%, the taxpayer would be required to pay $9,250 of the realized capital gain as income taxes.
In Example 3.7, the taxpayer was able to attribute $20,000 of the capital gain to the period prior to January 1, 1972. In doing so, he was able to reduce the income taxes on the capital gain from $9,250 to $4,250 (1/2 of $17,000 @ 50%) for a cash saving of $5,000. It is therefore extremely important for a taxpayer to be able to allocate as much of a realized capital gain to the period prior to January 1, 1972 and to be able to provide substantial support for that allocation.
Example 3.7
Calculation of Capital Gain on Disposal of Depreciable Property owned December 31, 1971

Assumptions:
1. Capital cost of property $60,000
2. Fair market value on December 31, 1971 80,000
3. Proceeds of disposition 100,000

Calculation of capital gain (taxable):
Deemed proceeds of disposition:
Capital cost $60,000
Add: Proceeds of disposition $100,000
Less F.M.V. Dec. 31/71 80,000 20,000
Deemed proceeds of disposition 80,000

Deduct:
Adjusted cost base (capital cost) 60,000
Legal fees, commissions etc. 3,000 63,000

Capital gain (taxable) $17,000
PERSONAL-USE PROPERTY

Personal-use property is property that is owned by an individual taxpayer which is used primarily for his own personal use or enjoyment or that of persons related to him. Residences, cottages, furniture, automobiles, and paintings are examples of such personal-use property. A capital gain that is realized on the disposition of personal-use property is taxable under the provisions of the new Act. The capital gain is determined in the same manner as a capital gain resulting from the disposition of capital property, that is, the capital gain is the excess of the proceeds of disposition over the cost base of the property. The cost base of personal-use property is normally the original cost of the property. Although most personal-use property depreciates over time, no capital cost allowance is allowed to be claimed by the new Act on this property. Consequently, the additional tax burden which results from the recapture of capital cost allowance on depreciable property does not arise with personal property.

Example 3.8 demonstrates the tax treatment afforded a capital gain realized by a taxpayer on the disposition of personal-use property. The taxpayer in Example 3.8 is required by the new Act to include the taxable capital gain of $1,500 in his 1976 income.

Although capital gains realized from the disposition of personal-use property are subject to tax, capital losses which are incurred on the disposition of personal-use property are not deductible for tax purposes except for losses incurred on disposition of listed personal property. Listed personal property includes a limited number of non-depreciable personal-use property such as paintings and coin and stamp collections. Capital losses incurred on the disposition of such listed personal
Example 3.8
Personal-Use Property
Calculation of Capital Gains

Assumptions:
1. In 1972, taxpayer purchases a lake cottage for $10,000.
2. Taxpayer uses cottage for his own enjoyment until 1976 when he sells it for $15,000.

Calculation of capital gain:

<table>
<thead>
<tr>
<th>Proceeds of disposition</th>
<th>$ 15,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less-adjusted cost base:</td>
<td></td>
</tr>
<tr>
<td>Acquisition cost</td>
<td>$ 10,000</td>
</tr>
<tr>
<td>Addition to cottage-1973</td>
<td>1,500</td>
</tr>
<tr>
<td>Adjusted cost base</td>
<td>11,500</td>
</tr>
<tr>
<td>-expenses of disposition</td>
<td>500</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>Taxable capital gain (1/2)</td>
<td>$ 1,500</td>
</tr>
</tbody>
</table>
Capital gains which have accrued on personal-use property as of December 31, 1971 will not be subject to tax under the provisions of the new Act. These pre-1972 capital gains will be exempted from tax in the same manner that the pre-1972 capital gains accrued on depreciable property are exempted from tax. The proceeds of disposition are deemed to be an amount such that the pre-1972 capital gain is excluded from the taxable capital gains calculation.

**Change In Use Election**

The new Act contains a provision which deems that a taxpayer has disposed of his property at its fair market value if he changes the use of the property (45.1). The Act defines a change in use of property as occurring when a property that was acquired for the purpose of producing income is used for some other purpose or when a property that was acquired for some other use is used to produce income (45.1). Thus, a taxpayer who converts personal-use property to income property or income property to personal-use property will be deemed by the Act to have disposed of the property at its fair market value at the time of the change and to have realized any capital gains or losses which have accrued on the property. Consequently, a taxpayer who moves into a house which he previously has used to earn rental income will be deemed to have sold the house for its fair market value. If the house has appreciated in value, he will have to pay tax on the taxable capital gain, even though he continues to own the house. According to this provision, even if a taxpayer temporarily changes the use of a property, for example, rents his summer cottage for a month, he will still be deemed to have disposed of the cottage and to have realized any capital gains or losses which have accrued on the property to that date.
In order to reduce the rather onerous impact of this change in use provision on property which is occasionally used to produce income, the new Act has provided that where a property has undergone a change in use from non-income producing to income producing, a taxpayer may elect in the year of the change in use to have the change in use ignored for tax purposes (45.2). Capital gains which have accrued on the property to the date of the change in use will still be subject to tax but they will not be deemed to be realized until the taxpayer's change in use election has been rescinded. By making this election, a taxpayer can occasionally use his personal-use property to earn income without being taxable on capital gains until he actually disposes of the property. Example 3.9 demonstrates the comparative advantages of making this change in use election.

Example 3.9 shows that the total amount of the taxable capital gain of $5,000 is the same whether or not the change in use election of Section 45.2 is taken. However by making use of this election, the taxpayer has avoided paying income taxes on the taxable capital gain until the year of actual disposition. For a taxpayer with a marginal tax rate of 60%, this means that he has deferred $1,800 (.60 \times $3,000) of income taxes until 1979 on taxable capital gains earned in 1974 and 1975.

Example 3.9 also demonstrates the fact that the adjusted cost base of property which has undergone a change in use is equivalent to the deemed proceeds of the latest deemed disposition whenever the change in use election is not taken. Thus the adjusted cost base of the cottage in 1979 is equivalent to the market value of the cottage at the time of the 1975 deemed disposition of $26,000.

Income earned by a property upon which the change in use election has been taken is still taxable in the year that it is earned. The taxable income can not however be
Example 3.9
Change in Use Election

Assumptions:
1. In 1972, a taxpayer purchased a lake cottage for his own use for $20,000.
2. In years 1974 and 1975, the taxpayer rents the cottage.
3. Cottage has a fair market value of $24,000 in 1974 and $26,000 in 1975.
4. In 1979, the taxpayer sells the cottage for $30,000.

Calculation of Taxable Capital Gains:

<table>
<thead>
<tr>
<th></th>
<th>No Election</th>
<th>Election</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1974 - Change in Use:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deemed proceeds of disposition</td>
<td>$24,000</td>
<td></td>
</tr>
<tr>
<td>Less: Adjusted cost base</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Deemed capital gain</td>
<td>$4,000</td>
<td></td>
</tr>
<tr>
<td>Taxable capital gain (1/2)</td>
<td>$2,000</td>
<td></td>
</tr>
<tr>
<td><strong>1975 - Change in Use:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deemed proceeds of disposition</td>
<td>$26,000</td>
<td></td>
</tr>
<tr>
<td>Less: Adjusted cost base</td>
<td>24,000</td>
<td></td>
</tr>
<tr>
<td>Deemed capital gain</td>
<td>$2,000</td>
<td></td>
</tr>
<tr>
<td>Taxable capital gain (1/2)</td>
<td>$1,000</td>
<td></td>
</tr>
<tr>
<td><strong>1979 - Actual Disposition:</strong></td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Proceeds of disposition</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Adjusted cost base</td>
<td>26,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Deemed capital gain</td>
<td>$4,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Taxable capital gain (1/2)</td>
<td>$2,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Total taxable capital gain</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
</tbody>
</table>
reduced by claiming capital cost allowance. The effect of the change in use election is to disregard the change in use which has actually taken place, therefore, since the property is considered to still be non-income producing, capital cost allowance can not be claimed.

Finally, it is important to reiterate that the change in use election of Section 45.2 can only be applied to those changes in use where the property is converted from a non-income producing to one that is an income producer. Consequently, taxable capital gains can not be deferred under this election where a property is converted from an income producer to some other use.

**Non-Taxable Capital Gains**

Generally all capital gains with the exception of windfall gains such as sweepstake winnings are subject to tax under the new Act. However, capital gains realized on two classes of personal-use property are not subject to tax. Non-taxable capital gains can be realized on personal-use property valued at under $1,000 and on principal residences.

In order to eliminate the need for taxpayers to account for capital gains realized on personal property of relatively low value, the new Act has stipulated that the income tax provisions relating to capital gains on personal-use property do not apply where the adjusted cost base of the property is less than $1,000 and the proceeds of disposition do not exceed $1,000. To implement this exemption provision, the Act deems that the adjusted cost base of all personal-use property is the greater of $1,000 or the actual adjusted cost base (46.1.a). The proceeds of disposition of personal-use property are also deemed to be the greater of $1,000 or the actual proceeds of disposition (46.1.b). The application of
these provisions is demonstrated in Example 3.10.

In Example 3.10, no taxable capital gain results from the disposition of personal-use property which cost and was sold for less than $1,000. Thus, the $300 capital gain realized on Property A is not taxable. Also, a property which cost less than $1,000 is only taxable on the proceeds of disposition in excess of $1,000. Only $400 of the $600 capital gain realized on the disposition of Property B is subject to tax. Finally, a property that has a cost base of more than $1,000 but is subsequently sold for less than $1,000 only incurs a capital loss to the extent that the cost base exceeds $1,000. Property C only incurs a capital loss for tax purposes of $500 rather than the actual loss of $700. However this latter case only creates a capital loss which is deductible from taxable capital gains where the property disposed of is listed personal property (paintings, stamps, and coins). The reason that losses incurred on the disposal of regular personal-use property are not deductible for tax purposes is that the taxing authorities feel that the loss in value of the items, evidenced by the loss on disposal, represents the cost of personal use of the item and is clearly a personal expense which is not deductible for tax purposes.

Capital gains which are realized from the disposition of principal residences are not taxable. Section 54.g of the new Act defines a principal residence of a taxpayer as a housing unit or a share of capital stock of a co-operative housing corporation owned in whole or in part by the taxpayer and ordinarily inhabited by him. The principal residence includes the land under and around the housing unit which contributes to the use and enjoyment of the taxpayer. However where the land area exceeds one acre, the taxpayer must justify that the excess land is necessary to his use and enjoyment of the residence (54.g). For a residence to
Example 3.10  
Non-Taxable Capital Gains  
$1,000 Rule

<table>
<thead>
<tr>
<th></th>
<th>Property A</th>
<th></th>
<th>Property B</th>
<th></th>
<th>Property C</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual Cost</td>
<td>Deemed Cost</td>
<td>Actual Cost</td>
<td>Deemed Cost</td>
<td>Actual Cost</td>
<td>Deemed Cost</td>
</tr>
<tr>
<td>Proceeds</td>
<td>$800</td>
<td>$1,000</td>
<td>$1,400</td>
<td>$1,400</td>
<td>$800</td>
<td>$1,000</td>
</tr>
<tr>
<td>Less: Cost Base</td>
<td>500</td>
<td>1,000</td>
<td>800</td>
<td>1,000</td>
<td>1,500</td>
<td>1,500</td>
</tr>
<tr>
<td>Capital Gain(Loss)</td>
<td>$300</td>
<td>Nil</td>
<td>$600</td>
<td>$400</td>
<td>$(700)</td>
<td>$(500)</td>
</tr>
</tbody>
</table>
qualify as a principal residence, it must be designated as the principal residence for the year by the taxpayer and no other property can also be so designated during that same year. Since only one property can be designated as a principal residence in one year, a taxpayer who sells his principal residence and purchases another one in the same year will normally designate the sold residence to be his principal residence of that year in order to avoid any tax on capital gains resulting from its disposition. Should the taxpayer sell two residences during the year, he must pay capital gains tax on one of the homes since he can only designate one principal residence in any given year.

If a residence owned by a taxpayer is designated as his one and only residence for every year that he owns it, then a capital gain arising upon disposition of this principal residence will not be subject to income taxes. The capital gain will be completely tax free. Tax implications however arise if during the period of ownership, the residence is not designated or does not qualify as a principal residence. To qualify as a principal residence, the residence must be "ordinarily inhabited" by the taxpayer. If the taxpayer is transferred to a new location for a few years, his residence can not be designated as his principal residence even if he owns no other residence. Also if he rents out his residence during this period, he will be deemed to have disposed of it for its fair market value even if he later reoccupies the residence. However this situation can be alleviated by the change in use election discussed previously. Under the change in use elective provision, a taxpayer can designate a residence to be his principal residence for up to four years without "ordinarily inhabiting" the residence and providing that it is used to earn income (54.g). In summary, a residence qualifies as a principal residence if it is ordinarily inhabited by the taxpayer or if it has been so
designated by the taxpayer in accordance with the change in use elective provision.

If during the period of ownership, a residence does not qualify as a principal residence, then all or part of the capital gain which arises on disposition of the residence will be subject to tax. Section 40.2.b of the new Act states that where a taxpayer is an individual the capital gain that is subject to tax is the capital gain realized on disposition minus that proportion which is:

1. one plus the number of taxation years ending after 1971 for which the property was his principal residence and during which he was a resident of Canada is of:

2. the number of taxation years ending after 1971 during which he owned all or part of the property.

Example 3.11 demonstrates the tax treatment afforded a capital gain realized on a principal residence.

In Example 3.11, only 10% of the capital gain realized on disposition of the house is subject to tax. Although the house was not designated as the principal residence for two of the ten years of ownership, Section 40.2.b enables all but one year to benefit from the non-taxable capital gain. In fact if the house had not be designated as a principal residence for only one year, the entire amount of the capital gain of $10,000 would have been exempt from tax. Finally, conversion of a residence to a principal residence or vica versa does not result in any deemed capital gains, unlike the conversion to income producing property.

The tax free status of a capital gain which has accrued to a principal residence greatly enhances the investment potential of home ownership. Urbanization has caused substantial increases in the value of existing houses, particularly over the past few years. Thus, a typical house which sold in Vancouver, British Columbia for $26,000 in 1971 would sell for about $39,000 in 1973. This gain in
value of $13,000 represents a 50% increase in value over two years. If such a house was the principal residence of a taxpayer, the entire amount of the gain would be tax free. A taxpayer with a 40% marginal tax rate would have to make a capital gain on an investment which was taxable of $16,250 in order to have a net after tax gain of $13,000 as is demonstrated below.

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital gain on a taxable investment</td>
<td>$16,250</td>
</tr>
<tr>
<td>Taxable capital gain (1/2 of above)</td>
<td>$8,125</td>
</tr>
<tr>
<td>Net gain after income taxes:</td>
<td></td>
</tr>
<tr>
<td>Capital gain</td>
<td>$16,250</td>
</tr>
<tr>
<td>Income Taxes 40% of $8,125</td>
<td>3,250</td>
</tr>
<tr>
<td><strong>Net gain after income taxes</strong></td>
<td><strong>$13,000</strong></td>
</tr>
</tbody>
</table>

The taxpayer in the above example would have to realize a capital gain on a taxable investment which is 1.25 times greater than the capital gain realized on his principal residence in order to realize the same gain after income taxes.

The tax free status of capital gains realized on a principal residence will act as a strong incentive for taxpayers to own their residence. This increased demand of taxpayers to own their home rather than rent one will be a further factor which will escalate house prices especially over the short term. Over the long term, the tax free status of the capital gain realized on a principal residence and the ability of the average taxpayer to use leverage in acquiring his home will make home ownership a desirable investment for most taxpayers.
Example 3.11
Calculation of the Taxable Capital Gain on the Disposition of a Principal Residence

Assumptions:
1. In 1972, a taxpayer purchases a house to be used as a summer residence for $25,000.

2. Taxpayer rents the house for years 1974 and 1975 but he designates house to be his principal residence during these years.

3. In 1976, taxpayer reoccupies house and continues to designate it as his principal residence.


Calculation of taxable capital gain:

2. Capital gain realized on disposition:
   Proceeds of disposition $35,000
   Less: Adjusted cost base 25,000
   Capital gain realized on disposition $10,000

3. Non-taxable portion of capital gain:
   \[
   \frac{\text{Years as principal residence} + \text{One}}{\text{Years of ownership}} = \frac{8 + 1}{10} = .9
   \]

4. Taxable capital gain:
   Capital gain realized on disposition $10,000
   Less: Non-taxable capital gain .9x10,000 = 9,000
   Capital gain subject to tax $1,000

   Taxable capital gain (\(\frac{1}{2}\)) $500
The strong incentive to invest in real estate for the purpose of making capital gains has been curtailed considerably by the new Act. The new Act stipulates that one half of a capital gain, called a taxable capital gain, is to be subjected to the normal rates of taxation. Under the old Act, capital gains were completely tax free. Justifiably however, one half of a capital loss, called an allowable capital loss, can be used to reduce the taxable capital gains of the taxpayer of the immediately preceding year, current year, and any future year. In addition, an individual taxpayer can apply $1,000 of a net capital loss in any one year against other income. Under the old Act, there was no tax relief for capital losses.

The new Income Tax Act is not retroactive so that unrealized capital gains which have accrued on property prior to January 1, 1972 remain free of tax. These pre 1972 tax free capital gains are preserved by utilizing either the tax free zone method or the fair market value method to determine the portion of a capital gain which is taxable upon disposition of a property owned by December 31, 1971 by the taxpayer.

Under the tax free zone method, the capital gain subject to tax is the excess of the proceeds of disposition over the higher of the property's cost or fair market value at December 31, 1971. Conversely, a capital loss is based on the difference between the lesser of the property's cost or fair market value at December 31, 1971 and the proceeds of disposition. If the proceeds of disposition lie between the cost and fair market value at December 31, 1971, neither a capital gain nor a capital loss results.

The fair market value method can only be used by individual taxpayers. Under this method, all capital gains and capital losses are based on the fair market value of the taxpayer's properties at December 31, 1971. The fair market
value method would benefit a taxpayer in the situation where his properties had a value on December 31, 1971 in excess of cost but where their proceeds of disposition are expected to be less than that valuation-day value. It is important to remember that a taxpayer may choose only one of the two methods and once he has chosen he must apply the same method to the disposition of all his pre 1972 properties.

Depreciable property which is also capital property is subjected to special provisions of the Income Tax Act because of its expected loss in value over time. Since the capital cost allowance provisions compensate the taxpayer for this loss in value, no capital losses are allowable for depreciable property. Capital gains can however accrue on depreciable property! Because recaptured capital cost allowance is fully taxable, these capital gains are based on the excess of proceeds over the original cost of the depreciable property rather than its undepreciated capital cost. These capital gains are taxable in the same manner as capital gains on non-depreciable property.

Capital gains which have accrued to depreciable property prior to 1972 are not subject to tax. However because of the special tax treatment granted depreciable property, neither the tax free zone method nor the fair market value method can be used to exempt pre 1972 capital gains. These capital gains are exempted however by reducing the proceeds of disposition by the amount of the pre 1972 capital gains before calculating the post 1971 capital gains which are taxable.

Under the new Act, property which is owned by a taxpayer and used for his own personal use or enjoyment or that of persons related to him is subject to the taxable capital gains provisions. However losses on disposal of such personal-use property are not deductible from taxable capital gains because the loss in value is deemed by the taxing authorities to be the normal wear and tear on the property. Deductible capital losses are allowable for a selected number of non-depreciable, personal-use properties such as paintings and
coin and stamp collections.

Capital gains resulting from the disposition of personal-use property are taxable in the same manner as other capital gains. Capital gains which have accrued on personal-use property as of December 31, 1971 are exempted from tax in the same way as pre 1972 capital gains on depreciable property. The proceeds of disposition are reduced to the extent of the pre 1972 capital gain before the taxable capital gains calculation is made.

Personal-use property is vulnerable to the change in use provisions of the new Act. Disposition at fair market value is deemed to have occurred if personal-use property is used to produce income or if income producing property becomes personal-use property. Consequently the capital gains arising from the deemed disposition will be taxable even though the same taxpayer continues to own the property. This onerous change-in-use provision is alleviated by the change in use election provision which enables a taxpayer to defer the paying of the tax on the capital gain until actual disposition occurs. This election provision however only applies where personal-use property is temporarily used to produce income.

Tax free capital gains continue to exist under the new Income Tax Act for some personal-use property. Capital gains arising from the disposition of personal-use property remain free of tax if the property has a cost base less than $1,000 and the proceeds of disposition do not exceed $1,000. Even more significantly, capital gains arising from the disposition of a principal residence remain tax free.

In summary, although the disposition of property now attracts income tax the amount of tax liability incurred is one-half of the normal rate due to the fact that only one-half of the gain is taxable. In addition, investing in real estate has generally been very lucrative. Although the real profit from the transaction will be reduced due to taxation, there will still continue to be high incentive for investing in real estate.
Involuntary disposions include dispositions of property by destruction, expropriation, theft, and foreclosure (54.h). To alleviate the potential hardships of the capital gains provisions of the new Act on involuntary disposions, the Act has prescribed special provisions for such dispositions.

Section 44 of the new Act stipulates that where a taxpayer has received proceeds for property destroyed or expropriated and has expended an amount to replace this property before the end of the following taxation year then the capital gain subject to tax will be the lesser of:

1. excess of the proceeds of disposition over the adjusted cost base of the disposed property, or
2. the amount, if any, by which the proceeds of disposition exceed the cost of the replacement property.

The cost base of the replacement property will be its capital cost minus any capital gain realized on the disposed property which is not taxable because of Section 44. This adjustment of the cost base of the replacement property ensures that any capital gain realized on the disposed property which was not taxable at the time of destruction or expropriation will be taxable if the replacement property is subsequently sold for more than its adjusted cost base. Example 4.1 demonstrates the tax treatment afforded destroyed or expropriated property.

In Case 1 of Example 4.1, the reinvestment of all of the proceeds of expropriation in another property has resulted in the capital gain realized on the expropriated property remaining free of income taxes.
### Example 4.1
### Disposition by Expropriation

#### Assumptions:
- Cost base of expropriated prop.: $50,000, $50,000, $50,000
- Proceeds of expropriation: 60,000, 60,000, 40,000
- Cost of replacement property: 60,000, 40,000, 45,000

#### Calculation of capital gain subject to tax:

<table>
<thead>
<tr>
<th>Case</th>
<th>Assumption</th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>A.</td>
<td>Proceeds of expropriation</td>
<td>$60,000</td>
<td>$60,000</td>
<td>$40,000</td>
</tr>
<tr>
<td></td>
<td>Less: Adjusted cost base</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td></td>
<td>Capital gain (loss)</td>
<td><strong>$10,000</strong></td>
<td><strong>$10,000</strong></td>
<td><strong>(10,000)</strong></td>
</tr>
<tr>
<td>B.</td>
<td>Proceeds of expropriation</td>
<td>$60,000</td>
<td>$60,000</td>
<td>$40,000</td>
</tr>
<tr>
<td></td>
<td>Less: Cost of replacement</td>
<td>$60,000</td>
<td>$40,000</td>
<td>$45,000</td>
</tr>
<tr>
<td></td>
<td>Capital gain</td>
<td>Nil</td>
<td>$20,000</td>
<td>Nil</td>
</tr>
<tr>
<td>C.</td>
<td>Capital gain (loss) subject to tax</td>
<td>Nil</td>
<td><strong>$10,000</strong></td>
<td><strong>(10,000)</strong></td>
</tr>
</tbody>
</table>

#### Adjusted cost base of replacement property:

<table>
<thead>
<tr>
<th>Case</th>
<th>Assumption</th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Capital cost</td>
<td>$60,000</td>
<td>$40,000</td>
<td>$45,000</td>
</tr>
<tr>
<td></td>
<td>Less: Capital gains deferred (A-C)</td>
<td>$10,000</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td>Adjusted cost base</td>
<td><strong>$50,000</strong></td>
<td><strong>$40,000</strong></td>
<td><strong>$45,000</strong></td>
</tr>
</tbody>
</table>
This capital gain of $10,000 has however reduced the cost base of the replacement property so that if it is sold for more than $50,000, the resulting capital gain will be subject to tax. Case 2 demonstrates that if the cost of the replacement property is less than the cost base of the expropriated property, then the entire amount of the capital gain is subject to tax. Finally Case 3 shows that where the proceeds of expropriation are less than the adjusted cost base of the expropriated property, then the resulting capital loss is eligible to be deducted from capital gains of the taxpayer.

Section 44 of the Act which enables the deferral of capital gains on destroyed or expropriated property does not apply to property stolen or damaged. However insurance proceeds used to repair damaged property in order to facilitate its sale will not be included as part of the proceeds of disposition (54.h) as is shown in Example 4.2.

Example 4.2
Tax Treatment of Insurance Proceeds on Damaged Property

Assumptions:
- Adjusted cost base of property before fire: $20,000
- Insurance proceeds used to repair damage: 10,000
- Proceeds of disposition: 20,000

Calculation of taxable capital gain:
- Proceeds of disposition: $20,000
- Adjusted cost base: 20,000
- Capital gain realized: Nil

The special tax provisions governing dispositions by foreclosure are included in Section 79 of the new Act. In a foreclosure, the mortgagor is deemed to have disposed of his mortgaged property for the amount of the outstanding principal, interest, and other costs of the mortgage (79.c).
Capital gains or losses of the mortgagor on the foreclosure of his property are based on this foreclosure amount. If at a later date, the mortgagor makes further payments in satisfaction of the mortgagee's claims, then such payments will be deemed to be capital losses of the mortgagor in the year of payment (79.d).

The mortgagee in a foreclosure is deemed to have acquired the property for the amount of the mortgage claims extinguished by the foreclosure (79.f). To prevent the creation of capital losses on the foreclosed mortgage, the Act stipulates that the adjusted cost base of the foreclosed mortgage is to be nil (79.g). A mortgagee will therefore only be able to realize an allowable capital loss on a foreclosure at the time of the actual disposition of the foreclosed property. Example 4.3 demonstrates the foreclosure provisions of the new Act.

In Example 4.3, the mortgagor, E, realizes a capital loss of $40,000 when his property is foreclosed. The mortgagee, M, does not realize either a capital gain nor a capital loss until the foreclosed property is sold. If at a later date, E makes a further payment to M then E will realize a capital loss and M will realize a capital gain at that time.
### Example 4.3
Foreclosures

<table>
<thead>
<tr>
<th>Assumptions:</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>E's equity</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>M's mortgage</td>
<td>60,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Cost of property</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>M forecloses and sells property</td>
<td>$50,000</td>
<td>$70,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>E's capital loss on foreclosure:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Deemed proceeds of foreclosure</td>
<td>$60,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Less: Adjusted cost base of property</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Capital loss</td>
<td>$40,000</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>M's capital on foreclosed mortgage:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds of foreclosure</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Less: Adjusted cost base of mortgage</td>
<td>Nil</td>
<td>Nil</td>
</tr>
<tr>
<td>Capital loss</td>
<td>Nil</td>
<td>Nil</td>
</tr>
</tbody>
</table>

| Adjusted cost base of property to M|          |          |
|which is equal to mortgage claims   | $60,000  | $60,000  |

<table>
<thead>
<tr>
<th>M's capital gain/(loss) on foreclosed property:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds of disposition</td>
<td>$50,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>Less: Adjusted cost base</td>
<td>60,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Capital gain (loss)</td>
<td>$(10,000)</td>
<td>$(10,000)</td>
</tr>
</tbody>
</table>
OPTIONS

The granting of an option is deemed by the Act to be a disposition of a property which has an adjusted cost base of zero (49.1). The capital gain realized by a taxpayer who has granted the option is equal to the consideration received for the option less any expenses of issuing the option. Thus, a taxpayer who receives $1,000 for a six month option on 100 acres of land that he owns would realize a capital gain as follows:

<table>
<thead>
<tr>
<th>Proceeds for granting option</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Adjusted cost base of option</td>
<td>Nil</td>
</tr>
<tr>
<td>Legal fees</td>
<td>$100</td>
</tr>
<tr>
<td>Capital gain realized</td>
<td>$900</td>
</tr>
</tbody>
</table>

The taxpayer who receives the option is deemed to have acquired the option for a cost base equal to the consideration paid for the option plus any other related expenses. In the above example, the cost base of the acquired option would be as follows:

<table>
<thead>
<tr>
<th>Consideration paid for option</th>
<th>$1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Add: Legal fees and other costs</td>
<td>250</td>
</tr>
<tr>
<td>Adjusted cost base of option</td>
<td>$1,250</td>
</tr>
</tbody>
</table>

Upon expiration of the option, the taxpayer holding the option would normally be considered to have incurred a capital loss equal to the adjusted cost base of the option. In the above example, a capital loss of $1,250 is incurred.

<table>
<thead>
<tr>
<th>Proceeds of disposition</th>
<th>Nil</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Adjusted cost base of option</td>
<td>$1,250</td>
</tr>
<tr>
<td>Capital loss</td>
<td>$1,250</td>
</tr>
</tbody>
</table>
Thus the granting of an option results in an immediate capital gain to the grantor of the option but does not result in a capital loss to the holder of the option until it has expired.

If during the option period, the holder of the option sells the option to another party then he would be deemed to have disposed of the option and to have realized a capital gain or loss as the case may be. If, in the example above, the option holder sells the option for $5,000, then he would realize a capital gain of $3,500.

<table>
<thead>
<tr>
<th>Proceeds of disposition of option</th>
<th>$5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Adjusted cost base</td>
<td>$1,250</td>
</tr>
<tr>
<td>Legal fees</td>
<td>250</td>
</tr>
<tr>
<td>Capital gain realized</td>
<td>1,500</td>
</tr>
<tr>
<td></td>
<td>$3,500</td>
</tr>
</tbody>
</table>

The cost base of the option to the second party who purchased the option would again be equal to the consideration paid plus any other related costs. Upon expiration of the option, the party holding the option would incur a capital loss equal to the adjusted cost base of the option. Subsequent sales of an option do not affect the tax situation of the original grantor of the option.

If the option is exercised, it is no longer regarded as a disposition of property by the grantor but as part of the consideration received for the property to which the option relates (49.3). Thus in the above example, the taxpayer granting the option is no longer considered to have realized a capital gain of $900. The $1,000 received for the option would be considered as part of the proceeds of disposition of the 100 acres and the $100 of expenses relating to the option would be included as part of the costs of disposition of the 100 acres. Similarly, the cost base of the property acquired through exercising the option includes all the costs of acquiring the option. Thus if in the example, the second
option holder exercises the option, then the cost base of the 100 acres would be as follow:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase price of 100 acres</td>
<td>$50,000</td>
</tr>
<tr>
<td>Less: Initial option paid</td>
<td>1,000</td>
</tr>
<tr>
<td>Acquisition cost of option</td>
<td>5,000</td>
</tr>
<tr>
<td>Related costs including option costs</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Adjusted cost base of 100 acres</strong></td>
<td><strong>$57,000</strong></td>
</tr>
</tbody>
</table>

The tax treatment of options described above applies to most real estate transactions. Exceptions to these rules occur when personal property is optioned. Capital gains realized on personal property are subject to tax so capital gains arising from options granted on personal property are also taxable. Thus the $100 received for an option on a taxpayer's lake cottage is a capital gain to him that is taxable. However, since capital losses incurred on the disposition of personal property are not deductible capital losses, capital losses arising from options on personal property are therefore not deductible to the purchaser of the option. Thus, the $100 paid for an option on a cottage which is not exercised is a non-deductible personal expenditure. Capital gains on the disposal of principal residences are exempt from tax so capital gains realized from granting options on a taxpayer's principal residence are also not taxable. Similarly, the purchaser of an option on a principal residence does not incur a deductible capital loss if he does not exercise the option.
**Example 4.4**  
**Summary of Tax Treatment of Options**  

<table>
<thead>
<tr>
<th>Event</th>
<th>Treatment of Grantor</th>
<th>Treatment of Holder</th>
</tr>
</thead>
<tbody>
<tr>
<td>Granting option.</td>
<td>Proceeds are taxable as a capital gain.</td>
<td>Cost base equal to acquisition cost.</td>
</tr>
<tr>
<td>Expiry of option.</td>
<td>No tax significance.</td>
<td>Disposition as of date of expiry. Capital loss equal to cost base.</td>
</tr>
<tr>
<td>Sale of option by holder.</td>
<td>No tax significance.</td>
<td>Disposition yields a capital gain or loss.</td>
</tr>
<tr>
<td>Exercise of option.</td>
<td>Proceeds of option are included as part of proceeds of disposition of property that was optioned.</td>
<td>Cost base of option included in cost base of acquired property.</td>
</tr>
</tbody>
</table>
NON-ARM'S LENGTH TRANSACTIONS

When a taxpayer decides to sell property to his brother, to give property to his children, or to bequeath property to his heirs, he is governed by specific provisions of the new Income Tax Act relating to non-arm's length transactions. Persons who are related to one another are deemed by the Act to not deal with each other at arm's length (251.1). Related persons include an individual and a corporation or corporations controlled by him as well as other individuals connected to him by blood relationship, marriage or adoption (251.2). A primary intent of the non-arm's length provisions of the Act is to prevent taxpayers from transferring capital gains and capital losses accruing on property to persons related to them.

To avoid paying income taxes on a capital gain, a taxpayer may decide to sell the appreciated property to a person related to him. For example, a father might sell a building lot to his son at its original cost in order to avoid a substantial taxable capital gain which would result if it was sold at its fair market value. In order to prevent such capital gain transfers, the new Act stipulates that disposition of property to persons with whom a taxpayer is not dealing at arm's length, for proceeds less than fair market value, will be deemed to be made for proceeds equal to the fair market value (69.1.b). However, the new Act does not stipulate that the person acquiring the property is also deemed to have acquired it at a cost equal to that fair market value. Consequently, a non-arm's length transaction for proceeds less than fair market value could result in a capital gain being taxed twice as is demonstrated in Example 4.5.

In Example 4.5, the non-arm's length provisions of the Act have deemed that A has realized a capital gain of
Example 4.5
Non-Arm's Length Transaction
Proceeds less than Fair Market Value

Assumptions:
1. Individual A sells 10 acres of land valued at $100,000 to his brother for $50,000.
2. Adjusted cost base of land to A is $50,000.
3. Brother sells land for $100,000.

A's Tax Position:
Deemed capital gain realized by A:
   Deemed proceeds of disposition (fair-market value) $100,000
   Less: Adjusted cost base 50,000
   Deemed capital gain realized by A $ 50,000

Brother's Tax Position:
Adjusted cost base of land to brother is equal to its acquisition cost (not fair market value) $ 50,000

Capital gains realized by brother:
   Proceeds of disposition $100,000
   Less: Adjusted cost base 50,000
   Capital gain realized by brother $ 50,000
$50,000 on disposition of the 10 acres of land to his brother even though the actual proceeds are equal to the cost base of the land. Although A has been deemed to have sold his land at its fair market value of $100,000, his brother has not been deemed to have acquired the land at that price but at his actual cost of $50,000. Thus, the brother is also deemed to have realized a $50,000 capital gain when he sells the land at its fair market value of $100,000. Consequently, the same capital gain of $50,000 is subject to tax in the hands of A as well as those of his brother.

In order to gain some tax relief, a taxpayer may attempt to incur an artificial capital loss by acquiring property from a related person at an inflated price and then disposing of the property for a capital loss. For example, a father in a high marginal tax bracket might attempt to incur a substantial allowable capital loss by selling a parcel of land he has recently acquired from his son at a highly inflated price. Therefore, to prevent the creation of such artificial losses, the new Act stipulates that where a taxpayer acquires property in a non-arm's length transaction, at an amount in excess of its fair market value, then he is deemed to have acquired the property at that fair market value (69.1a). However, this provision does not stipulate that the person selling the property will also be deemed to have sold the property for its fair market value. Thus, the taxpayer will be prevented from claiming a capital loss on the transaction but the seller could still incur an additional taxable capital gain or a reduced allowable capital loss as is demonstrated in Example 4.6.

In attempting to transfer a capital loss of $50,000 accrued on the 10 acres of land from his brother to himself, Individual A in Example 4.6 has transferred the capital loss from his brother to himself, but because of the non-arm's length provisions of the Act, A is unable to claim the capital loss for tax purposes. Consequently neither A
Example 4.6
Non-Arm's Length Transaction
Proceeds in Excess of Fair Market Value

Assumptions:
1. Individual A purchases 10 acres of land valued at $100,000 from his brother for $150,000.
2. Adjusted cost base of land to brother is $150,000.
3. A sells land for $100,000.

Brother's Tax Position:
Capital loss incurred by brother:
    Proceeds of disposition (received from A) $150,000
    Less: Adjusted cost base 150,000
    Capital loss incurred by brother Nil

A's Tax Position:
Adjusted cost base of land to A is deemed by Act to be its fair market value $100,000

Deemed capital loss incurred by A:
    Proceeds of disposition $100,000
    Less: Deemed adjusted cost base of land 100,000
    Deemed capital loss incurred by A Nil
nor his brother will be able to utilize an actual capital loss of $50,000.

Depreciable Property

The non-arm's length provisions of the new Act apply to depreciable property in the same manner as other capital property. Where proceeds of disposition are less than fair market value, the depreciable property is deemed to have been sold for its fair market value. At this fair market value, a capital gain and/or a recapture of capital cost allowance may occur which would not otherwise have resulted. The purchaser, in turn acquires the property at his actual cost, being less than fair market value. Similarly, where the proceeds of disposition exceed the fair market value, the depreciable property is deemed to have been acquired at its fair market value. Consequently, the excess proceeds paid for the property will increase the capital gain or capital cost allowance recapture of the seller but will not increase the capital cost of the property to the buyer. However, the application of the general non-arm's length provisions relating to depreciable property under the new Act differ greatly from the tax treatment afforded depreciable property under the old Act.

Under Section 17.7 of the old Act, depreciable property sold for less than its fair market value in a non-arm's length transaction was not deemed to have been sold at its fair market value. Proceeds of disposition to the seller of the depreciable property were deemed to be the actual proceeds received. On the other hand, the purchaser was deemed to have acquired the property at a capital cost equal to that of the seller irregardless of whether or not the actual acquisition cost was less than or exceeded the seller's capital cost. If the actual acquisition cost was
less than the capital cost however, then the basis for claiming capital cost allowance by the purchaser was deemed to be this lower acquisition cost. The difference between the capital cost and this lower acquisition cost was deemed by the old Act (20.4) to have been previously claimed by the purchaser as capital cost allowance so that a subsequent disposition for proceeds in excess of this lower acquisition cost would result in a recapture of capital cost allowance. The comparative advantages of the non-arm's length provisions of the old Act over those of the new Act are demonstrated in Example 4.7.

In Example 4.7, Taxpayer A has sold his apartment building valued at $150,000 to his brother for only $100,000. A's brother sells the apartment to a stranger for its market value of $150,000. Under the old Act, Taxpayer A would only have incurred income taxes on the capital cost allowance recapture of $20,000 which is the amount by which the proceeds received from his brother of $100,000 exceed the undepreciated capital cost of the apartment of $80,000. However, under the new Act, Taxpayer A is deemed to have sold his apartment building for its fair market value of $150,000. Consequently he would be taxable on a deemed capital gain of $30,000 which is the excess of the deemed proceeds over his capital cost of $120,000 as well as a recapture of capital cost allowance of $40,000. When A's brother sells the apartment for $150,000, he was only deemed under the old Act to have realized a capital gain of $30,000 which is the excess of the proceeds over A's capital cost of $120,000 and a recapture of capital cost allowance of $20,000. Under the new Act, A's brother will not incur a recapture of capital cost allowance but he will realize a capital gain of $50,000 which is the excess of the proceeds over his actual acquisition cost of only $100,000. Realizing that capital gains were tax free under the old Act, it is
Example 4.7
Depreciable Property
Comparison of Non-Arm's Length Provisions
of the old Act and the new Act

Assumptions:
1. Taxpayer A sells his apartment to his brother $100,000
2. Capital cost of apartment building to A 120,000
3. Undepreciated capital cost at date of sale 80,000
4. Fair market value at date of sale 150,000
5. Subsequent sale of apartment by brother 150,000

A's Tax Position:
Deemed capital gain realized by A:
\[
\begin{align*}
\text{Deemed proceeds of disposition} & : \$150,000 \quad \$100,000 \\
\text{Less: Capital cost} & : 120,000 \quad 120,000 \\
\text{Deemed capital gain realized by A} & : 30,000 \quad \text{Nil}
\end{align*}
\]
Recapture of capital cost allowance by A:
\[
\begin{align*}
\text{Lesser of proceeds or capital cost} & : 120,000 \quad 100,000 \\
\text{Less: Undepreciated capital cost} & : 80,000 \quad 80,000 \\
\text{Recapture of capital cost allowance} & : 40,000 \quad 20,000
\end{align*}
\]

Brother's Tax Position:
Deemed capital cost of property to B
\[
\begin{align*}
\text{Basis of capital cost allowance to B;} & \\
\text{N.A.-Acquisition cost} & : 100,000 \\
\text{O.A.-Lesser of capital or acq. cost} & : 100,000
\end{align*}
\]
Capital gain realized by brother B:
\[
\begin{align*}
\text{Proceeds of disposition} & : 150,000 \quad 150,000 \\
\text{Less: Deemed capital cost} & : 100,000 \quad 120,000 \\
\text{Capital gain realized by B} & : 50,000 \quad 30,000
\end{align*}
\]
Recapture of capital cost allowance by B:
\[
\begin{align*}
\text{Lesser of proceeds or capital cost} & : 100,000 \quad 120,000 \\
\text{Less: Undepreciated capital cost} & : 100,000 \quad 100,000 \\
\text{Recapture of capital cost allowance} & : \text{Nil} \quad 20,000
\end{align*}
\]

Summary:
Capital gains realized by-
\[
\begin{align*}
\text{A} & : 30,000 \quad \text{Nil} \\
\text{Brother} & : 50,000 \quad 30,000 \\
\text{Total capital gains realized} & : 80,000 \quad 30,000
\end{align*}
\]
Recapture of capital cost allowance by-
\[
\begin{align*}
\text{A} & : 40,000 \quad 20,000 \\
\text{Brother} & : \text{Nil} \quad 20,000 \\
\text{Total recapture of C.C.A.} & : 40,000 \quad 40,000
\end{align*}
\]
easy to see the substantial benefits provided for depreciable property under the non-arm's length provisions of the old Act which do not exist under the new Act.
TAX FREE ROLLOVERS

A real estate investor who is an individual may desire at some time to transfer property to his children or some other related individuals or he may desire to take advantage of the corporate entity by transferring his properties to a corporation controlled by him. However, under the non-arm's length provisions of the Income Tax Act, an investor who transferred his property in such a manner would be subject to tax on his unrealized capital gains and recaptured capital cost allowance. Consequently, most investors would be reluctant to undertake such actions. However, both the old Act and the new Act permitted, under limited conditions, the transfer of properties free of tax to certain related persons. These tax free rollovers of properties from one person to another include transfers of property by an individual to the following:

1. Canadian corporations owned 80% by the individual.
2. His spouse or a trust on behalf of his spouse.
3. Heirs of the individual.

Property Transfers by Individuals to Corporations

Section 85.1 of the new Act provides that where a taxpayer after 1971 disposes of capital property to a Canadian corporation of which immediately after the disposition the taxpayer owns not less than 80% of the issued shares of each class of the capital stock of the corporation, then the taxpayer and the corporation may jointly elect on a prescribed form to stipulate the proceeds of disposition and the corporation's cost of the property. Utilization of this section by a taxpayer and a corporation enables capital gains accrued on property to be transferred without
Example 4.8
Tax Free Rollovers
Individuals to Corporations

Assumptions:
1. Individual A sells 40 acres of land for 10,000 common shares to his wholly owned Canadian corporation B.

2. Adjusted cost base of land $50,000
3. Fair market value of land on date of sale 200,000
4. Fair market value of the 10,000 shares 200,000
5. Transfer price agreed to in the election 50,000

Calculation of capital gains on disposition of land:
Deemed proceeds of disposition (elected price) $50,000
Less: Adjusted cost base of land 50,000
Capital gain deemed to be realized Nil

Cost base of 40 acres of land to corporation B which is equal to the elected price $50,000

Cost base of the 10,000 shares to A which is equal to the elected price $50,000
tax from an individual taxpayer to an 80% controlled corporation. Without this election, the unrealized capital gains would be deemed by the Act to be realized and would therefore be taxable even though the taxpayer may own 100% of the corporation. Example 4.8 demonstrates the tax advantages derived from this rollover provision of the new Act.

Individual A in Example 4.8 has utilized the rollover provisions of the new Act in order to transfer land owned by him to a wholly owned corporation without incurring tax on his unrealized capital gain of $150,000. A subsequent sale of the land for proceeds in excess of its cost base of $50,000 will result in a taxable capital gain to Corporation B but not to Individual A. Individual A will not be deemed to have realized a capital gain until he disposes of the 10,000 shares for proceeds in excess of their deemed cost of $50,000. In effect, Individual A has exchanged 40 acres of land valued at $200,000 and having a cost base of $50,000 for 10,000 common shares with the same market value and cost base as the land.

The rollover provisions of Section 85.1 are subject to specific constraints which govern the elected transfer price agreed upon by an individual and his controlled corporation. If this agreed price exceeds the fair market value of the property transferred, then the Act deems the elected price to be equal to that fair market value (85.1.c). This constraint prevents a capital loss that has accrued on property of an individual from being transferred to a corporation as is demonstrated in Example 4.9.

In Example 4.9, Individual A could have transferred a capital loss of $50,000 to his corporation if this rollover constraint did not exist. The rollover constraint, however, causes the elected transfer price to be equal to the fair market value of the land of $200,000. Consequently, the unrealized capital loss of $50,000 can not be transferred to the corporation but must be realized by Individual A on the transfer date.
Example 4.9
Rollovers of Capital Losses
Individuals to Corporations

Assumptions:
1. Individual A sells land to a wholly owned corporation for 5,000 common shares.
2. Adjusted cost base of land \( \$250,000 \)
3. Fair market value of both land and shares \( \$200,000 \)
4. Elected price agreed upon by A and corporation \( \$250,000 \)
5. Corporation sells land \( \$200,000 \)

<table>
<thead>
<tr>
<th>Capital loss incurred on rollover of land:</th>
<th>Sec. 85.1 Constraint</th>
<th>No Constraint</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deemed proceeds of disposition</td>
<td>$200,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Less: Adjusted cost base</td>
<td>250,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Capital loss incurred by A</td>
<td>$50,000</td>
<td>Nil</td>
</tr>
</tbody>
</table>

| Cost base of land to corporation          | \$200,000           | \$250,000     |

| Cost base of 5,000 shares to A            | \$200,000           | \$250,000     |

<table>
<thead>
<tr>
<th>Capital loss incurred on disposition of land:</th>
<th>Sec. 85.1 Constraint</th>
<th>No Constraint</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds of disposition</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Less: Adjusted cost base</td>
<td>200,000</td>
<td>250,000</td>
</tr>
<tr>
<td>Capital loss incurred by corporation</td>
<td>Nil</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
A second rollover constraint of the Act prevents the realization of a capital gain with the transfer for consideration other than common shares of an 80% controlled corporation (85.1.b). If the consideration, other than common shares, which is received for the property has a fair market value in excess of the agreed price, then the elected price will be deemed to be equal to that fair market value. Example 4.10 demonstrates the constraint over the elected price of a rollover where the consideration excluding common shares has a fair market value in excess of the price agreed upon by the individual and his corporation.

Without the Section 85 rollover constraint, Individual A in Example 4.10 could have realized a $50,000 tax free capital gain on the land for consideration other than common shares (cash). Because of the constraint, Individual A has realized a capital gain of $50,000 which is subject to tax and also the cost base of the common shares received by him has been reduced to zero.

Although the constraints of Section 85 limit the flexibility of the rollover provisions between individuals and 80% controlled corporations, an individual can nevertheless transfer property to a 80% controlled corporation for any agreed price which does not exceed the fair market value of the property or which is not less than the fair market value of the consideration other than common shares.

Section 85.1.e includes an additional rollover constraint which is specifically related to depreciable property. If the proceeds of disposition of a depreciable property as determined by the general rollover provisions of Section 85 are less than the least of the following:

1. undepreciated capital cost of the property
2. capital cost of the property
3. fair market value of the property as of the rollover date
then the proceeds of disposition will be deemed to be the
**Example 4.10**

**Tax Free Rollovers and Realized Capital Gains**

**Individuals to Corporations**

**Assumptions:**
1. Individual A sells land to his wholly owned corporation for 5,000 common shares and $100,000 in cash.
2. Fair market value of land $200,000
3. Adjusted cost base of land 50,000
4. Elected price agreed upon by A and corporation 50,000

<table>
<thead>
<tr>
<th>Sec. 85.1 Constraint</th>
<th>No Constraint</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital gain realized on rollover:</strong></td>
<td></td>
</tr>
<tr>
<td>Deemed proceeds of disposition</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less: Adjusted cost base of land</td>
<td>50,000</td>
</tr>
<tr>
<td>Capital gain realized by A</td>
<td>$ 50,000</td>
</tr>
<tr>
<td><strong>Cost base of land to corporation</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Cost base of shares to A:</strong></td>
<td></td>
</tr>
<tr>
<td>Deemed proceeds of disposition</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less: Consideration other than shares</td>
<td>100,000</td>
</tr>
<tr>
<td>Cost base of common shares</td>
<td>Nil</td>
</tr>
</tbody>
</table>
lesser of these three amounts. Example 4.11 demonstrates the application of this constraint to a rollover of depreciable property.

Example 4.11 demonstrates that the rollover price elected by the individual and the corporation will only be deemed to be the proceeds of disposition if it exceeds the lesser of the capital cost, undepreciated capital cost or the fair market value of the property. If the deemed proceeds exceed the undepreciated capital cost of the property, then a recapture of capital cost allowance occurs. Alternatively a terminal loss can be incurred if the deemed proceeds are less than the undepreciated capital cost of the property. Finally, the capital cost of the depreciable property to the corporation is the same as that of the individual. If the deemed proceeds of disposition are less than this capital cost, then the corporation is deemed to have claimed capital cost allowance equivalent to the difference. If the property is subsequently sold for more than its acquisition cost, then it will be subject to tax on the recapture of this deemed capital cost allowance.

Property Transfers by Taxpayer to Spouse

The second type of tax free rollovers of property which are permitted by the new Act consist of transfers of property from a taxpayer to his spouse. Section 73.1 of the new Act stipulates that after 1971, capital property other than depreciable property is deemed to have been disposed of at its adjusted cost base to the taxpayer if it is transferred to his spouse or a trust created by him under which his spouse is the exclusive beneficiary of the income from the property during her lifetime. In turn, the spouse or trust of the spouse is also deemed to have acquired the property for this same adjusted cost base.
### Example 4.11
Tax Free Rollovers of Depreciable Property
Individuals to Corporations

<table>
<thead>
<tr>
<th>Assumptions:</th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elected price of transferred property</td>
<td>$100,000</td>
<td>$ 80,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Constraints over deemed proceeds of disposition:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Undepreciated capital cost</td>
<td>$110,000</td>
</tr>
<tr>
<td>2. Capital cost</td>
<td>150,000</td>
</tr>
<tr>
<td>3. Fair market value on rollover</td>
<td>130,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deemed proceeds of disposition:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Greater of - Elected price</td>
<td>$100,000</td>
</tr>
<tr>
<td>- Lesser of 1, 2, or 3</td>
<td>110,000</td>
</tr>
<tr>
<td>Deemed proceeds of disposition</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Recapture of capital cost allowance:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Deemed proceeds of disposition</td>
<td>$110,000</td>
</tr>
<tr>
<td>Less: Undepreciated capital cost</td>
<td>110,000</td>
</tr>
<tr>
<td>Recapture (terminal loss)</td>
<td>Nil</td>
</tr>
</tbody>
</table>

| Capital cost of property to corporation which is the same as that of individual | $150,000 | $150,000 |

<table>
<thead>
<tr>
<th>Capital cost allowance deemed to have been claimed by corporation:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital cost of depreciable property</td>
<td>$150,000</td>
</tr>
<tr>
<td>Less: Acquisition cost</td>
<td>110,000</td>
</tr>
<tr>
<td>Capital cost allowance deemed to have been claimed</td>
<td>$ 40,000</td>
</tr>
</tbody>
</table>
Consequently, capital gains accrued on capital property other than depreciable property that is transferred to a spouse continues to remain free of income taxes. However, capital gains which are realized by the disposition of the property transferred to the spouse will be included in the taxable income of the taxpayer and not the income of the spouse (74.2). This provision prevents a taxpayer from transferring a taxable capital gain to his spouse who is likely to be in a much lower marginal tax bracket. A further restriction of the Act over property rollovers states that income from property which is transferred by a taxpayer to his spouse or a trust of the spouse shall be deemed to be income of the taxpayer (74.1). Thus neither a realized capital gain nor income from the appreciated property can be transferred by a taxpayer to his spouse. Also, property which is substituted for transferred property is governed by these provisions. Thus the rollover provisions governing transfers of capital property from a taxpayer to his spouse permit property to be transferred without incurring income taxes but they do not eliminate nor reduce the ultimate tax liability on capital gains or income from the transferred property.

Depreciable property transferred by a taxpayer to his spouse or a trust of his spouse is deemed to have been disposed for its undepreciated capital cost to the taxpayer (73.1.c). The spouse is also deemed to have acquired the transferred property at this same undepreciated capital cost. In addition, the capital cost of the property to the spouse is also deemed to be equal to the capital cost of the property to the taxpayer (73.2). This latter provision ensures that any capital cost allowance which was claimed by the taxpayer that is recaptured on a subsequent disposition will be subject to tax. Capital gains realized on disposition of the depreciable property and income earned by the property are included in the income of the
taxpayer and not the income of the spouse. Thus depreciable property like other capital property can be transferred by a taxpayer to his spouse without incurring income taxes on the transfer but realized capital gains and other income of the property is taxable income of the taxpayer, not the spouse.

Property Transfers by Individuals to Their Heirs

An individual taxpayer who dies on or after January 1, 1972 is considered by the new Act to have disposed of each capital property owned by him immediately before his death (70.5). The proceeds of disposal to the taxpayer and the acquisition cost to the heirs of capital property other than depreciable property is deemed to be the fair market value of the property at time of death. Consequently no tax free rollover of non-depreciable capital property is permitted by the new Act. All capital gains and losses accrued on non-depreciable property are deemed to be realized at time of death and are therefore subject to income taxes.

The new Act permits a limited tax free rollover of depreciable property. Depreciable property is deemed to have been disposed of immediately prior to death for an amount that is midway between the undepreciated capital cost of the property and its fair market value (70.5.b). Capital gains, recapture of capital cost allowance and terminal losses are based on this calculated amount. Heirs of the deceased are deemed to have acquired the depreciable property at a cost equal to the calculated amount, however if the calculated amount is less than the capital cost of the property to the deceased then the heirs are also deemed to have acquired the property at a capital cost equal to that of the deceased (70.5.e). This latter provision means that capital gains
and capital cost allowance recaptures resulting from future dispositions will be based on the capital cost of the property to the deceased. Example 4.12 demonstrates the tax implications of bequests of depreciable property.

Example 4.12 demonstrates that part of the tax on capital gains accrued on depreciable property at time of death can be deferred. In Case 1, a substantial portion of the capital gain is transferred tax free to the heirs of the taxpayer as is shown below:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value of property at date of death</td>
<td>$170,000</td>
</tr>
<tr>
<td>Less: Capital cost</td>
<td>100,000</td>
</tr>
<tr>
<td>Actual capital gain at date of death</td>
<td>70,000</td>
</tr>
<tr>
<td>Less: Capital gain deemed to be realized</td>
<td>10,000</td>
</tr>
<tr>
<td>Capital gain transferred tax free to heirs</td>
<td>$ 60,000</td>
</tr>
</tbody>
</table>

If the depreciable property of Case 1 is subsequently sold for proceeds that are greater than its acquisition cost of $110,000 then all or part of the transferred capital gain will be subject to tax.

Capital cost allowance, claimed by the deceased on his depreciable property, which is not recaptured at the date of death will be subject to tax at a later date if the heirs sell the property for an amount in excess of their acquisition cost. In Case 2 of Example 4.12 all or part of the $40,000 ($100,000 - $60,000) of capital cost allowance which is not recaptured at date of death will be taxable if the heirs sell the property for more than their acquisition cost of $60,000.

The general provisions of the new Act described above do not apply to capital property bequeathed to a spouse or a trust on behalf of a spouse of the taxpayer. The tax treatment afforded property left to a spouse (or trust) are basically the same as those provisions governing transfers of capital property to a spouse during the taxpayer's lifetime. Capital property other than depreciable
### Example 4.12
**Tax Free Rollovers**
**Bequests of Depreciable Property**

<table>
<thead>
<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assumptions:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. U.C.C. at date of death</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>2. F.M.V. at date of death</td>
<td>170,000</td>
<td>70,000</td>
<td>30,000</td>
</tr>
<tr>
<td>3. Capital cost of property</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
</tbody>
</table>

**Deemed proceeds of disposition to deceased and acquisition cost to heirs:**

<table>
<thead>
<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.C.C.</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Add (deduct) (\frac{1}{2}) of excess (deficiency) of F.M.V. over the U.C.C.</td>
<td>60,000</td>
<td>10,000</td>
<td>(10,000)</td>
</tr>
<tr>
<td></td>
<td>$110,000</td>
<td>$60,000</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

**Calculation of realized capital gains at time of death:**

<table>
<thead>
<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deemed proceeds of disposition</td>
<td>$110,000</td>
<td>$60,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Less: Capital cost</td>
<td>100,000</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Capital gain</td>
<td>$10,000</td>
<td>Nil</td>
<td>Nil</td>
</tr>
</tbody>
</table>

**Recapture of capital cost allowance (terminal loss):**

<table>
<thead>
<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lesser of deemed proceeds of disposition or capital cost</td>
<td>$100,000</td>
<td>$60,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Less: U.C.C.</td>
<td>50,000</td>
<td>50,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Recapture of capital cost allowance (terminal loss)</td>
<td>$50,000</td>
<td>$10,000</td>
<td>$(10,000)</td>
</tr>
</tbody>
</table>
property is deemed to have been disposed by the deceased taxpayer and to have been acquired by the spouse (or trust) at its adjusted cost base to the deceased taxpayer (70.6). Depreciable property is deemed to have been disposed by the deceased and acquired by his spouse at its undepreciated capital cost (70.6). Where this undepreciated capital cost is less than the capital cost of the property to the deceased taxpayer then for purposes of determining capital gains and capital cost allowance recaptures, the capital cost of the property to the spouse is deemed to be that of the deceased. These provisions enable a taxpayer to bequeath his capital property to his spouse (or trust) completely free of income taxes. No income taxes will be incurred by the spouse (or trust) on capital gains accrued on the property until the spouse disposes of the property or until her death. Income earned by the property during her lifetime will be included in her taxable income.

The rollover provisions which apply to bequests of capital property which have been described above differ greatly from the rollover provisions of the old Act. Under the old Act, property of a deceased taxpayer was not deemed to have been transferred to his heirs at its fair market value (O.A. 20.6.d). Consequently a deceased taxpayer could avoid completely the tax on capital cost allowance recapture by disposing of depreciable property in his will at its undepreciated capital cost. Valuation of property bequests had no effect on the taxation of capital gains since such capital gains were not taxable under the old Act. The property acquired by the heirs was deemed by the old Act to be acquired by them at its fair market value irregardless of the disposition value used by the deceased (O.A. 20.6.c). This latter provision enabled the heirs to claim capital cost allowance on depreciable property which may have been fully depreciated by the deceased taxpayer. Example 4.13 demonstrates the significant advantages of the
rollover provisions of the old Act which governed bequests of depreciable property over the rollover provisions of the new Act.

Example 4.13 shows that under the old Act capital gains were not subject to income taxes so that an unrealized capital gain of $70,000 on the depreciable property was not taxable in the hands of the deceased nor in those of the heirs. However under the new Act, all of this capital gain could be subject to income taxes. Since the depreciable property is deemed to have been disposed for $110,000, $10,000 of the unrealized capital gain is therefore deemed to have been realized by the deceased of which $5,000 will be added to the taxable income of the deceased. The disposition of the property for $170,000 by the heirs will result in the remainder of the unrealized capital gain of $60,000 to be deemed to have been realized by the heirs of which $30,000 will be added to the taxable income of the heirs.

Under the old Act, the tax on capital cost allowance recaptures could be avoided completely whereas all of the recapture could be taxable under the new Act. Under the old Act in Example 4.13, the deceased taxpayer could transfer his depreciable property having a fair market value of $170,000 to his heirs at its undepreciated capital cost of only $50,000. Accordingly, no recapture of capital cost allowance was deemed to have occurred. However the heirs were deemed to have acquired the depreciable property for $170,000 and could therefore begin to take capital cost allowance on this amount. Under the new Act, the deceased taxpayer is deemed to have recaptured $50,000 of capital cost allowance which is fully taxable. Also the heirs are deemed to have acquired the depreciable property for only $100,000 upon which they may base their capital cost allowance claims.

In summary, Example 4.13 demonstrates that a depreciable
Example 4.13
Comparison of the Rollover Provisions Governing Bequests of Depreciable Property under the old and new Acts

Assumptions:

<table>
<thead>
<tr>
<th></th>
<th>Old Act</th>
<th>New Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. U.C.C. of property at date of death</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>2. F.M.V. of property at date of death</td>
<td>170,000</td>
<td>170,000</td>
</tr>
<tr>
<td>3. Capital cost of property to deceased</td>
<td>100,000</td>
<td>100,000</td>
</tr>
<tr>
<td>4. Proceeds to heir from disposition</td>
<td>170,000</td>
<td>170,000</td>
</tr>
</tbody>
</table>

Tax Consequences to Deceased:

Deemed proceeds of disposition to deceased:
- U.C.C. of property: $50,000
- Add $\frac{3}{4}$ of excess of F.M.V. over U.C.C.: n/a
- Deemed proceeds of disposition: $50,000

Calculation of taxable capital gains at time of death:
- Deemed proceeds of disposition: $50,000
- Less: Capital cost: 100,000
- Capital gains deemed to be realized: Nil
- Taxable capital gains ($\frac{3}{4}$): Nil

Recapture of capital cost allowance:
- Lesser of deemed proceeds or capital c.: $50,000
- Less: U.C.C. of property: 50,000
- Recapture of capital cost allowance: Nil

Tax Consequences to Heir:

Calculation of taxable capital gain:
- Proceeds of actual disposition: $170,000
- Less: Deemed capital cost to heir: 170,000
- Capital gain realized: Nil
- Taxable capital gain ($\frac{3}{4}$): Nil

Recapture of capital cost allowance:
- Lesser of proceeds or deemed capital c.: $170,000
- Less: U.C.C. of property: 170,000
- Recapture of capital cost allowance: Nil

Summary of additions to income caused by bequest and subsequent disposition:

To Deceased:
- Taxable capital gain: Nil
- Recapture of capital cost allowance: Nil

To Heir:
- Taxable capital gain: Nil
- Total additions to income subject to tax: Nil

<table>
<thead>
<tr>
<th></th>
<th>Old Act</th>
<th>New Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable capital gain</td>
<td>Nil</td>
<td>$5,000</td>
</tr>
<tr>
<td>Recapture of capital cost allowance</td>
<td>Nil</td>
<td>$50,000</td>
</tr>
<tr>
<td></td>
<td>Nil</td>
<td>$55,000</td>
</tr>
<tr>
<td>Taxable capital gain</td>
<td>Nil</td>
<td>$30,000</td>
</tr>
<tr>
<td>Total additions to income subject to tax</td>
<td>Nil</td>
<td>$85,000</td>
</tr>
</tbody>
</table>
property having an unrealized capital gain of $70,000 and claimed capital cost allowance of $50,000 could be transferred free of income taxes by a deceased taxpayer to his heirs under the old Act. Under the new Act, the deceased taxpayer would incur a taxable capital gain of $5,000 and a recapture of capital cost allowance of $50,000. In addition, the heirs would incur a taxable capital gain of $30,000 upon disposition of the depreciable property. In total, income taxes must be paid on taxable income of $85,000 which is one half of the fair market value of the depreciable property in Example 4.13.
CONCLUSION

The new Income Tax Act has made special provisions for involuntary dispositions, options, non-arm's length transactions, and tax free rollovers which have a major effect on many real estate investments.

An involuntary disposition of a property through expropriation or destruction would normally subject any unrealized capital gains accruing on the property to be taxable even if all of the proceeds were used to acquire a similar property. To alleviate this obvious injustice, the new Act provides that the tax on the capital gain can be deferred if the proceeds of the involuntary disposition are reinvested in another property. In a mortgage foreclosure, the mortgagor is deemed to have received proceeds for his property equal to the amount of the mortgage claims at the date of foreclosure. Any subsequent amounts paid by the mortgagor to the mortgagee are deemed capital losses of the mortgagor in the year of payment. The mortgagee does not incur any capital gains or losses until he finally disposes of the foreclosed property.

With the advent of taxable capital gains, the tax treatment of options is an important consideration to real estate investors. A property owner who receives money for granting an option to purchase his property is deemed to have realized a capital gain equal to the monies received since the cost base of the option granted is deemed to be zero. These option monies will only be deemed to be part of the sale proceeds of the property if and when the option is exercised. Money paid for an option to purchase either becomes a capital loss upon expiration of the option or becomes part of the cost base of the property when the option is exercised.

The income tax implications under the new Act of non-arm's length transactions are of crucial importance to real estate investors. Appreciated property transferred between related persons at a price below fair market value will be
deemed to have been sold by the vendor at that fair market value but the property will be deemed to have been acquired by the purchaser at the actual price paid. Consequently, the original owner will be deemed to have realized completely the unrealized capital gain but the new owner could also realize the same gain if he sells the property for more than his low acquisition cost. Thus a capital gain could be subject to tax twice if the property is transferred between related persons at an amount below fair market value.

An attempt to transfer a capital loss from one related person to another could result in the loss of an otherwise deductible capital loss. The purchaser is deemed by the Act to have acquired the property at its fair market value and not its inflated acquisition cost so that subsequent disposition at the same fair market value will not incur a capital loss. On the other hand, the seller will be deemed to have received proceeds equal to the inflated price. All or part of an actual capital loss could well be eliminated by this sale of property in excess of fair market value. The overall result is that a tax deductible capital loss can not be utilized by either taxpayer-buyer or seller.

Under the new Act transfers of depreciable property between related persons can incur substantial income taxes which were not incurred under the old Act. Under the old Act, depreciable property was deemed to have been sold for the actual proceeds received and to be acquired at the seller's undepreciated capital cost. The property's undepreciated capital cost was deemed to equal the proceeds paid. Consequently, unrealized capital gains could be completely transferred to related person and, depending upon the actual price of the depreciable property, all or part of the capital cost allowance claimed could avoid recapture. Under the new Act, the transfer of depreciable property between related persons is deemed to have occurred at its fair market value. Consequently the substantial income taxes on unrealized
capital gains and capital cost allowance recaptures can not be avoided nor deferred as was the case under the old Act.

The new Income Tax Act stipulates certain situations where a taxpayer can rollover property to other persons without incurring an income tax liability. An individual can transfer property to a corporation in exchange for shares without realizing a capital gain on the property provided that he owns 80% of every class of share of the corporation. The shares will have a cost base equal to the old cost base of the transferred property so that subsequent disposition of the shares will result in a taxable capital gain even if the corporation still retains the property. Property can be transferred by a taxpayer to his spouse under the new Act without the capital gains accrued thereon being deemed to have been realized. However subsequent disposition of the property by the spouse will cause the capital gain to be realized by the taxpayer and not by the spouse for tax purposes.

Provisions of the new Act also ensure that any capital gains or capital cost allowance recaptures caused by disposition by the spouse will also be deemed to be realized by the taxpayer rather than the spouse. Finally, a taxpayer can obtain limited tax relief by disposing of his property through his will. Property left to his spouse or a trust on behalf of his spouse is deemed to have been sold by him and acquired by her at its adjusted cost base to the deceased. The tax on unrealized capital gains and recaptured capital cost allowance is deferred until subsequent disposition by the spouse or until her death. Capital property, other than depreciable property, bequeathed to heirs other than the taxpayer's spouse is deemed to have been disposed at their fair market value. Unrealized capital gains will therefore finally be subject to income taxes under the new Act. Under the old Act, none of the capital gains accruing on bequeathed property would have been subject to income taxes. Depreciable property is also deemed to have been disposed of at date of death, but at a
reduced price. Deemed proceeds of disposition for depreciable property are the amount midway between the undepreciated capital cost of the property and its fair market value. Realized capital gains and capital cost allowance recaptures are based on this designated amount. However, subsequent disposition of the depreciable property by the heirs, for proceeds in excess of the designated amount, will result in further amounts of the previously unrealized capital gain or untaxed capital cost allowance recaptures being subject to taxation. The tax implications for bequeathed depreciable property are immense under the new Act especially when it is considered that under the old Act, neither unrealized capital gains nor capital cost allowance recaptures were subject to taxation when depreciable property was bequeathed.


