Know Your ACBs

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Calculating capital gains and adjusted cost base (ACB) can be a tedious and time-consuming chore. Canadian brokerages unfortunately do not provide investors with complete and authoritative details on capital gains on T3 or T5 slips. This would be difficult in general since the Canada Revenue Agency (CRA) requires you to calculate ACB on all identical assets owned, and a brokerage is unaware of whether you own identical assets through another brokerage. Further, when securities are transferred between brokerages, the receiving brokerage is unaware of the transaction history that's necessary to calculate the ACB. Alas, the onus of tracking ACB falls on the shoulders of the investor.

South of the border, the IRS has estimated it is losing $11 billion per year in tax revenue as a result of U.S. taxpayers misreporting capital gains. To alleviate this problem, the Emergency Economic Stabilization Act (or the "bailout bill") included new requirements for brokerages to track and report adjusted cost base to investors as well as the IRS, beginning in 2011 and going forward. No such requirement exists in Canada.

This article summarizes the process of calculating capital gains and ACBs for several types of transactions according to CRA rules. Also, a free web-based tool – AdjustedCostBase.ca – is introduced, which simplifies the process of tracking capital gains and ACBs for Canadian investors.

The information below and the web-based tool are presented under the assumption that all transactions are on capital accounts (as will be the case for most individuals) as opposed to income accounts. The rules for determining whether transactions are considered on capital accounts are beyond the scope of this article, so if you are unsure please consult the CRA or a tax professional.

Purchases and Sales

The ACB of a security is its cost for tax purposes. ACB is tracked for each group of identical properties owned by an individual. For the case of stocks, shares of the same corporation and of the same class are considered to be identical properties. An individual must normally calculate one ACB for each group of identical stocks, bonds, funds, or trusts, even if they are purchased on multiple dates or held in separate accounts. ACB is maintained on an ongoing, cumulative basis, until all identical units are sold. If transactions of the same security occur in both registered accounts (such as TFSAs and RRSPs) and non-registered accounts, the transactions in registered accounts are ignored when determining the ACB. When trades are made near the end of the calendar year, it is important to remember that the settlement date is used to determine the taxation year of the transaction, not the trade date.

Purchases and sales of securities affect the ACB and capital gains as follows:

- The purchase of shares increases the ACB by the cost of the shares plus any brokerage commissions.
- The sale of shares results in a reduction in the ACB equal to the ACB per share multiplied by the number of shares sold. The sale triggers a capital gain on the settlement date equal to the proceeds of the shares, less any brokerage commissions, less the reduction in the ACB. If the amount is negative, then a capital loss occurs.

Example - On January 29, 2010 you initially hold no shares of TD and buy 100 shares at $63/share. On May 28, 2010 you buy an additional 60 shares of TD at $72/share. On September 10, 2010 you sell 50 shares at $75/share. You pay a commission of $10 per transaction.

- On January 29 your initial ACB for TD is: ACB = (100 shares × $63/share) + $10 = $6,310.
- On May 28 your ACB increases: ACB = $6,310 + (60 shares × $72/share) + $10 = $10,640.
- On September 10 your ACB decreases: ACB = $10,640 – ($10,640 × (50 shares/160 shares)) = $7,315.

You incur a capital gain in 2010: CG = (50 shares × $75/share) – $10 – ($10,640 × (50 shares/160 shares)) = $415.

Return of Capital

A portion of distributions from funds or trusts often falls under the category of return of capital, which normally occurs when distributions exceed income. A brokerage or fund will report your return of capital on T3 slips. You may only receive one T3 slip for multiple securities with a consolidated total of return of capital, in which case you must determine the individual return of capital for each individual security.

Return of capital has the effect of reducing the total ACB by the total return of capital on the record date of the distribution. It does not result in an immediate tax event, but has the effect of increasing capital gains (or reducing capital losses) when the shares are eventually sold.

Example - On January 2, 2009 you initially hold no shares of XRE and buy 1,000 shares at $8.37/share. In 2009, XRE distributes $0.42237/share in return of capital. On January 4, 2010 you sell all your XRE shares for $11.58/share. You pay a commission of $10 per transaction.

- On January 2, 2009 your initial ACB for XRE is: ACB = (1,000 shares × $8.37/share) + $10 = $8,380.
- The return of capital in 2009 results in a decrease in ACB: ACB = $8,380 – (1,000 shares × $0.42237/share) = $7,957.63.

You incur a capital gain in 2010: CG = (1,000 shares × $11.58/share) – $10 – $7,957.63 = $3,612.37.

The CRA does not allow ACB to fall below zero due to return of capital. If you receive a distribution with a return of capital portion greater than your ACB, the difference between the return of capital and your ACB is a capital gain in the year of the distribution and your ACB is reduced to zero. If your ACB is already zero, the entire return of the capital portion of the distribution is an immediate capital gain.

Stock Option Trading

The trading of stock options can have rather complex tax consequences. There are a dozen possible outcomes resulting from different combinations of buying/selling calls/puts that expire/are exercised/are closed out. The table below summarizes the effects on the ACB and capital gains for all possible opening and closing transaction combinations for options trading. In all cases, transaction costs and commissions should be added to the cost of buying options and shares. Similarly, transaction costs and commissions should be deducted from the proceeds of selling options and shares. Different rules may apply when employee stock options are granted. The settlement date for options is usually one business day after the trade date.

Example

You own 300 shares of XIU with an ACB of $6,000. On December 1, 2009 you sell covered call options for 300 shares of XIU with a strike price of $17 for $1.45/share and pay a commission of $14.50. The options are exercised on June 18, 2010 with a commission of $45.

- You incur a capital gain in 2009: CG = ($1.45/share × 300 shares) – $14.50 = $420.50.
- When the options are exercised the capital gain is annulled. If you already submitted your tax return for 2009 it must be amended.

You incur a capital loss in 2010: CL = $6,000 – (300 shares × $17/share) + $45 – ($1.45/share × 300 shares) + $14.50 = $524.50.

Opening Trans / Closing Trans	Buy Call Options	Buy Put Options	Sell Call Options	Sell Put Options
Options are Exercised	The cost of the options plus the cost of the shares is added to the ACB of the underlying security when the options are exercised.	The cost of the options is deducted from the proceeds of the shares when calculating the capital gain (or loss) on the sale of the shares when the options are exercised.	The proceeds from the sale of the options are a capital gain in the year of the sale, but the capital gain is cancelled on the excercise date (if the gain was reported on a previous year's tax return, that year's return must be amended). The proceeds from the sale of the options are added to the proceeds from the shares to determine the capital gain on the sale of the shares when the options are exercised.	The proceeds from the sale of the options are a capital gain in the year of the sale, but the capital gain is cancelled on the exercise date (if the gain was reported on a previous year's tax return, that year's return must be ammended). The cost of the shares, less the proceeds from the sale of the options, is added to the ACB of the underlying security when the options are excrised.
Options Expire	The cost of the options is a capital loss in the year the options expire.		The proceeds from the sale of the options are a capital gain in the year the options are sold.	
Options are Closed Out	The cost of the options is deducted from the proceeds of the sale to determine the capital gain (or loss) in the year the options are sold to close.		The cost of the options is a capital loss in the year the options are bought to close.	

AdjustedCostBase.ca

The ongoing task of maintaining the ACB and calculating capital gains for a large number of securities and transactions can be quite cumbersome. To simplify the process, I have created a web-based application: AdjustedCostBase.ca (http://www.adjustedcostbase.ca). The tool is free for anyone to use (it is supported by ads). Users enter their security and transaction data and the system automatically maintains a running total of the ACB for each security, and reports whenever any event triggers a capital gain or loss. The calculations are performed according to the rules and guidelines set by the CRA. Registration is extremely simple and does not require any personal information. The tool supports a wide array of transaction types including buys and sells, as well as more complex transactions such as return of capital, splits, reinvested distributions, and the trading of stock options. A sample report is shown below using the same data from the preceding examples.

Conclusion

After reading the above details on calculating the ACB, you may be asking yourself whether you wasted your time when a tool exists that automatically tracks the ACB. However, understanding how your investments are taxed will allow you to plan a better investment strategy. A "shoot first, ask questions later" attitude whereby you do not consider the tax consequences of your investment decisions until income tax season is not usually the optimal strategy. Greater net returns can often be achieved with no additional risk by reducing taxes and fees.

I often hear of investors who avoid certain types of investment strategies in taxable accounts solely because of their complex tax outcome, ignoring the more important factors. Armed with better knowledge and a tool to assist you, hopefully this can be avoided. I invite *MoneySaver* readers to try out AdjustedCostBase.ca. I am always looking to improve the tool and welcome any feedback or suggestions.

Security	Date	Transaction	Amount	Shares	Amount/Share	Commission	Capital Gain (Loss)	Share Balance	New ACB	New ACB/Share
TD	2010-Sep-10	Sell	$3,750.00	50	$75.00	$10.00	$415.00	110	$7,315.00	$66.50
XIU	2010-Jun-18	Call Options Exercised (Strike: $17.00)	$5,100.00	300	$17.00	$45.00	($524.50)	0	$0.00	-
TD	2010-May-28	Buy	$4,320.00	60	$72.00	$10.00	-	160	$10,640.00	$66.50
TD	2010-Jan-29	Buy	$6,500.00	100	$65.00	$10.00	-	100	$6,510.00	$65.10
XRE	2010-Jan-04	Sell	$11,580.00	1,000	$11.58	$10.00	$3,612.37	0	$0.00	-
XRE	2009-Dec-30	Return of Capital	$422.37	1,000	$0.42	-	-	1,000	$7,957.63	$7.96
XIU	2009-Dec-01	Sell Call Options (to Open) (Strike: $17.00)	$435.00	300 Opt.	$1.45	$14.50	~~$420.50~~	300	$6,000.00	$20.00
XRE	2009-Jan-02	Buy	$8,370.00	1,000	$8.37	$10.00	-	1,000	$8,380.00	$8.38

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The activities listed here are those attended by Dale Ennis

➥ **February 5 & 6, 2011** - *MoneySaver* will have a booth and sponsor eight contributing editors during The Investment Show being held at the Hyatt Regency Toronto Hotel on King Street. Benj Gallander, Cynthia Kett, Dan Bortolotti, Norm Rothery, Hank Cunningham, Margot Bai, John Stephenson and Brian Quinlan will be our sponsored speakers. Mark your calendars to attend this information-packed event.

See details on pages two and forty-four.

➥ **February 26-March 9, 2012** - The next cruise which meets the stringent criteria for a *MoneySaver* event will be a 12-day itinerary onboard Oceania's Insignia. This South American cruise is jam-packed with daily port visitations. We leave just after Rio de Janeiro's carnival is over and head south along the Brazilian coast to Uruguay and Argentina (destination Buenos Aires, Argentina).

Full details are posted on CanadianMoneySaver.ca and on page 31. You may contact Maria Etzler at The Cruise Professionals (800-265-3838 or 905-281-4475 or *maria@cruiseprofessionals.com*) for further information and to book at the specially discounted *MoneySaver* rate.