Canada Revenue Agency Agence du revenu du Canada

Canada

Income Tax Information Circular

Investment Clubs

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SUBJECT: **Investment Clubs**

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1. This Circular applies to the ordinary investment club, whether in existence at December 31, 1971 or formed thereafter, where each member owns an undivided interest in each security or other asset held by the club. It has no application to clubs that are partnerships, trusts or corporations.

2. The term "units" used in the Circular refers to a member's interest in a club. When reference is made to an action or decision of a club, it means a collective action or decision of its members.

3. Part I of the Circular describes an optional method of reporting income, capital gains and capital losses for tax purposes for 1972 and subsequent years. This optional method is available to any club provided that certain conditions described in paragraph 5 and, if applicable, paragraph 6, are met, and the club elects to use it.

4. Part II of the Circular deals with transitional matters in respect of assets on hand at December 31, 1971. It applies only to clubs in existence at that date, of course, and ceases to have any application after all such assets are disposed of by the club.

PART I

5. For some investment clubs the inclusion of taxable capital gains and allowable capital losses in the income base effective for 1972 and subsequent years has created problems in determining and reporting the amount of capital gain or loss to be attributed to each member on the "undivided interest" basis. As indicated in Appendix C, which comments on the peculiarities of the undivided interest basis, a great many mathematical calculations are required where securities are traded frequently, or where members contribute uneven amounts of capital or occasionally buy or sell units in the club. To facilitate compliance and administration, the Department will allow a club which so elects as described in paragraph 14 to treat the club for income tax purposes essentially as if it were a partnership (hereinafter called the "modified partnership" basis). The election to be taxed on the modified partnership basis is available to a bona fide investment club provided that all its members agree

(a) to use the modified partnership basis of reporting income and to compute the income of the club on a calendar year basis,

(b) to accept the club treasurer's statement of income and the amount taxable in the hands of each member including capital gains and losses, and

(c) that records will be kept of the tax cost of each member's "partnership interest" in the club (hereinafter called the adjusted cost base - see paragraphs 9 and 10).

6. If the club was in existence on December 31, 1971, all the members must also agree to choose the same method of computing the "cost" of assets owned by the club at December 31, 1971 - see Part II.

7. An investment club will generally be considered to be "bona fide" where

(a) all its members are individuals,

(b) the majority of the members are not members of the same family,

(c) members of the same family did not, at any time, own more than 50% of the outstanding units of the club,

(d) substantially all of its property consists of cash, shares, bonds, or units of a unit trust, and

(e) dispositions of the property of the club will give rise to capital gains or losses rather than gains or losses on income account.

8. On the modified partnership basis, a club and its members are treated as if each member owned a partnership interest in the club instead of an undivided interest in each asset of the club. This basis permits the determination of capital gains and losses at the club level as if the club were an entity itself owning the property and realizing capital gains and losses thereon. These gains or losses, together with any other income such as dividends or interest, are allocated in some reasonable manner amongst the members in the year in which they are received by the club (see paragraph 15).

9. The modified partnership basis requires that records be kept of a member's adjusted cost base in order to determine the capital gains or losses arising when a member disposes of any of his units in the club. The following items are recorded in the member's adjusted cost base account:

As Additions

(a) Contributions of capital to the club other than loans.

(b) The cost of units acquired from other members.

(c) Allocations of the excess of capital gains over capital losses in a year (100% of the gain or loss).

(d) Allocations of other net income in a year without grossing-up dividends from taxable Canadian corporations.

(e) Allocations of capital dividends received by the club in respect of shares held by it (see paragraph 11).

As deductions

(f) Withdrawals from the club (e.g. a withdrawal of part of capital or all or part of income) other than by way of a disposition of units.

(g) Allocations of the excess of capital losses over capital gains in a year (100% of the gain or loss).

(h) Allocations of a net loss in a year, if any, on income account.

(i) In the event that a member disposes of some, but not all, of his units, the portion of his adjusted cost base at the time reasonably allocable thereto.

10. The total of amounts shown in (d) and (h) and one-half of the amounts shown in (c) and (g) of the paragraph above are included in computing the income for the year of the member to whom they have been allocated. This income of the club is reported by the club member in the year it is earned by the club, whether it is paid to him in that year or not; however, the entries to the adjusted cost base referred to above ensure that this same income will not be included in his income a second time when he actually receives it, or when he disposes of any of his units.

11. There are two types of tax-free dividends that may be received by a club. The first type is called a "capital dividend". Such dividends are not reported as income on Form T3 prepared by the club for each member (see paragraph 15 below), but the portion of the dividend attributed to a member is added to his adjusted cost base. The second type, which is paid out of a corporation's surplus accumulated prior to 1972 (technically called "tax-paid undistributed surplus on hand" or "1971 capital surplus on hand"), is not reported on Form T3 as income of a member and does not affect his adjusted cost base, but the amount of the dividend reduces the adjusted cost base of the shares of the payer corporation held by the club.

Sale of Units to Other Members, or Units Redeemed by the Club

12. When a member sells all his units or the club redeems them, the proceeds he receives are compared with his adjusted cost base account at that time to determine his gain or loss of which one-half is included in computing his income. If only part of his units are sold or redeemed, the proceeds are compared with the appropriate portion of his adjusted cost base at that time. In the case of redemptions by the club, a part of the gain or loss on assets sold to provide cash for the redemptions may or may not be allocated to the departing member, as the club pleases or according to its rules; but if no part of such gain or loss is allocated to the departing member, the total gain or loss must be allocated to the remaining members.

13. A new member who purchases after 1971 the units of a departing member starts his adjusted cost base account with his purchase price. The purchase price may include an amount in respect of the unrealized capital gains in the club's assets at that time. If the club later realizes all or part of such gains, the new member will be subject to tax on the amount attributed to him on Form T3, but he will be allowed a deduction for the amount paid to the vendor when he disposes of his units in the club (since it is included in his adjusted cost base).

Method of Making Elections

14. If a club wishes to elect the modified partnership basis, the secretary or other officer should so indicate in a letter addressed to the appropriate District Taxation office and filed with the T3 Return (see paragraph 15). The letter should state that the club agrees to follow the conditions outlined in paragraph 5(a) to (c), and if applicable paragraph 6, of this Circular and it should be signed by all members of the club. As new members are admitted to the club, a similar letter should be filed to indicate their acceptance of the modified partnership basis.

Reporting of Income

15. Ordinarily, an officer of the club undertakes to file Form T3 for a taxation year (a calendar year) as the agent for the members and to report thereon the income of each member. In effect, a club receives investment income on behalf of its members which must be reported by the members on a calendar year basis. For 1972 and subsequent years, "income" includes the excess of taxable capital gains over allowable capital losses (one-half the capital gain or loss). Where allowable capital losses exceed taxable capital gains in a year, such losses should be shown as a negative figure in the "taxable capital gains" box on Form T3. The amount of taxable dividends received by the club to be allocated to the members is the gross amount, i.e., before the deduction of any related expense such as interest. In the event that the related expense exceeds non-dividend income of the year, the excess should be allocated and identified on Form T3 as a non-capital loss which is deductible by the member in full.

PART II

Transitional Provisions in Respect of Assets Owned by the Club on December 31, 1971

16. As mentioned in paragraph 6 of Part I, a club that elects the modified partnership basis can choose to use either one or two methods to determine the "cost" of all its assets owned on December 31, 1971. The two methods are

(a) Valuation Day value, and

(b) Median rule.

An explanation of the terms "Valuation Day value" and "median rule" may be found in the publications issued by the Department entitled "Capital Gains" and "Valuation Day".

17. Where a club elects the modified partnership basis, the choice by the club of either Valuation Day value or median rule will not bind the individual members in respect of their similar choice for their own assets.

18. If the club wishes to elect to use Valuation Day value, it should so indicate in a letter addressed to the District Taxation Office and filed with the T3 Return. However, such an election need not be made until the year the first disposition occurs on which there is a gain or loss. The election, once made, applies to all assets held by the club on December 31, 1971. If no election is made in the year stipulated above, the median rule applies automatically to all assets held by the club on December 31, 1971.

Valuation Day Value

19. The Valuation Day value method of determining "cost" is recommended because of its simplicity. It enables the "cost" of assets held on December 31, 1971 to be established quickly; such cost is established once and for all; and the amount of the capital gain or loss determined under this method is used for both the reporting of income of members and the adjustments to their adjusted cost base accounts. If the club uses this method, the result to the member will be essentially the same as if he had adopted Valuation Day value in respect of his interest in the assets of the club.

20. There will be cases where a larger gain will result by using Valuation Day value rather than median rule, but such cases will arise only where the Valuation Day value of an asset is less than both the cost and the proceeds. On the other hand, Valuation Day value will produce a larger loss when it exceeds both the cost and the proceeds. When Valuation Day value is the median amount, the results will be the same, of course, Appendix A illustrates the use of the Valuation Day value method showing the calculation of capital gains and losses of the club and the entries in the adjusted cost base accounts of members. It should be noted that the opening entry in a member's adjusted cost base account is the fair market value of the units owned by him on December 31, 1971.

Median Rule

21. This method of determining "cost" is more complicated. Unlike the Valuation Day value method, it does not establish the "cost" once and for all. The capital gain or loss on dispositions determined by using the median rule is used only for the purpose of reporting the income of members on Form T3. It is also necessary under the median rule to calculate what the capital gain or loss would have been by using Valuation Day value for the purpose of the entries to be made to the member's adjusted cost base accounts. Appendix B illustrates the use of the median rule showing the calculation of the capital gains and losses of the club.

22. Under either the Valuation Day value method or the median rule method, the opening entry in a member's adjusted cost base account is the fair market value of units owned by him on December 31, 1971.

23. In respect of assets acquired before 1972, the modified partnership basis assumes that the member's cost is equal to the club's cost. It does not provide for the situation where a member's cost is more or less than the club's cost, which could be so where a member purchased from other members, and before 1972, units in the club at their fair market value. In such cases it may be preferable to use either the "undivided interest" basis (see Appendix C) or the basis provided by the Income Tax Act for regular partnerships. Either basis will be accepted by the Department, provided all the members agree to use the same basis and so advise the Department. They must then continue to use that basis in subsequent years.

Appendices A and B

24. For simplicity, only round figures have been used in the illustrations in Appendices A and B and the following assumptions have been made:

(a) The club has only four members.

(b) The units owned by the members did not change from December 31, 1971 to December 31, 1973.

(c) All the assets held on December 31, 1971 are disposed of by December 31, 1973.

(d) Since one purpose is to illustrate the adjustment to the adjusted cost base accounts in respect of the gains or losses on dispositions of assets, other amounts mentioned in paragraph 9 above which normally are included in the adjusted cost base accounts have been omitted.

APPENDIX A

Valuation Day Value Method of Determining "Cost" of Assets on Hand on December 31, 1971

Year Ending December 31, 1972

On Hand at December 31 1971	Cost (1) $	Valuation Day Value (2) $	Proceeds on Sale in 1972 $	Gain in 1972 $	Loss in 1972 $
A Company - 100 shares		2750	3150	400	
B Company - 25 shares		710	620		90
C Company - 10 shares		640	840	200	
D Company - 25 shares		1100			
E Company - 40 shares		220			
F Company - 10 bonds		880			
Acquired in 1972					
G Company - 30 shares	2400		2350		50
H Company - 60 shares	840				
I Company - 100 shares	3600				
		$6300		$600(3)	$140(3)

Year Ending December 31, 1973

On Hand at December 31, 1972	$	$	$	$	$
D Company - 25 shares		1100	700		400
E Company - 40 shares		220	190		30
F Company - 10 bonds		880	930	50	
G Company - 60 shares	840		880	40	
H Company - 100 shares	3600				
Acquired in 1973					
J Company - 50 shares	2750			90(3)	$430(3)

Adjusted Cost Base Accounts

	Total	MEMBER			
		1	2	3	4
Units held	300	60	75	75	90
Fair market value of units at Dec. 31, 1971 (assume no cash on hand)	$6300	$1260	$1575	$1575	$1890
Add: Allocation of net gain for 1972 as shown above (4)	460	92	115	115	138
Balance December 31, 1972	6760	1352	1690	1690	2028
Deduct Allocation of net loss for 1973 as shown above	340	68	85	85	102
Balance December 31, 1973	$6420	$1284	$1605	$1650	$1926

(1) The cost of shares on hand at December 31, 1971 is irrelevant under the Valuation Day value method.

(2) This amount is the number of shares held multiplied by the quoted price at December 22, 1971 for publicly traded shares and the value at December 31, 1971 for other assets.

(3) The net amount of all gains and losses in the year is allocated to the members for the purpose of reporting on Form T3, that is, a net gain of $460. in 1972 and a net loss of $340. in 1973. One-half of these amounts is reported on Form T3.

(4) The allocation of capital gains and losses according to units held at a particular time may not be appropriate in all cases. Provided it is reasonable, the decision on the allocation of such gains and losses, and of any other income, rests with the club.

APPENDIX B

Median Rule Method of Determining "Cost" of Assets on Hand on December 31, 1971

Year Ending December 31, 1972

On Hand at December 31 1971	Cost	Valuation Day Value (1)	Proceeds on Sale in 1972	Gain in 1972	Loss in 1972
A Company - 100 shares	$1800	$2750(2)	$3150	$400	$
B Company - 25 shares	550	710	620(2)	-	-
C Company - 10 shares	800(2)	640	840	40	
D Company - 25 shares	850	1100			
E Company - 40 shares	240	220			
F Company - 10 bonds	1000	880			
Acquired in 1972					
G Company - 30 shares	2400		2350		50
H Company - 60 shares	840				
I Company - 100 shares	3600				
	$6300			$440(3)	$50(3)

Year Ending December 31, 1973

On Hand at December 31, 1972	Cost	Valuation Day Value	Proceeds of Sale in 1973	Gain in 1973	Loss in 1973
D Company - 25 shares	$ 850(2)	$1100	$ 700	$	$150

E Company - 40 shares	240	220(2)	190		30
F Company - 10 bonds	1000	880	930(2)	-	-
H Company - 60 shares	840		880	40	
I Company - 100 shares	3600				
Acquired in 1973					
J Company - 50 shares	2750			40(3)	$180(3)

(1) This amount is the number of shares held multiplied by the quoted price at December 22, 1971 for publicly traded shares and the value at December 31, 1971 for other assets.

(2) The median amount which becomes "cost" under the median rule.

(3) The net amount of all gains and losses in the year is allocated to the members for the purpose of reporting on Form T3, that is, a net gain of $390. in 1972 and a net loss of $140. in 1973. One-half of these amounts is reported on Form T3.

Adjusted Cost Base Accounts

The adjusted cost base accounts are the same as those appearing in Appendix A. It should be noted that the net gain or loss allocated to members is not that used for T3 purposes; rather the net gain or loss must also be computed under the Valuation Day value method for the purpose of the entries in the adjusted cost base accounts.

APPENDIX C "UNDIVIDED INTEREST" BASIS

Some investment clubs, particularly those whose members change infrequently and make equal contributions to the club, may wish to use the "undivided interest" basis of reporting capital gains or losses rather than electing the modified partnership basis. The following comments on the peculiarities of the undivided interest basis may assist a club in making its choice between this basis and the modified partnership interest basis:

(a) Legally, a member of a club owns an undivided interest in each asset held by the club. For example, if a club of ten members who made equal contributions held fifty shares of a company, each member would own one-tenth of fifty shares. Thus if the club sold the shares, a member would compare one-tenth of the total proceeds with his cost of one-tenth of fifty shares to determine his capital gain or loss.

(b) If contributions to the club are uneven, there are in effect, constant dispositions and acquisitions of assets among the members since their fractional interests in the assets have changed. This would necessitate a determination of the capital gain or loss on each disposition by a member whose fractional interests decreased and a determination of a new cost to a member whose fractional interest increased.

(c) Where a member sells all or part of his units in a club to new or existing members, only the parties to the transaction are involved in the calculation of capital gains or losses to the vendor on each asset held by the club and the determination of new costs of each asset to the purchaser or purchasers. However, where a club redeems all or part of a member's units, all the other members become involved in the determination of the new costs of each asset. Likewise, all the members of a club are involved in the calculation of capital gains or losses on each asset if a new member is admitted to the club. For example, assume that the ten members mentioned in (a) above admitted one new member on an equal ownership basis. Each of the ten members would dispose of 1/11th of (1/10th of 50) shares. Each of the eleven members would then hold 1/11th of 50 shares.

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