

Capital gains taxation – Deferred, preferred and more



Four ways to give a tax assist to your investment returns

As an investor you may hold stocks and bonds directly, or you may hold them inside a mutual fund. Either way, your investment objectives will be a combination of principal protection, income generation and capital growth.

Your priorities among these objectives will vary over time depending on your other income sources, your current and future spending needs, and your emotional comfort level with the performance of the securities market.

Acknowledging the importance of principal protection, the key distinction for tax purposes is between income and capital. Income off investments includes things such as interest and dividends that are tax annually as earned and paid. Capital on the other hand is essentially the principal that is invested, with many favourable aspects applying to its taxation.¹

Of syrup & hardwood, income & capital

While not a perfect analogy, income is like the sap that flows from a maple tree. The annual harvest is converted to syrup, while the remaining nutrients allow the tree to continue to grow. At such time as the owners decide they'd rather have a hardwood floor than a sugary treat, the tree can be cut down. Similarly, regular income is annually taxable, but capital is allowed to appreciate until harvested.

It is the growth in the capital that is taxed, not the entire capital. The starting point for the calculation is the adjusted cost base (ACB) of the investment. Most often the ACB is simply your acquisition cost, but there may be some adjustments, for example it is increased by purchase costs, such as commissions.

The capital gain (or capital loss – more on that below) is the difference between the fair market value (FMV) as proceeds of disposition, and the ACB. Generally, the proceeds of disposition will be the sale price less any commissions and other selling costs. However, if the proceeds are less than FMV, for example if the investment is given as a gift, the investor/giver's capital gain will still be FMV minus ACB.

How do the tax rules work in favour of capital gains?

Focusing then on capital, there are a number of ways that our tax system treats capital gains favourably.

1. Deferral until disposition

In order for there to be a capital gain (or loss), there must be an actual or deemed disposition of property. An actual disposition would be an intentional sale of a stock on an exchange, or a redemption of units from a mutual fund provider. Deemed dispositions are imposed by law (that's what is meant by "deemed") in situations like a direct transfer to another person, or when the investor becomes a non-resident or dies.

Until there is a disposition, the capital may grow in value year after year without being taxed. Comparatively, most investment income (such as interest, royalty payments and dividends), is taxed annually when it is received. In some situations, the amount will be deemed to be received, such as when interest is credited to an investment rather than paid directly to the investor, or when dividends are automatically reinvested in a stock or a mutual fund. In either situation, the investor will have to use other money to pay the tax on the income, and in the case of dividend reinvestment, this increases the investor's ACB.

¹ This discussion is about non-registered investments; there is no relevant tax distinction between income and capital gains in registered accounts like RRSPs, RRIFs and TFSA's.

2. Preferred treatment, with only partial income inclusion

As noted, a capital gain is equal to FMV minus ACB, but only a portion of that is taxable. The “taxable capital gain” is derived by applying the income inclusion rate to that capital gain. The inclusion rate has varied over the decades:

- Capital gains were tax-free prior to the major overhaul of the income tax system in 1971.
- Beginning in 1972, 1/2 of capital gains were taxable.
- In 1988, the inclusion rate was raised to 2/3, along with a \$100,000 lifetime capital gains exemption (LCGE).
- In 1990, the rate was increased to 3/4, and by 1994 the LCGE was restricted to farm and fishery property, and small business corporation shares. As of 2024, the LCGE is \$1.25M, with indexing resuming in 2026.
- Early in 2000 the rate was dropped to 2/3, and then later that year it was brought back down to 1/2.

The 2024 Federal Budget (*with implementation legislation pending at time of publication*), raised the inclusion rate again to 2/3, but the 1/2 rate remains available for individuals on the first \$250,000 of capital gains in any year. For trusts and corporations, the 2/3 rate applies to all capital gains. The 1/2 rate is used in the examples for the balance of this article, on the assumption that the investor is an individual with less than \$250,000 of annual capital gains.

3. Proportional imposition of tax on disposition

If an investor does not sell the entire investment, the capital gain will be proportional to that disposition. This can result in a current tax effect that is less than the investor’s actual tax rate at the time. The best way to illustrate this is through an example: An investor who has a constant marginal tax bracket rate of 40% puts \$1,000 into a mutual fund that grows to \$1,500 over five years when she withdraws \$150.

- \$100 is a non-taxable return of capital, calculated by multiplying the withdrawal times the ACB divided by the FMV: $\$150 \times [\$1,000/\$1,500] = \100 . (The ACB is reduced to \$900 for future calculations.)
- The capital gain is the difference: $\$150 - \$100 = \$50$. At 1/2 inclusion, the taxable capital gain is \$25.
- At a 40% bracket rate, the tax on the taxable capital gain is $\$25 \times 40\% = \10 .

In sum, the net after-tax cash from the \$150 withdrawal is \$140, which is an effective tax rate of 6.7%. Tax is not disappearing; it is just being deferred until later dispositions.

4. Capital gains distributed from a mutual fund

When a mutual fund rebalances its holdings, it may realize capital gains. As a high tax rate entity, it will commonly distribute such capital gains to instead be taxed to its investors. Fortunately, those distributed gains retain their character, and so are taxed to the investor as capital gains, with the investor’s inclusion rate determining the size of the taxable capital gain.

Note that a mutual fund may be legally structured as a trust or corporation. In a corporate structure there are multiple funds within it that must net their gains and losses, sometimes resulting in lower capital gains distributions compared to trust-structured mutual funds. While this may affect the expected amount of distributions in a given year, the character of such distributions remains capital gains.

The other side of the coin – Capital losses

If an investor disposes of capital property for less than its ACB, there will be a capital loss instead of a capital gain. When a capital loss is realized in a year, it is applied to reduce any capital gains in that year. If the capital losses exceed the capital gains in the current year, the investor can choose to carry back any remaining losses to offset capital gains in any of the three immediately preceding tax years. In doing so, the investor re-files the income tax return for the relevant year(s) to obtain a refund of taxes previously paid.

Another option is to carry the capital loss forward to be used against future capital gains. There is no limit to the time that capital losses may be carried forward.

Transfers between spouses

Capital property may generally be transferred to a spouse at its ACB, both during lifetime and upon death. This also applies to transfers to a trust where the spouse is the capital beneficiary. In the case of investments that have appreciated, as long as there is no disposition there will be a continued deferral of capital gains realization.

Even though transfer is at ACB, later realized capital gains (and future income) is usually attributed to the original spouse, though some of this effect may be limited with informed planning, so obtain tax advice.

For more information, please consult your advisor and tax professional.

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