Understanding Capital Gains Tax in Canada

Description

You’ve done your research, picked a stellar company to invest in, and let your investment grow. Your stock has turned into a sizeable sum, and you’re ready to cash in and collect some serious gains. There’s just one thing left to do before you count your profits.

And that’s calculating your *capital gains tax.*

A capital gains tax is a tax imposed on any profit you make from selling an asset. The amount you pay will depend on your marginal tax bracket and whether you’re a day trader or not.

Taxes can be complicated, but fortunately, the capital gains tax in Canada is fairly easy to understand. Let’s take a closer look at when you pay a tax on your capital gains and how much you can expect to owe.

What are capital gains?

A capital gain is any profit you make when you sell an asset (such as a stock, bond, or piece of property) for more than you paid for it.

In more technical terms, a capital gain occurs when you sell an asset above its adjusted cost base (ACB)—with the ACB being the price you originally paid—and subtract any expenses incurred in the sale. As a formula, this would look like:

For instance, let’s say you bought 10 shares of a stock for $100 per share. Let’s also say your online broker charges a $10 trading commission to trade stocks. With the purchase of 10 shares, your ACB would be $1,010 ($1,000 for the stock and $10 in expenses).

After some time, you notice that the stock price has gone up to $120 per share and you decide to cash out. Your broker will charge you another $10 to sell your shares, which brings your ACB to $1,020.

At $120 per share, you sell for an initial profit of $1,200 ($120 x 10 shares). However, because of the trading fees, your capital gain would come out to $180 ($1,200 – $1,020).

What is capital gains tax?

A capital gains tax is a tax you pay when you sell any asset for a profit outside of a registered retirement account. The tax is collected by the CRA and calculated using your marginal tax rate.

What is the capital gains tax rate in Canada?

In Canada, your marginal tax rate (that is, the tax rate that corresponds to your income bracket) is also your capital gains tax rate. For instance, if your marginal tax rate is normally 26%, then it's likely your capital gains tax rate will also be 26%.

As we'll talk about below, this doesn't mean you'll pay 26% on *all* your capital gains. But when you do pay taxes on profits earned from selling assets, it will be based on this rate.

How is capital gains tax calculated?

The way the CRA calculates your capital gains tax will depend entirely on whether they consider you a day trader or not.

A day trader is someone whose income is almost entirely derived from buying and selling assets for a profit. For example, if you're unemployed, but you're earning most of your living from buying and selling stocks, the CRA would consider you a day trader. As such, they'll treat your capital gains as business income and tax 100% of it at your marginal tax rate.

Most Canadian investors, however, are not day traders. As a non-day trader, the CRA will tax only 50% of your capital gains at your marginal tax rate.

Using our example from above, let's say you bought 10 shares of a stock for $100 a pop and sold them later for $120, earning $180 in capital gains ($200 minus the $10 trading fee on both the buy and sell sale). As a non-day trader, the CRA would divide this in half and consider $90 taxable income. They'll add the $90 to your other forms of taxable income and tax the entire amount by your marginal tax rate.

When do you pay capital gains tax?

You'll only pay a capital gains tax when you sell assets held in a non-registered account for a profit. That means, if your investments are inside of a registered retirement account (like a TFSA or RRSP), then you don't have to pay a capital gains tax when you sell assets for a profit.

How to avoid paying capital gains tax in Canada

Here are a few ways to avoid capital gains tax:

Try tax loss harvesting

In Canada, your losses can be applied against your gains to reduce the total amount that's considered taxable. This is called tax loss harvesting.

For instance, if you sold enough assets to earn $10,000, but you also sold assets for a loss of $10,000, then your gains and losses would cancel each other out and you would pay $0 in capital gains taxes.

Invest within tax-sheltered accounts like a TFSA or RRSP

Investments held within TFSAs and RRSPs are not subject to capital gains taxes. No matter how much you earn, you don't have to include it as taxable income on your tax filing.

The only exception is U.S. dividend stocks held within a TFSA: the dividends are subject to a 15% tax rate imposed by the IRS.

Keep track of your expenses

Keep an accurate and detailed ledger of any expenses you incur while buying or selling assets. This could include trading commissions from brokers or MERs (on your investment like ETFs and mutual funds). You can subtract these from your profits to lower your capital gains.

How to report capital gains on your tax return

The CRA requires you to report your capital gains as income for the tax year in which you sold the asset. You'll report your capital gains on Form 5000-S3 Schedule 3.

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