A SURVEYOR'S BUSINESS

The Capital Gains Tax

This series is furnished by R. Scott White, a life underwriter and a graduate of the Osgoode Hall Law School. They are written by him and other writers including lawyers, accountants and investment people exceptionally knowledgeable in their fields.

DEEMED DISPOSITIONS

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What is the effect of the capital gains tax when property passes to heirs at death or by way of gifts during lifetime? Property by definition covers a wide range of assets and includes stocks, bonds, mortgages and real estate and such personal possessions as works of art and antiques.

For the purposes of the Capital Gains Tax, when a taxpayer dies, he or she is "deemed" or considered to have disposed of all capital property immediately prior to death. In the same way, when the taxpayer gives property to another person while living, the property is deemed to have been disposed of for capital gains tax purposes. In passing, let it also be noted that if a taxpayer is taking up residence in a foreign country, there are certain deemed dispositions of property which will bring about deemed capital gains or losses with which he should make himself familiar.

It will be recalled that succession duties and gift taxes are now defunct in Ontario. It is apparent from the foregoing however, that another tax effective under the same circumstances of death or gifting has come into play whose impact must be assessed by the taxpayer.

As was the case for gift taxes, the taxpayer himself or his estate is liable for capital gains tax and the cash must be found to pay them. No proceeds of sale reach the taxpayer or his estate with which to do so.

Capital gains taxes on death are payable with the taxpayer's return filed by his executors for the year of his death. Such return has to be filed and taxes paid within six months of the taxpayers death.

In the case of gifts the capital gains tax with respect thereto must be included in the income tax return for the year the gifts were made.

Special Treatment for Spouses

As an exception to the foregoing, when property is bequeathed to the spouse or given to him or her during their lifetime, no capital gains tax is payable. This also applies to a trust created solely for the spouse either in a will or during lifetime. The spouse or the trust - in effect the trustees acting in accordance with the trust document - takes the place of the taxpayer from a tax standpoint. A trust which benefits other beneficiaries besides the spouse, such as children, would not qualify. Thus, a will which sets up a life interest trust for the spouse with powers of encroachment for the children would not be eligible for this special treatment.

In effect, as payment for the transfer of this property, a taxpayer is "deemed" to have received a value equal to its "adjusted cost base" (in most cases, the cost of the asset). This means that although the spouse or widow may acquire the property without capital gains tax being payable, the tax is simply postponed until the property is sold or transferred to beneficiaries other than a spouse. Further, at such time, the gain in the property's value will be determined by reference to the cost to the original owner.

It should be noted that in the case of property for which the taxpayer has claimed depreciation in the past, this deemed sale may trigger two things. The full amount of recaptured depreciation up to the original cost may be required to be included in taxable income. Any gain above this figure is a capital gain and the taxable portion i.e. the taxable capital gain, is 50% of such amount.

One would expect that property which is used to earn income could be depreciated and, in fact, various kinds of depreciable property with varying rates of depreciation are laid down in the Income Tax Act. Based on these rates a portion of the original cost is written off each year. The balance not yet written off is called the undepreciated capital cost.

The spouse receives this property at its undepreciated capital cost and no capital gain or losses or recapture of depreciation arises at this time. Again, when the spouse later disposes of this property, any capital gain or loss on recapture of depreciation will be computed with reference to the cost of the original owner.

As an example, a person holds shares (which are not depreciable property) for which he paid $20,000. Their current value is $50,000. If he dies and leaves the shares to his wife or gives them to her during life, his estate will be deemed to have received $20,000 for them just prior to death and she in turn will be deemed to have a cost base of $20,000 for any future transactions.

In this connection the attribution provisions of the Income Tax Act must not be overlooked. If, when the shares are sold at a later date, the original owner is alive, is resident in Canada and still married to the spouse who received the property, any capital gain or loss or recapture of depreciation will be taxable in his hands. In the above example, suppose the man gave the shares to his wife and they were immediately sold for $50,000. The 30,000 capital gain would be attributed to him and the taxable capital gain of $15,000 would be taxable in his hands.

The favourable tax treatment accorded to the spouse or a trust created solely for the spouse when property is passed on, death or by way of a gift is essentially a tax deferral. The full capital gain or loss will ultimately be taxed when the spouse disposes of the property. Except in the case where the gain or loss is attributed to the original owner, the capital gain will be taxed in the spouse's hands at his or her tax rate.

This tax treatment does not apply to common law spouses who are treated as strangers for capital gains tax purposes. In other words, there is an immediately deemed capital gain or loss when property is transferred to common law spouse as outlined below. It may be of interest to note that the income from a property

gifted to a common law spouse does not come under the attribution rule but would be taxable income to the common law spouse and presumably of possible tax advantage to the spouses through income splitting.

Property Not Passing To The Spouse

When a taxpayer dies and property is passed to a person other than the spouse - for example to children or a brother or sister - or to a trust not created solely for the spouse, then a deemed capital gain or loss or recapture of depreciation may arise which is taxable at that time. The taxpayer is deemed to have received fair market value where the property is not eligible for a depreciation allowance. If the property can be depreciated, it is deemed to have been disposed of at a value halfway between the fair market value and the as yet undepreciated capital cost which may be a tax advantage for the deceased taxpayer. The new owner will use this artificial value for determining capital gains or losses or recapture of depreciation when he later sells the property.

Where the taxpayer gives property during lifetime to anyone other than the spouse or to a trust not created solely for the spouse, then he is deemed to have received fair market value for the property. This applies to both depreciable property and property which is not depreciable.

In the earlier example, if the taxpayer gives the shares of stock for which he paid $20,000 to his son when the fair market value is $50,000, then he will be deemed to have received $50,000 for the stock. A capital gain of $30,000 will be taxable in the father's hands in the year in which the gift was made.

If the stock is left to the son on his father's death, the same capital gain of $30,000 will be taxable to the father and will be included in his tax return in the year of death.

Persons Not Dealing At Arm's Length

When a person sells property to another person who is not at arms length, then the proceeds shall be deemed to be fair market value for capital gains tax purposes regardless of how much actual cash changes hands.

People do not deal at arms length if they are related by blood, marriage or adoption. Generally speaking, a person does not deal at arms length with a corporation in which he has a controlling interest nor do two corporations deal with each other at arms length if they are controlled by the same or related persons.

In the above example, if the father sells the shares to his son for $30,000 when they are worth $50,000, then the father will be deemed to have received $50,000 (fair market value) for them and will incur a capital gain of $30,000 based on a cost of $20,000. Furthermore, of great importance the son's cost for determining future capital gains will be the $30,000 he actually paid and not $50,000.

By the same token if the son pays $60,000 for the shares when they are worth $50,000, the father will incur a capital gain of $40,000 ($60,000 - $20,000). The son will be deemed to have paid $50,000 (the fair market value) and this will be the son's cost for determining future capital gains. Thus, not only are the proceeds tied to fair market value but the difference between the actual proceeds are taxed twice - once in the original owner's hands and again in the the new owner's hands. To avoid this double taxation, the property should either be given to the person or sold for its fair market value.

This treatment does not apply to transactions between persons who are dealing at arms length. If an individual wishes to pay more or accept less for a property when dealing at arms length, then the actual proceeds form the basis for capital gain or loss on the sale and for the new owner's cost for future capital gains tax purposes.

Estate Problems

It should be noted that capital gains arising on the death of the taxpayer cannot be forward averaged through the purchase of an income averaging annuity contract. As the taxpayer is deceased there is no life upon which to base the annuity. This means that if a large capital gain is realized on death, the entire taxable capital gain will be taxed in the year of death at the taxpayer's highest marginal rate.

It is also important to note that when a capital gain is realized in a particular tax year and the taxpayer dies before an income averaging annuity contract can be purchased, then the entire taxable capital gain will be included in the taxpayers final return and fully taxed. As there is generally an advantage to tax deferral there is a strong argument for purchasing an income averaging annuity as soon as the capital gain is realized.

If a taxpayer purchases an income averaging annuity contract and later dies, there may be remaining instalments payable uder the annuity to a beneficiary appointed by the taxpayer. These payments will be taxable in the beneficiary's hands as received at the beneficiary's tax rate.

Under normal circumstances allowable capital losses (equal to one half of capital losses) can be written off against other income only up to $2,000. Any excess is carried back one year and forward indefinitely into future taxation years. On the other hand and of great importance, capital losses arising on death and any losses being carried forward from past years at the time of death may be applied against all income without limitation in the year of death and in the preceding tax year.

As noted above, property can be passed to the spouse with no immediate capital gains tax liability. If property is passed to the children or other beneficiaries, large capital gains may arise in the taxpayer's final tax return. This may create a liquidity problem in the estate as the taxpayer has not received any cash for the asset he is deemed to have sold and it may be necessary to sell other assets. A far sighted taxpayer can purchase life insurance in anticipation of the problem.

Capital gains which arise when property is gifted may also present the taxpayer with a cash flow problem. Again, he has received no cash for the property. However, he must either include the taxable capital gain in his tax return that year and pay tax at his top marginal rate or purchase an income averaging annuity contract. Both these require cash and a forced sale of other assets may be necessary.

SURVEYORS ON THE MOVE

Andrew Gibson of Arnprior has announced that **Les Sury** is now a partner in his firm effective January 1, 1980. The firm will be known as Gibson & Sury Limited.

Eric Van Soeren is the second O.L.S. to seek the warmer climes of Bermuda. Eric is joining Richard Edgerton with the firm of Bermuda-Caribbean Engineering Limited, in Hamilton, Bermuda.

A retirement dinner was held at the home of Jack Kirkup in Thunder Bay recently for **Howard Keffer.** Howard had recently retired and many of the surveyors from North Western Ontario were present to offer their good wishes.

Tudor Jones has reported that the Surveys & Mapping Division of the City of Ottawa is moving from the City Hall to 1355 Bank Street.

Ross Taggart O.L.S. has recently purchased the survey business of G. Bracken Limited, in Almonte, Ontario. Ross's address and telephone number is Box 1346, Almonte, 613-256-2707.