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CESTNICK

TAX MATTERS

Social media-driven trading frenzy has tax implications

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The only thing better than reality television is what happens in real life. You may be aware of what's been taking place this week in the world of social media and the stock market. Several different stocks on the market have seen incredible rallies as the result of calls on social media to buy names such as GameStop Corp.

GME-N +72.59% ^, American Airlines Group AAL-Q -4.14% v, AMC Entertainment Holdings Inc. AMCN +64.66% ^ and more.

More than four million members of the Reddit thread WallStreetBets have led the social-media frenzy, driving up certain stock prices. This is day-trading at its craziest. How does the taxman view all of this? Today, I want to visit the tax implications of day-trading and some things to consider if you're going to take part in it.

High-flying stocks crash to earth as trading platforms hit the brakes

GameStop is a great David vs. Goliath story, but no blueprint for investing success

Silver, precious metal mining shares the latest hit by Reddit-fuelled volatility

How did the Reddit stock market rally happen and why did it start to fizzle on Thursday?

THE BASICS

Okay, first things first. The term "day-trading" doesn't appear in our tax law. And who, exactly, is a day-trader? It's not clear. But there are some principles that have been established by the courts that the Canada Revenue Agency (CRA) follows, and that we should look at.

When an investor sells a stock or other security, and makes a profit, it will be taxed as either a capital gain or regular income. I'm talking about dollars invested outside of a registered plan such as a registered retirement savings plan or tax-free savings account. Profits inside those plans are typically taxdeferred or tax-free (although there can be an exception which I'll talk about in a minute).

When profits are taxed as capital gains, this is called as being on "capital account," while profits taxed as regular income are on "income account."

Profits that are taxed on capital account are reported as capital gains, and just one half of those gains are taxable today. However, profits on income account are fully taxable. So, most people prefer their profits to be on capital account.

THE FACTORS

So, will you be taxed on capital or income account? The taxman will look at your intention when you bought the securities. Your course of conduct will say a lot about your intention. If your intention was to quickly buy and then flip an investment, the taxman's view is that the investment is more akin to business inventory, and you should be taxed on account of income. Specifically, the following are the factors that the taxman considers when determining your intention.

Frequency of transactions: If you have a history of buying and selling securities, or quickly turning over securities or properties (including real estate), this may be an indication that your activity is akin to a business and the taxman may consider your profits as on income account.

Period of ownership: If you own a stock or other security for a very short time, the taxman may consider the transaction to be part of a business, or an "adventure in the nature of trade," which is taxed like business income.

Knowledge of securities markets: The more knowledgeable you are about the equity markets, and the more experience you have in trading stocks, the more the taxman will consider your activity to be on income account.

Your ordinary business: If trading in securities is part of your ordinary business, your transactions are more likely to be considered on income account.

Time spent on trading: If a substantial part of your time is spent studying stocks, other securities, or the markets, and investigating potential purchases, these facts may point the taxman towards income treatment for any profits.

Financing your purchases: The more you engage in borrowing to invest, or purchasing on margin, the more likely the taxman will point to your transactions being on income account.

Advertising your trading: If you happen to advertise or make it known that you're willing to purchase securities on behalf of others, the more your investment activities will be considered on income account.

Nature of the securities: The more speculative in nature the securities are, and the less likely those securities are to pay dividends or interest, the more the taxman will consider trades in those securities to be on income account.

THE NUANCES

Just three more points. First, if you decide to short-sell a stock because you believe it's going to drop in value (a common view regarding some of these social media-driven stocks), any profits on short-selling are automatically considered to be on income account.

Second, if your profits in a TFSA are on income account (that is, if the CRA considers you to be carrying on a business in your TFSA), the taxman may look to tax those profits as business income.

Finally, there's an election you can make to treat your profits on the disposition of Canadian securities as always being on capital account. This election will apply to all tax years going forward (you can't rescind the election later) and isn't available to certain folks in the business of selling securities.

The more of the above factors that apply to your trading, the more likely any gains from your activity are likely to be to be considered income.

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