

# 4X and Personal Taxes

## Canada

an update re filing your 2005 return

*At the end of reading through this report you should no longer be confused as to the appropriate reporting method or what to do to clarify any lingering issues as to which method specifically pertains to you.*

*Do not consider this report to be a professional opinion, but rather only as information for your consideration from another group member.*

### Background

Last year, as a Chartered Accountant, I was asked to give a seminar on this topic to about 60 of my fellow members of the 4XME Ontario Users Group at the Markham Library on the outskirts of Toronto. This report, the last of 3 recent comments issued to the members, concludes that presentation and prepares the basis for any 2006 seminar that may be undertaken.

The following update includes:

1. confirmation of the CRA requirement to file under the Income Method; and,
2. an exploration of the Capital Gains Method that unexpected time constraints did not allow for at last year's seminar.

My only purpose in this report is to clarify a confused situation on the 4XOntario board and further to tell you how your tax return will be assessed by the responsible authorities if an audit should ever be performed. It is important that you know the basis that will be used to assess your reported income: an importance that grows along with your income growth.

I am not trying to convince anyone of the appropriateness of one method or the other – but rather to report the results of recent discussions on this subject. You should decide for yourselves how this information applies to you and whether or not you want to follow it.

I have not repeated the previous seminar contents of 'how to' report under the Income Method as a careful reading of the CRA Guide adequately covers the general issues. The Guide is available at (<http://www.cra-arc.gc.ca/E/pub/tg/t4002/README.html>) where you must select the download format with which you are comfortable.

I strongly encourage you to obtain professional financial assistance from a local Chartered Accountant regarding this very important matter.

### Introduction

The fact that there are two methods of reporting profits from trading the foreign exchange market is well known to many Canadians. It is similar to situations found throughout the modern world. There are two reporting methods in Canada for individual taxpayers: the Income Method and the Capital Gains Method.

### Which Method is most desirable?

With only one exception, the answer is easy and not complicated: the Capital Gains Method would be best used by (and financially rewarding for) a successful 4X trader, if it were allowed.

### Why?

The ongoing costs associated with trading this market are reasonably fixed: monthly data feeds being one of the most important. As expenses remain relatively constant and revenues increase (perhaps dramatically on a year over year basis) more revenues flow to the bottom line and the net profit from foreign exchange trading grows.

Reporting under the 'Capital Gains Method' results in a lower tax liability simply because only 50% of the "gross profits" from 4X trading (revenues less brokers' fees - only) are classified as a Capital Gain and subject to normal rates of taxation. Under the 'Income Method', 100% of the "net 4X profits" (revenues less allowed business expenses and allowances) are taxed at the normal rate.

Be sure you understand the implications of the details of the above differences.

### The exception

The only exception pertains to the initial startup situation where operating costs are most likely to exceed profit and then the Income Method would be most appropriate.

Since we know the best reporting method, why is there confusion? Let's look at the confusion as it materializes for most Canadian taxpayers.

**The Nature of the Confusion:**

The guidance you receive depends on how you contact Canada Customs and Revenue Agency. By making the contact, inadvertently, you have already made the decision regarding the reporting method to be used as initially each section only deals with their own specific reporting issues and mechanics.

Calling **General Enquiries / Capital Gains** (1-800-959-8281) for assistance in preparing your 2005 personal tax return will yield this guidance:

1. Use Schedule 3 – Capital Gains.

**T1-2005 Capital Gains (or Losses) in 2005 Schedule 3**

Read line 127 in the *General Income Tax and Benefit Guide*. For more information, read Chapter 2 in guide T4037, *Capital Gains*. Attach a separate sheet of paper if you need more space. **Attach a copy of this schedule to your return.**

**Note:** If you have a business investment loss, see line 217 in the *General Guide*.

	(1) Year of acquisition	(2) Proceeds of disposition	(3) Adjusted cost base	(4) Outlays and expenses (from dispositions)	(5) Gain (or loss) (column 2 minus columns 3 and 4)
<b>1. Qualified small business corporation shares (report, in "3," below, mutual fund units, deferral of eligible small business corporation shares, and other shares including publicly traded shares)</b>					
No. of shares					Gain (or loss) <b>107</b>
Total <b>108</b>					
<b>2. Qualified farm property</b>					
Address or legal description					Gain (or loss) <b>110</b> +
Total <b>109</b>					
<b>3. Mutual fund units, deferral of eligible small business corporation shares, and other shares including publicly traded shares</b>					
Address or legal description					Gain (or loss) <b>124</b> +
Total <b>123</b>					
<b>4. Real estate, depreciable property, and other properties</b>					
Address or legal description					Gain (or loss) <b>138</b> +
Total <b>136</b>					
<b>5. Bonds, debentures, promissory notes, and other similar properties</b>					
Face value					Gain (or loss) <b>153</b> +
Total <b>151</b>					
<b>6. Other mortgage foreclosures and conditional sales reposessions</b>					
Address or legal description					Gain (or loss) <b>155</b> +
Total <b>154</b>					
<b>7. Personal-use property (full description)</b>					
					Gain only <b>158</b> +
<b>8. Listed personal property (LPP) (full description)</b>					
					Net gain only <b>159</b> +
<b>Note:</b> You can only apply LPP losses against LPP gains. Subtract: Unapplied LPP losses from other years					
					Net gain only <b>159</b> +
Capital gains deferral from qualifying dispositions of eligible small business corporation shares (included in 3 above) <b>161</b> -					
Farming income eligible for the capital gains deduction from the disposition of eligible capital property (see your farming income guide for details) <b>178</b>					
<b>Information slips</b> – Capital gains (or losses) from all your T5, T5013, and T4PS slips <b>174</b> +					
<b>Information slip</b> – Capital gains (or losses) from all your T3 slips <b>176</b> +					
<b>Capital loss</b> from a reduction in your business investment loss <b>178</b> -					
<b>Total of all gains (or losses) in column 5 before reserves and gifts</b> 191 =					
Reserves from line 6706 of Form T2017 (if negative, show it in brackets and subtract it) 192 +					
Adjusted capital gains on gifts of certain capital property (attach Form T1170) 193 +					
<b>Total capital gains (or losses)</b> 197 =					
<b>Taxable capital gains (or net capital loss) in 2005:</b>					
Multiply the amount on line 197 by 50%. Enter the taxable capital gains on line 127 of your return. If it is a net capital loss, see line 127 in the guide. 199					

- a. Enter the information under section entitled "Mutual Fund Units and other...."
- b. Enter the entry price as the ACB
- c. Enter exit price as proceeds of disposition
- d. For short sales, reverse the entry steps above in b and c.
- e. See the Capital Gains Guide (particularly

- f. No deductions, aside from brokers' fees, are allowed.

However, it is important to realize that CRA staff are dealing with the common situation of the allocation of a gain in the value of a financial instrument: regardless of whether it's a stock, bond, option, commodity or foreign exchange contract; and they do not deal with the underlying nature of the transaction nor a determination of the purpose of the taxpayer: that is too complicated for the intended purpose of general help line and if you ask such questions you will be directed to an external expert to help in defining your particular situation.

Calling **Business Help** (# 1-800-959-5525) for assistance in reporting your foreign exchange results will yield this guidance:

1. Use form T2124
  - a. Enter revenues

**Canada Customs and Revenue Agency / Agence des douanes et du revenu du Canada STATEMENT OF PROFESSIONAL ACTIVITIES**

For more information on how to complete this form, see the *Business and Professional Income Guide*.

**Identification**

Your name: \_\_\_\_\_ Your social insurance number: \_\_\_\_\_

From: Year \_\_\_\_\_ Month \_\_\_\_\_ Day \_\_\_\_\_ To: Year \_\_\_\_\_ Month \_\_\_\_\_ Day \_\_\_\_\_ Was 2005 the last year of your professional business? Yes  No

Business name: \_\_\_\_\_ Main product or service: \_\_\_\_\_

Business address: \_\_\_\_\_ Industry code (see the appendix in the *Business and Professional Income Guide*): \_\_\_\_\_

City, province or territory: \_\_\_\_\_ Postal code: \_\_\_\_\_ Partnership filer identification number: \_\_\_\_\_

Name and address of person or firm preparing this form: \_\_\_\_\_ Tax shelter identification number: \_\_\_\_\_

Business Number: \_\_\_\_\_ Your percentage of the partnership: \_\_\_\_\_ %

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**Income**

Professional fees (includes work-in-progress) \_\_\_\_\_ a

Minus – Goods and services tax/harmonized sales tax (GST/HST) and provincial sales tax (if included in fees above) \_\_\_\_\_

– Work-in-progress (WIP), end of the year (election to exclude WIP, see Chapter 2 of the guide) \_\_\_\_\_

**Total of the above two lines** \_\_\_\_\_ b

Subtotal (line a minus line b) \_\_\_\_\_

Plus – Work-in-progress, start of the year (election to exclude WIP, see Chapter 2 of the guide) \_\_\_\_\_

Adjusted professional fees (total of the above two lines) **6000**

Reserves deducted last year **6290**

Other income **6230**

**Gross income (total of the above three lines) – Enter on line 164 of your income tax return** **6299** c

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**Expenses (enter business part only)**

Advertising **8821**

Bad debts **8990**

Business tax fees, licenses, dues, memberships, and subscriptions **9160**

Delivery, freight, and express **9278**

Fuel costs (except for motor vehicles) **9224**

Insurance **8890**

Interest **8710**

Maintenance and repairs **8966**

Management and administration fees **8874**

Meals and entertainment (allowable part only) **8523**

Motor vehicle expenses (not including CCA) (see Chart A on page 4) **9281**

Office expenses **8810**

Supplies **8811**

Legal, accounting, and other professional fees **8860**

Property taxes **8180**

Rent **8910**

Salaries, wages, and benefits (including employer's contributions) **9060**

Travel **9206**

Telephone and utilities **9220**

Other expenses **9270**

**Subtotal** **9308**

Allowance on eligible capital property **9306**

Capital cost allowance (from Area A on page 3) **9306**

**Total expenses (total of the above three lines)** **9368**

**Net income (loss) before adjustments (line c minus line d)** **9369** d

Your share of line 9369 above \_\_\_\_\_ e

Minus – Other amounts deductible from your share of net partnership income (loss) (from the chart on page 2) **9943** f

**Net income (loss) after adjustments (line e minus line f)** \_\_\_\_\_ g

Minus – Business-use-of-home expenses (from the chart on page 2) **9946** h

**Your net income (loss) (line g minus line h) (enter on line 137 of your income tax return)** **9946**

- b. Enter business expenses in the box opposite the appropriate line title
- c. Capital items must be reported on a Schedule 8 and the CCA reported herein.
- d. The calculation of non-deductible

personal portion of certain expenses have prescribed methods for calculation and must be followed (particularly regarding automobiles, meeting and entertainment expenses and convention attendance but other specific rules apply to many line items as well)

### **How is the ultimate decision made regarding reporting methods?**

The Technical Interpretations branch makes such decisions and provides direction to the tax assessment staff who may ultimately determine your final tax liability. Their position is unchanged from that reported at last Spring's seminar, use the:

## ***Income Method.***

### **What is the basis of their opinion?**

The staff relies upon definitions that have existed for the greater part of two generations and they are reported to have been tested in court on numerous occasions, to the benefit of CRA. These issues are well understood in the business community, even if the foreign exchange market is not.

*(IT-459 supports this view as each situation is determined in light of its own particular facts)*

### **Major Tests**

1. length of time held
  - a. capital gains are to be derived from holding an instrument over a long period of time (discussions by CRA were in terms of years of holding)
  - b. revenues are derived from quick buying and selling

*(Note: IT-95 has text to the contrary as does ITA s.38 - but IT-459 supports this view)*

2. use of margin
  - a. using borrowed funds to undertake a transaction confirms the short term nature and hence business activity of the

transaction

3. ongoing and repetitive nature
  - a. buying and selling on an ongoing basis indicates a business operation and therefore the use of the Income Method rather than an investment situation where the Capital Gains Method would be used.

*(IT-346 provides for Speculator treatment and therefore use of the Capital Gains Method)*

### **Are there conflicts with this opinion and other formal CRA documents?**

**Yes!** *(as noted above as examples – there are others)*

Individual statements can be found that differ with or apparently should modify this view. But ultimately CRA relies on a grander perspective of the intentions of the taxpayer as noted above to override such individual commentary. One could surmise from the dates on various related documents (ITs date from the early '80s and late '70s) that CRA is satisfied with their position regarding 4X transactions and their ability to enforce that position.

### **Is there wiggle room?**

In practice there may be some very limited amount of discretion for first time traders. Despite the fixed nature of the CRA position to use the Income Method, it may initially be possible to properly apply the Capital Gains Method until you are sufficiently successful and making numerous trades when you will be mandated to apply the Income Method. This is a very difficult discussion which can only be addressed individually. Only a financial professional with knowledge of your particular situation can advise you on this: contact a local Chartered Accountant to assist you in making such an evaluation if necessary.

It may or may not be financially advantageous to you to use the Capital Gains Method at the outset – a careful financial review is required even if you prefer to take this aggressive step which contradicts the position of CRA.

## **Conclusion**

CRA states that if you are trading repeatedly in the 4X market, the resulting gains are to be reported under the Income Method on form T2124. However, there is enough documentation from CRA to allow for the consideration of the Capital Gains Method in certain limited situations – but not for successful traders making repeated trades.

If you have any questions, you should retain professional advice from a local Chartered Accountant as to which Method is most appropriate in your particular circumstances and the full implications of each.

**The position of CRA is unwavering for successful group members: the Income Method is to be the basis of reporting 4X gains.**

## **Why have others “successfully” reported under the Capital Gains Method?**

1. This is a situation of “Size Does Matter” from a processing point of view. If the gains (including those from stocks, etc.) are not large in themselves and there is not a significant jump in reported amounts from year to year, the taxpayer will be flying below the CRA radar screen and the issue will not arise... until later when it becomes of such significant dollar amounts to attract the consideration of the CRA staff.
2. There are other larger sources of relatively stable revenues (ie: from employment) that tend to mask the amount reported on schedule 3 and obscure the question of proper reporting.

Do remember that under normal circumstances, the CRA has four years from the date of the assessment notice to reassess a return for any year.

## **\*\*Caution\*\* for those still considering the Capital Gains Method of reporting**

If you report under the Capital Gains Method recognize that an additional tax liability will also be growing from year to year if the Income Method is later determined to be more appropriate by CRA and applied retroactively through re-assessments over a number of years.

At the least, you should be prepared to fund that differential, along with interest and any penalties, even if your intention is to fight any re-assessment should; or, or more likely, when it arises.

My last comment is to reiterate that this issue will grow in importance as your revenues from successful trading in the foreign exchange market grow. Be cautious in your approach to this matter. Due to the above reasons, for an increasingly successful 4X trader continued use of the Capital Gains Method is one of those “Tax Traps” that we discussed last year.

← End of Report →

