



Capital Gains Reserve

You may realize a capital gain on the property, like real estate or marketable securities if your selling price (net of costs like commissions or legal fees) exceeds your cost of the property. For income tax purposes, one-half of this gain is included in your income and subject to tax.

Sometimes the terms of sale provide that some of the proceeds won't be receivable until after the year of sale. To alleviate having to pay tax on the full gain, when only partial proceeds have been received, you may be entitled to claim a "capital gain reserve". This reserve is basically a deduction in your tax return against the full amount of the capital gain added to your income. However, even if a reserve is claimed, a portion of the capital gain is added to income each year. The amount added is a function of the number of proceeds receivable per year and a minimum amount that ensures that the entire gain will be included in income over 5 years.

Claiming the reserve is optional, but you cannot claim the reserve if you sell the property to a corporation or partnership that is controlled by you immediately after the sale.

Assuming you choose to claim it, the capital gain reserve (i.e., **the deduction**) is **the lesser of** these two amounts:

- The portion of the capital gain that relates to the proceeds that are due after the year – multiply the capital gain by the percentage of uncollected proceeds.
- A set percentage of the capital gain such that at a minimum, at least 20% of the gain, cumulatively, is included in income each year. (Reserve of 80% in year 1; 60% in year 2; 40% in year 3; 20% in year 4; 0% in year 5)

When you claim the reserve for a given year, you add the amount you claimed back into your capital gains income for the next year. However, you continue to claim the reserve if there are still uncollected proceeds from the sale. Over time (maximum 5 years) the gain is taken into income.

Knowing these tax rules can help to structure the agreed payment schedule when negotiating the sale. You'd want to make sure that you're at least collecting enough proceeds to cover the amount of capital gain that will have to be taken into income each year. You can consult with your Padgett advisor for assistance on this.

