NO.: **IT-232R3** DATE: July 4, 1997

SUBJECT: INCOME TAX ACT

Losses – Their Deductibility in the Loss Year or in Other Years

REFERENCE: Subsection 111(1) and paragraph 3(d) (also sections 3, 31, 41, 80, 110.5, 111.1 and 120.1, the definitions of "personal-use property" and "listed personal property" in section 54, subsections 46(1), 96(2.1), 96(2.2), 96(2.4), 110.4(2), 111(1.1), 111(2), 111(3), 111(8), 111(10) and 152(6), paragraphs 3(b), 12(1)(x.1), 186(1)(c) and 186(1)(d), and subparagraph 40(2)(g)(iii))

Contents

Application

This bulletin cancels and replaces IT-232R2 dated December 30, 1987.

Summary

The *Income Tax Act* contains a system of rules the purpose of which is to determine how and when a taxpayer's losses are to be applied against income.

This bulletin first discusses the rules that determine the extent to which each of the following types of losses can be used in the taxation year in which the loss is incurred (the "loss year"):

- a loss from an office, employment, business or property, including
  – a limited partner's share of a loss of a limited partnership; and
  – a loss from a farming business.
- a capital loss (i.e., the allowable portion for tax purposes), including
  – a business investment loss;
  – a capital loss from the disposition of personal-use property;
  – a capital loss from the disposition of listed personal property; and
  – a capital loss from the disposition of other capital property.

To the extent that a loss (or the allowable portion of a capital loss) cannot be used in the loss year, it becomes a carried-over loss that can be used in calculating the taxable income of another year or years, subject to certain limitations. A carried-over loss falls into one of the following categories:

- a **limited partnership loss**;
- a **restricted farm loss**;
- a **farm loss**;
- a **non-capital loss**;
- a **net capital loss**; or
- a **listed-personal-property loss**.

For each type of carried-over loss, this bulletin discusses

- the amounts that are included in that loss;
- the carry forward and carry back rules that apply to it; and
- any restrictions on the type of income against which it can be used.

The bulletin also discusses the "inclusion rate adjustment" rule that can apply when using a **net capital loss**.

Finally, the bulletin briefly discusses other related topics, including the special loss rules that apply as a result of the death of an individual.

This bulletin is primarily written for full-year residents of Canada. Loss application rules that pertain to non-residents and part-year residents of Canada are discussed in the current version of IT-262, *Losses of Non-Residents and Part-Year Residents*.

Other bulletins dealing with the deductibility of losses in specific circumstances, are the current versions of the following:

IT-239 *Deductibility of Capital Losses From Guaranteeing Loans for Inadequate Consideration and From Loaning Funds at Less Than a Reasonable Rate of Interest in Non-Arm's Length Circumstances.*

IT-302 *Losses of a Corporation – The Effect That Acquisitions of Control, Amalgamations, and Windings-Up Have on Their Deductibility – After January 15, 1987.*

Discussion and Interpretation

Losses From an Office, Employment, Business or Property, and ABILs – Amount Used in the Loss Year

¶ 1. When calculating income for a particular taxation year in accordance with section 3 of the *Income Tax Act*, a taxpayer can deduct (subject to certain limitations as described in ¶s 2 to 5 below)

- losses from an office, employment, business or property, and
- allowable business investment losses

incurred in the year, against all types of income for the year. An allowable business investment loss (ABIL) is the allowable portion (for tax purposes) of a special type of capital loss. For a detailed explanation of the nature and calculation of an ABIL, see the current version of IT-484, *Business Investment Losses*.

Any reference in this bulletin to the "loss year" means the taxation year in which the particular loss was incurred.

Losses from a partnership

¶ 2. A taxpayer's loss from business or property can be a share of a loss of a partnership of which the taxpayer is a member. If the taxpayer is a "limited partner" as defined in subsection 96(2.4), the rules in subsection 96(2.1) can prevent the taxpayer's share of the loss from being fully deductible in the loss year. By virtue of subsection 96(2.1), the portion of a limited partner's share of partnership losses from business (other than a farming business) or property that can be deducted in the loss year is based on the limited partner's "at-risk amount" (which is determined under subsection 96(2.2)) at the end of the fiscal period of the partnership that ends in the year less certain amounts specified in subsection 96(2.1).

See ¶ 8 below regarding the portion of a limited partner's share of partnership losses that cannot be deducted in the loss year because of the operation of subsection 96(2.1).

Losses from farming

¶ 3. If a taxpayer incurs a loss from carrying on a farming business or businesses, section 31 of the Act may limit the amount of the loss that can be deducted in the loss year. The section 31 limitation rule applies if the taxpayer's chief source of income for the loss year is neither farming nor a combination of farming and some other source of income. The current version of IT-322, *Farm Losses*, mentions factors that should be considered for purposes of determining whether section 31 would apply in a particular case.

¶ 4. If section 31 does apply, the taxpayer calculates the portion of the loss from farming that can be deducted in computing income for the loss year by following these steps:

Step 1: Determine the amount of the loss incurred in the year from carrying on the farming business. For this purpose, calculate the loss before making any deduction for scientific research and experimental development (SR&ED) under section 37 or 37.1.

Notes:

1. If the taxpayer carries on more than one farming business, the income earned or loss incurred for the year from each farming business is calculated. Again, each calculation is made before making any deduction for SR&ED under section 37 or 37.1. If the incomes are greater than the losses, the losses (as well as the SR&ED deductions, if any, under section 37 or 37.1) are fully deductible in the loss year and the taxpayer does not need to proceed with steps 2 to 5. If, on the other hand, the losses are greater than the incomes (without deducting any amounts for SR&ED), the taxpayer subtracts the incomes from the losses and the resulting net loss incurred in the year from all the farming businesses becomes the loss determined under step 1.

2. *In Bill C-69, it is proposed that section 37.1 be repealed for the 1995 and subsequent taxation years.*

Step 2: Subtract $2,500 from the loss determined under step 1 and divide the answer by 2. In other words, calculate the amount determined by the formula: 1/2 of (step 1 loss – $2,500).

Step 3: Take $6,250 or the amount determined in step 2, whichever is less, and then add $2,500.

Step 4: Take the loss determined in step 1 or the amount determined in step 3, whichever is less.

Step 5: Take the amount determined in step 4 and add the amount of any deductions for SR&ED under section 37 or 37.1 that were excluded from the calculations in step 1. The result is the portion of the loss incurred in the loss year from carrying on the business of farming that can be deducted in the loss year.

Example:

Barry reports income of $50,000 from carrying on a retail store business. He also incurs a loss of $10,000 from carrying on a farming business, and section 31 applies. The loss includes a section 37 SR&ED deduction of $2,000. Under the rules in section 31, Barry calculates the portion of the loss from the farming business that he can deduct in the loss year as follows:

Step 1: Loss before claiming the $2,000 SR&ED deduction = $8,000.

Step 2: 1/2 of ($8,000 – $2,500) = $2,750.

Step 3: Lesser of $6,250 and $2,750, plus $2,500 = $2,750 + $2,500 = $5,250.

Step 4: Lesser of $8,000 and $5,250 = $5,250.

Step 5: Portion of loss Barry can deduct in the loss year = $5,250 + $2,000 = $7,250.

See ¶ 9 below regarding the portion of a loss from a farming business that cannot be deducted in the loss year because of the operation of section 31.

¶ 5. The total amount of a taxpayer's

- losses from an office or employment,
- losses from business or property (i.e., the portion of such losses that are otherwise deductible in the loss year after following, if applicable, the rules discussed in ¶ 2 above for a limited partner and the section 31 rules discussed in ¶s 3 and 4 above for a loss from a farming business), and
- ABILs,

are deductible when calculating the amount (if any) of section 3 income for the loss year. That is, the above-mentioned losses are deducted from the amount (if any) of paragraph 3(c) income for the loss year. (Paragraph 3(c) income for a particular year is the amount of the income, including the net taxable portion of capital gains as discussed in ¶s 6 and 7 below, for the year after subdivision e deductions but before deducting losses for the year.)

Losses **cannot be used** to reduce **section 3 income below nil**. However, **to the extent** that the above-mentioned **losses can be used** in the loss year (i.e., without reducing section 3 income below nil), they **must be used in the loss year or forfeited**.

See ¶ 10 (and also ¶ 11) below regarding the portion of the above-mentioned losses that cannot be used in the loss year.

Capital Losses

¶ 6. Capital losses (other than ABILs) enter into the calculation of the net taxable portion of capital gains, which in turn becomes part of paragraph 3(c) income (as mentioned in ¶ 5 above). The calculation which takes into account capital losses from the disposition of most types of capital property is discussed in ¶ 7 below. There are special rules, however, for losses from the disposition of personal-use property and listed personal property.

Subparagraph 40(2)(g)(iii) generally provides that a taxpayer's loss from the disposition of a "**personal-use property**" (which is defined in section 54) is deemed to be **nil**.

Subparagraph 40(2)(g)(iii) does not apply, however, to losses from the disposition of personal-use property that is also **listed personal property** (works of art, jewellery, stamps, coins or rare manuscripts, folios or books—for further particulars, see the definition of "listed personal property" in section 54). For purposes of calculating any gain or loss from a disposition of a listed personal property, a rule in subsection 46(1) (referred to in this bulletin as the "$1,000 threshold rule") applies. Generally, under that rule, if the adjusted cost base of a personal-use property at the time of its disposition is less than $1,000, it is deemed to be $1,000. Similarly, if the proceeds of disposition of a personal-use property are less than $1,000, they are deemed to be $1,000. Thus, a reportable gain from the disposition of a listed personal property (or any other personal-use property) can occur only if the proceeds of disposition are more than $1,000. A reportable loss from the disposition of a listed personal property can occur only if the adjusted cost base at the time of the disposition is more than $1,000 (as mentioned above, a loss from the disposition of any other personal-use property is, in any event, generally deemed to be nil).

Under subsection 41(2), losses from the disposition of listed personal property for a particular taxation year can generally be deducted from gains for the year from such dispositions. If the gains exceed the losses, the taxpayer has a **net gain** for the year from dispositions of listed personal property. More precisely, the taxpayer starts out with such a net gain because it could be reduced or eliminated by the use of other years' "listed-personal-property losses" (see below). If the taxpayer ends up with a net gain for the year from dispositions of listed personal property (after the deduction, if any, of other years' "listed-personal-property losses"—see below), such net gain is multiplied by the inclusion rate of 3/4 to determine the amount of the **taxable net gain** for the year from dispositions of listed personal property (see subsection 41(1)). Such taxable net gain enters into the overall calculation of the taxable portion of capital gains—see ¶ 7(b) below. If, on the other hand, the losses for the year from dispositions of listed personal property exceed the gains for the year from such dispositions, the rules in section 3 of the Act do not allow the resulting net amount of loss from the disposition of listed personal property to be deducted in the loss year against income for the year (not even against taxable capital gains for the year from the disposition of other types of property). However, such net amount of loss from the disposition of listed personal property generally becomes a "**listed-personal-property loss**" for the year (see subsection 41(3)). A listed-personal-property loss is a type of carried-over loss, i.e., it can be used only in other years. Furthermore, a listed-personal-property loss can be used only to reduce other years' **net gains** from dispositions of listed personal property, in accordance with the following rules in subsection 41(2):

(a) A listed-personal-property loss can be carried back three years and forward seven years. (Note that subsection 41(2) does not require that a listed-personal-property loss be used in the earliest year possible within this carry-back/carry-forward period. If, for example, a taxpayer had a listed-personal-property loss of $100 for 1994 and net gains from dispositions of listed personal property of $200 for 1995 and $500 for 1996, the taxpayer might decide to use the 1994 loss to reduce the net gain for 1996 from $500 to $400 rather than to reduce the net gain for 1995 from $200 to $100.)

(b) A listed-personal-property loss cannot reduce another year's net gain from dispositions of listed personal property to an amount below nil.

(c) An amount of listed-personal-property loss cannot be deducted more than once.

(d) No amount of listed-personal-property loss for a particular loss year is deductible until the deductible listed-personal-property losses for previous years have been deducted. If, for example, a taxpayer had listed-personal-property losses for 1994 and 1995, the 1995 loss could not be used in other years until the 1994 loss had been fully used in other years.

Further information about the rules pertaining to listed personal property and other personal-use property can be found in the current version of IT-332R, *Personal-Use Property*.

Example

Ann sold the following items of her personal-use property (all were also listed personal property):

In 1995, she sold a bracelet for $900. Because of the $1,000 threshold rule, her deemed proceeds of disposition were $1,000. Her adjusted cost base of the bracelet was $1,300. She therefore had a loss on the sale of the bracelet of $1,300 – $1,000 = $300.

Ann also sold a painting in 1995 for $1,200. Although it had cost her only $700, her deemed adjusted cost base under the $1,000 threshold rule was $1,000. She therefore had a gain on the sale of the painting of $1,200 – $1,000 = $200.

Finally in 1995, Ann sold another painting for $500. It had cost her $300. Since the $1,000 threshold rule deemed both her proceeds of disposition and her adjusted cost base to be $1,000, she had neither a gain nor a loss from this sale.

Combining the results of the 1995 transactions, Ann had a net amount of loss from the disposition of listed personal property for 1995 equal to the excess of the $300 loss over the $200 gain = $100. Because of the rules in section 3, Ann could not deduct this $100 against her income for 1995. The $100 did become, however, a **listed-personal-property loss** for 1995, which she had available to carry over to other years (subject to the rules discussed above).

In 1996, Ann sold a ring for $1,400. Her adjusted cost base was $1,100 and her gain was therefore $1,400 – $1,100 = $300.

On her 1996 return, Ann decided to deduct her 1995 listed-personal-property loss of $100 against her $300 gain from the sale of the ring. This gave her a **net gain** from the disposition of listed personal property of $200 and a **taxable net gain** from the disposition of listed personal property equal to 3/4 of $200 = $150. (This amount went into the overall calculation of Ann's taxable portion of capital gains for 1996—see ¶ 7(b) below).

¶ 7. Any allowable capital losses of a taxpayer (i.e., capital losses multiplied by the inclusion rate of 3/4), excluding ABILs, for a particular taxation year from dispositions of property other than listed personal property are deducted from the total of

(a) any taxable capital gains (i.e., capital gains multiplied by the inclusion rate of 3/4) for the year from dispositions of property other than listed personal property (note that this amount includes any taxable capital gains from dispositions of personal-use property that are not listed personal property and also note that, for purposes of calculating a capital gain from such a disposition, the $1,000 threshold rule described in ¶ 6 above applies); and

(b) the taxable net gain (if any) for the year from dispositions of listed personal property (see ¶ 6 above).

If the net result of the above calculation is a positive amount, it represents the **net taxable portion of capital gains**, which becomes part of the taxpayer's paragraph 3(c) income (against which any losses as described in ¶ 5 above for the year are deducted).

The net taxable portion of capital gains **cannot be less than nil**. In other words, no amount of the above-mentioned allowable capital losses can be deducted from any income for the year other than the amounts described in (a) and (b) above. However, **to the extent** that the **allowable capital losses** mentioned above **can be used** in the loss year against the amounts described in (a) and (b) above, they **must be so used in the loss year or forfeited.**

See ¶ 12 below regarding the portion of the above-mentioned allowable capital losses that cannot be used in the loss year because of these rules.

Limited Partnership Losses

¶ 8. The portion of a limited partner's share of a loss from a limited partnership that cannot be deducted in the loss year because of the operation of subsection 96(2.1) (see ¶ 2 above) is deemed by that subsection to be the limited partner's "limited partnership loss" for the year. The taxpayer's limited partnership loss for the loss year can be carried over to and used in other years to offset the taxpayer's income from the limited partnership for those years in accordance with the rules discussed in ¶s 18(e), 19 and 23 below.

Restricted Farm Losses

¶ 9. A restricted farm loss occurs when section 31 prevents a taxpayer's loss from a farming business from being fully deductible in the loss year. If the loss amount determined in step 1 in ¶ 4 above is greater than the amount determined in step 3, section 31 provides that the difference between these two amounts becomes the taxpayer's "restricted farm loss" for the year (which could be reduced, if applicable, by the adjustment described in ¶ 17 below). The taxpayer's restricted farm loss for the loss year can be carried over to and used in other years to offset income from farming businesses for those years in accordance with the rules discussed in ¶s 18(c), 19 and 23 below.

Example:

Going back to the example in ¶ 4 above, Barry's restricted farm loss for the loss year is equal to the $8,000 amount from step 1 less the $5,250 amount per step 3 = $2,750 (assuming there is no adjustment as referred to in ¶ 17 below).

Summary of the entire example: Of Barry's $10,000 loss from the farming business, Barry can deduct $7,250 in the loss year (against the $50,000 income from the store), and the remaining $2,750 is his restricted farm loss for the loss year that he can apply against income from farming businesses for other years in accordance with the rules discussed in ¶s 18(c), 19 and 23 below.

Non-Capital Losses

¶ 10. By virtue of its definition in subsection 111(8), a taxpayer's "non-capital loss" for a particular loss year includes the following unused losses (i.e., losses to the extent that they cannot be used in the loss year—see ¶ 5 above):

- unused losses from an office, employment, business or property, and
- unused ABILs.

Note that the taxpayer's non-capital loss for the year can include the unused portion of the taxpayer's share of

- partnership losses from business or property, or
- partnership ABILs.

The taxpayer's non-capital loss cannot, however, include a "limited partnership loss" or a "restricted farm loss" (these carried-over losses are discussed in ¶s 8 and 9 above, respectively). The amount of the taxpayer's non-capital loss may be subject to certain adjustments—see the discussion of the "farm loss" in ¶ 11 below, as well as the discussion of adjustments in ¶s 14, 15, 16, 17, 25, and 26 below. The taxpayer's non-capital loss for the loss year can be carried over to and used in other years to offset income for those years in accordance with the rules in ¶s 18(a), 19, 22 and 23 below.

Farm Losses

¶ 11. A taxpayer's unused losses from farming and fishing businesses are initially included with unused losses from other types of businesses in the calculation of the taxpayer's non-capital loss for the loss year, in accordance with the rules described in ¶ 10 above. However, the taxpayer's "farm loss" for the year, which is defined in subsection 111(8), includes the lesser of two amounts:

(a) the amount (if any) of the taxpayer's net losses (i.e., losses net of incomes) for the loss year from all farming and fishing businesses; and

(b) the amount of the taxpayer's non-capital loss for the year as initially calculated (i.e., including the unused losses from farming and fishing businesses).

For purposes of calculating a farm loss, see also the discussion of adjustments in ¶s 17 and 26 below. Once the amount of the farm loss for the year is determined, the **non-capital loss** for the year (as initially calculated) is then reduced by the farm loss. When section 31 is applicable to a loss from a farming business, note that both (a) and (b) above take into account only the portion of the loss from the farming business that is available for deduction in the loss year as determined under the rules in section 31 (see ¶ 4 above). Neither (a) nor (b) above takes into account a restricted farm loss amount. The taxpayer's farm loss for the loss year can be carried over to and used in other years to offset income for those years in accordance with the rules discussed in ¶s 18(d), 19, 22 and 23 below.

Example:

Blanche incurs a loss of $8,000 from her farming business. Section 31 applies to the loss because her chief source of income for the loss year is neither farming nor a combination of farming and some other source of income, but rather is her clothing business. According to the rules in section 31 (see ¶ 4 above), $5,250 of the loss from the farming business is available for deduction in the loss year. The remaining $2,750 is her restricted farm loss for the loss year, which she can carry over to other years (assume in this example that there is no adjustment to the restricted farm loss as referred to in ¶ 17 below). For the year in which she incurs the loss from the farming business, Blanche reports income from the clothing business of $40,000 and she also has an ABIL of $42,000. Her subdivision e deductions which she can claim for purposes of calculating her section 3 income for the year amount to $3,000. Blanche's losses that are available for deduction in the loss year come to a total of $47,250, calculated as follows:

Portion of loss from the farming business available for deduction in the loss year under rules in section 31	$ 5,250
Plus: ABIL	42,000

Total losses available for deduction in the loss year	$ 47,250
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However, her paragraph 3(c) income for the year (see ¶ 5 above) is only $37,000:

Clothing business income	$ 40,000
Deduct: Subdivision e deductions	3,000

Paragraph 3(c) income	$ 37,000
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Therefore, she can use only $37,000 of her losses in the loss year because she can only reduce her section 3 income for the year to nil (see ¶ 5 above).

Blanche's initial calculation of her non-capital loss for the loss year is as follows:

Total losses available for deduction in the loss year	$ 47,250
Less: Paragraph 3(c) income = portion of losses that she can use in the loss year	37,000

Initial calculation of the non-capital loss	$ 10,250
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Blanche's farm loss for the year is equal to the lesser of

- $5,250, which is the portion of her loss from the farming business that is available for deduction in the loss year under the rules in section 31; and
- $10,250, which is her non-capital loss for the year as initially calculated.

Thus, her farm loss for the year is $5,250 and her non-capital loss for the year becomes $10,250 – $5,250 = $5,000.

To summarize, the losses for the loss year that Blanche can carry over to and use in other years (in accordance with the rules discussed in ¶s 18, 19, 22 and 23 below) are characterized as follows:

Restricted farm loss for the year	$ 2,750
Farm loss for the year	5,250
Non-capital loss for the year	5,000

Total losses for the loss year that can be carried over to other years	$ 13,000
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The reason why an unused loss from a farming or fishing business (i.e., other than a restricted farm loss) is taken out of the loss year's "non-capital loss" and instead included in a "farm loss" for the year is to enhance the ability of those engaged in the business of farming or fishing to carry forward losses. The longer carry forward period for a "farm loss" (compare ¶ 18(d) with ¶ 18(a) below and also compare the carry-forward treatment for a "farm loss" and a "non-capital loss" in ¶ 22 below) is of particular benefit to those starting up a farming or fishing business. Such start-ups have a longer period of time to become profitable without losing the ability to deduct losses incurred in the initial years of operation.

Net Capital Losses

¶ 12. To the extent (if any) that the amount of the allowable capital losses mentioned at the beginning of ¶ 7 above cannot be used in the loss year (i.e., in accordance with the rules discussed in ¶ 7 above), the unused amount is included in the taxpayer's "net capital loss" for the loss year, as defined in subsection 111(8). For purposes of calculating a net capital loss, see also the discussion of adjustments in ¶s 17 and 27 below. The taxpayer's net capital loss for the loss year can be carried over to and used in other years to offset the taxable portion of capital gains (and in some cases to offset other income) for those years in accordance with the rules discussed in ¶s 18(b), 19, 20, 21 and 23 below.

Adjustments to Carried-Over Loss Amounts

¶ 13. The discussions above indicate the types of losses that, to the extent that they cannot be used in the loss year, are included in the taxpayer's losses for the loss year that can be carried over to another year or years (the year or years "of loss application") in accordance with the rules discussed in ¶s 18 to 23 below. The definition of each of these carried-over losses is contained in a particular provision of the *Income Tax Act*, as follows:

- a "limited partnership loss" – see subsection 96(2.1);
- a "restricted farm loss" – see section 31;
- a "non-capital loss" – see subsection 111(8);
- a "farm loss" – see subsection 111(8); and
- a "net capital loss" – see subsection 111(8).

Some of these definitions require that certain adjustments be made for purposes of calculating the carried-over loss amounts. These adjustments are discussed in ¶s 14 to 17 and 25 to 27 below. (The adjustments referred to in ¶s 25 to 27 take into account differences in the loss application rules for certain types of carried-over losses, as described in ¶s 18 to 23 below.)

Note: A "listed-personal-property loss" is also a type of carried-over loss. The calculation of a listed-personal-property loss and the special carry-forward and carry-back rules which apply to it are discussed in ¶ 6 above.

Addition to non-capital loss for capital gains deduction and certain deductible amounts

¶ 14. As indicated in ¶ 10 above, a taxpayer's **non-capital loss** for a particular loss year includes the following unused losses:

- unused losses from an office, employment, business or property, and
- unused ABILs.

The inclusion of only the **unused** portion of the above-mentioned losses in the taxpayer's non-capital loss occurs by means of a formula, "E – F", that is part of its calculation. The result of this formula cannot be less than nil. Variable E in the formula includes the total of all the taxpayer's losses incurred in the year from an office, employment, business or property, as well as ABILs, incurred in the year. Variable F represents paragraph 3(c) income (i.e., section 3 income as calculated after the deduction of subdivision e deductions but before deducting the above-mentioned losses). If there were no other amounts included in variable E, the result obtained from E – F would simply represent losses that cannot be used in the loss year. However, variable E also includes the following amounts:

- the amount (if any) of a taxpayer's section 110.6 capital gains deduction for the year, and
- the amounts (if any) that are deductible by the taxpayer in the year under paragraph 110(1)(d), (d.1), (d.2), (d.3), (f), (j) or (k), section 112 or subsection 113(1) or 138(6).

All of the above provisions permit a deduction, for purposes of calculating taxable income, that has the effect of eliminating all or a portion of the tax on a specific amount included in income for the year or otherwise subject to tax. The inclusion of a section 110.6 capital gains deduction or an above-mentioned deductible amount in variable E is needed because when the income amount to which it pertains is included in section 3 income, such income amount is included in variable F of the E – F formula (i.e., the income amount reduces the amount of the non-capital loss). Furthermore, the inclusion of a section 110.6 capital gains deduction or an above-mentioned deductible amount in variable E means that the portion (if any) of that deduction or deductible amount that is over and above the portion thereof that was needed to bring taxable income to nil will be included in the taxpayer's non-capital loss for the year, which can be carried over to and used in other years in accordance with the rules in ¶s 18(a), 19, 22 and 23 below.

Example 1:

On his tax return for the year, Willie reports his salary of $30,000 from employment, a stock option benefit of $20,000 that is included in his income under subsection 7(1) of the Act, and a loss of $45,000 from his business. His subdivision e deductions which he can claim for purposes of calculating his section 3 income for the year amount to $3,000. For purposes of calculating his taxable income for the year, the only deductible amount is a paragraph 110(1)(d) deduction of $5,000. This deduction is calculated by multiplying the subsection 7(1) stock option benefit by 1/4. Thus, the net effect of subsection 7(1) and paragraph 110(1)(d) is that only 3/4 of Willie's stock option benefit should be included in his taxable income. However, as indicated by the following calculation, Willie cannot use the full amount of the $5,000 paragraph 110(1)(d) deductible amount, i.e., he does not need the full $5,000 to bring his taxable income for the year to nil:

Salary	$ 30,000
Add: Stock option benefit	20,000

	50,000
Deduct: Subdivision e deductions	3,000

Paragraph 3(c) income	47,000
Deduct: Business loss (see rules in ¶ 5 above)	45,000

Section 3 income	2,000
Deduct: Paragraph 110(1)(d) deduction	5,000

Taxable Income for the year	$ nil
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The above calculation shows that, in arriving at a taxable income of nil, Willie in fact only uses $2,000 of the $5,000 amount that is deductible under paragraph 110(1)(d).

If the paragraph 110(1)(d) deduction were not available to him at all, Willie would not have a non-capital loss for the year:

Business loss = variable E	$ 45,000
Less: Variable F = paragraph 3(c) income (see above)	47,000

Non-capital loss for the year = E – F (cannot be less than nil)	$ nil
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However, the inclusion of his $5,000 paragraph 110(1)(d) deductible amount in variable E of the E – F formula means that Willie ends up with a non-capital loss for the year:

Business loss	$ 45,000
Add: Deductible amount under paragraph 110(1)(d)	5,000

Total = variable E	50,000
Less: Variable F = paragraph 3(c) income	47,000

Non-capital loss for the year = E – F	$ 3,000
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Thus, in this example, the $3,000 portion of the paragraph 110(1)(d) deductible amount that Willie cannot use in the year becomes his non-capital loss for the year, which he can carry over to and use in other years in accordance with the rules in ¶s 18(a), 19, 22 and 23 below.

Example 2:

Joe has a $50,000 taxable capital gain, no subdivision e deductions and a $50,000 business loss. According to the rules in section 3, the business loss must be fully used against the taxable capital gain to bring income to nil (see ¶ 5 above). At this point, the offsetting of these two amounts also results in a non-capital loss of nil. However, assume also that Joe has available to him and in fact claims a $50,000 capital gains deduction with respect to the $50,000 taxable capital gain. The capital gains deduction was not needed because taxable income was already nil (nor does this deduction reduce taxable income to an amount below nil). The capital gains deduction claimed by Joe is, however, added into the calculation of (i.e., creates) a non-capital loss of $50,000. In other words, Joe claims the capital gains deduction in order to reinstate the business loss as a non-capital loss.

Another adjusting item that is provided for in variable E of the calculation of a "non-capital loss" is discussed in ¶ 25 below.

Addition to non-capital loss because of addition to taxable income to avoid foreign tax credit wastage

¶ 15. For the sole purpose of increasing its foreign tax credit under subsection 126(1) or (2), a corporation is allowed by section 110.5 to add an amount to its taxable income otherwise determined. Because of the way in which a foreign tax credit is calculated, a decrease in income for a particular taxation year caused by a loss incurred in the year can result in a foreign tax credit that is less than the full amount of applicable foreign taxes paid for the year. However, an addition of an amount to taxable income otherwise determined, as allowed under section 110.5, can prevent this "foreign tax credit wastage." For further particulars, see the current version of IT-270, *Foreign Tax Credit*. If an amount is added to a corporation's taxable income otherwise determined for a particular year under section 110.5, that amount is also added in the calculation of the corporation's **non-capital loss** for the year.

Reduction to non-capital loss for fuel tax rebate

¶ 16. The subsection 111(8) definition of a "non-capital loss," in conjunction with subsection 111(10), provides for a reduction to the amount of a taxpayer's unused **non-capital loss or losses** for one or more of the seven taxation years preceding the taxation year (the rebate year) in which the taxpayer has received a fuel tax rebate as specified in subsection 111(10). The reduction amount calculated under subsection 111(10) is equal to 10 times the total of such fuel tax rebates received in the rebate year (net of repayments). Any such reductions to unused non-capital losses under subsection 111(10) are made to the extent decided upon by the taxpayer. (Any portion of the reduction amount not used by the taxpayer to reduce non-capital losses is includable in the taxpayer's income for the rebate year under paragraph 12(1)(x.1) of the *Income Tax Act*.)

Reduction to carried-over losses for debt forgiveness

¶ 17. A taxpayer's **restricted farm loss, farm loss, net capital loss** and **non-capital loss** are reduced as required by section 80. Generally, such a requirement can occur when there is a "forgiven amount" in connection with the settlement of a "commercial obligation" issued by the taxpayer.

Loss Application Rules for the Use of Non-Capital Losses, Net Capital Losses, Restricted Farm Losses, Farm Losses and Limited Partnership Losses in Other Years

¶ 18. When calculating the taxable income for a particular taxation year (the "year of loss application"), section 111 provides for the deduction of carried-over losses of other years, as follows:

(a) A **non-capital loss** can be carried back three years and forward seven years under paragraph 111(1)(a), and it can be deducted against any type of income for the year of loss application.

(b) A **net capital loss** can be carried back three years and forward indefinitely under paragraph 111(1)(b). When determining the amount of the loss year's net capital loss that can be deducted in the year of loss application, see the rules discussed in ¶s 20 and 21 below.

(c) A **restricted farm loss** can be carried back 3 years and forward 10 years under paragraph 111(1)(c). However, by virtue of that paragraph, no amount in respect of restricted farm losses is deductible in the year of loss application except to the extent of the taxpayer's incomes for that year from all farming businesses carried on by the taxpayer.

(d) A **farm loss** can be carried back 3 years and forward 10 years under paragraph 111(1)(d), and it can be deducted against any type of income for the year of loss application.

(e) A **limited partnership loss** cannot be carried back, but it can be carried forward indefinitely under paragraph 111(1)(e). However, by virtue of that paragraph, no amount is deductible in the year of loss application in respect of a limited partnership loss except to the extent of the taxpayer's "at-risk amount" in respect of the partnership (as determined under subsection 96(2.2)) as at the end of the last fiscal period of the partnership that ends in the year of loss application, less certain amounts specified in subparagraph 111(1)(e)(ii).

Ordering rule for individuals

¶ 19. Section 111.1 requires a taxpayer who is an individual to apply the following provisions, when computing taxable income, in this order:

(a) **subsection 110.4(2)**—this subsection provides for an addition to taxable income for the year under the forward averaging rules (as discussed in ¶ 26 below);

(b) **section 110**—this section provides for a number of specific deductions for purposes of calculating taxable income;

(c) **section 111**—the application of carried-over losses from other years, in accordance with the rules discussed in this bulletin;

(d) **section 110.6**—the capital gains deduction; and

(e) **section 110.7**—the northern residents deduction.

The ordering rules in section 111.1 ensure the following:

- The individual can apply the deductions described in (b) to (e) above not only against income as determined under section 3 of the Act but also against any amount added to taxable income under the forward averaging rules as referred to in (a) above.
- The individual reduces taxable income by the section 110 deductions for the year to which the individual is entitled, before applying carried-over losses of other years.

Use of net capital loss: inclusion rate adjustment and limitation on amount used

¶ 20. If a taxpayer decides to use all or a portion of a net capital loss in a particular year of loss application, the amount that can actually be deducted under paragraph 111(1)(b) in the year of loss application is subject to the rules in subsection 111(1.1).

Subparagraph 111(1.1)(a)(ii) provides for an adjustment which is referred to in this bulletin as the "**inclusion rate adjustment**". The inclusion rate is simply the rate that is used to determine the portion of a capital gain or loss that is taxable or deductible for income tax purposes. For example, a taxable capital gain is equal to the capital gain multiplied by the inclusion rate. The inclusion rate has changed over the years from 1/2 to 2/3 to 3/4. The inclusion rate adjustment in subparagraph 111(1.1)(a)(ii) applies when the inclusion rate for the loss year and the inclusion rate for the year of loss application are different. The inclusion rate adjustment is calculated by the following formula:

$$A \times \frac{B}{C}$$

The variables in the formula are as follows:

A is the amount of the net capital loss for the loss year that is "claimed" (i.e., used) in the year of loss application;

B is the inclusion rate in effect for the year of loss application; and

C is the inclusion rate in effect for the loss year.

Example:

Sarah has an unused 1987 net capital loss of $6,000. She wishes to use all of that net capital loss when calculating her 1996 taxable income. Since the 1987 inclusion rate was 1/2 and the 1996 inclusion rate was 3/4, the inclusion rate adjustment results in the following amount:

$$\$\ 6{,}000 \times \frac{3/4}{1/2}$$

$$= \$\ 6{,}000 \times \frac{3}{4} \times \frac{2}{1}$$

$$= \$\ 6{,}000 \times [\,1\ \frac{1}{2}\,]$$

$$= \$\ 9{,}000$$

Thus, when using her 1987 net capital loss of $6,000 in the 1996 year, Sarah actually gets to deduct 1 1/2 times $6,000 = $9,000. (This is because the inclusion rate of 3/4 for 1996 is in fact 1 1/2 times greater than the inclusion rate of 1/2 for 1987.)

However, the amount determined in subparagraph 111(1.1)(a)(ii), i.e., the amount resulting from the inclusion rate adjustment, is subject to a **limitation rule** contained in subparagraph 111(1.1)(a)(i). The limitation under that subparagraph is calculated as follows:

> Any taxable capital gains, for the year of loss application, from dispositions of capital property other than listed personal property
>
> Plus
>
> The taxable net gain (if any), for the year of loss application, from dispositions of listed personal property (see ¶ 6 above)
>
> Minus
>
> Any allowable capital losses (other than ABILs), for the year of loss application, from dispositions of capital property other than listed personal property.

The subparagraph 111(1.1)(a)(i) limitation ensures that the loss year's net capital loss, as adjusted by the subparagraph 111(1.1)(a)(ii) inclusion rate adjustment, cannot be deducted against income that is not the net taxable portion of capital gains for the year of loss application (subject to the exception described in ¶ 21 below). The loss year's net capital loss cannot be used, for instance, against employment or business income reported in the year of loss application.

Example:

Continuing on with the above example, assume that Sarah's 1996 income includes a taxable capital gain of $10,000 and an allowable capital loss of $5,500. Her subparagraph 111(1.1)(a)(i) limitation for 1996 is equal to $10,000 – $5,500 = $4,500. As a result, Sarah actually can deduct only $4,500, rather than the $9,000 calculated in the first part of this example, in respect of her 1987 net capital loss when calculating her 1996 taxable income. Note also that she actually has to use only $3,000 of the $6,000 1987 net capital loss in order to come up with the $4,500 amount she deducts in 1996 (i.e., because the inclusion rate adjustment multiplies the $3,000 by 1 1/2 to come up with the $4,500 amount she deducts). Thus, she still has $3,000 of the 1987 net capital loss (i.e., $6,000 less the $3,000 used in 1996) that she can use in other years.

Use of pre-1986 capital loss balance included in net capital loss

¶ 21. There is an exception to the rule stated above that a net capital loss cannot be used against income that is not the net taxable portion of capital gains for the year of loss application. This exception is contained in paragraph 111(1.1)(b) and it is relevant only if the taxpayer is an individual with a **pre-1986 capital loss balance**. A "pre-1986 capital loss balance" is calculated under subsection 111(8) and, generally, it represents the individual's unused net capital losses from dispositions made before May 23, 1985 (subject to a grandfathering rule) minus the total of the following amounts pertaining to taxation years preceding the particular year of loss application for which the pre-1986 capital loss balance is being calculated:

(a) the total of all section 110.6 capital gains deductions for taxation years before 1988;

(b) 3/4 of the total of all section 110.6 capital gains deductions for taxation years ending after 1987 and before 1990; and

(c) 2/3 of the total of all section 110.6 capital gains deductions for taxation years ending after 1989.

The effect of the exception rule in paragraph 111(1.1)(b) is that the portion of the individual's unused net capital losses

- that consists of the individual's pre-1986 capital loss balance (as calculated for the year of loss application), and
- that is not already being used against the individual's net taxable portion of capital gains for the year of loss application

can be deducted under paragraph 111(1)(b), up to a maximum amount of $2,000 per year, against the individual's income for the year of loss application that does not represent the net taxable portion of capital gains for that year. Note that the inclusion rate adjustment that is described in ¶ 20 above does not apply to any portion of the pre-1986 capital loss balance that is deducted by virtue of the exception rule in paragraph 111(1.1)(b).

Example:

Once again continuing on with the above example, assume that Sarah's $6,000 net capital loss resulted from a disposition of property in 1984 rather than in 1987. Assume also that she had a taxable capital gain of $2,000 for the 1986 taxation year but that, when calculating her 1986 taxable income, she claimed a section 110.6 capital gains deduction of $2,000 instead of using up $2,000 of her 1984 net capital loss. When calculating her taxable income for 1996, she uses $3,000 of her $6,000 1984 net capital loss in order to offset the $4,500 net taxable portion of her capital gains for 1996 (based on the inclusion rate adjustment calculation given earlier in the example, she only needs to use $3,000 of the 1984 net capital loss in order to deduct $4,500 in 1996 because the inclusion rate for 1984, like 1987, was 1/2 and the inclusion rate for 1996 was 3/4). Assume that Sarah also reports $40,000 income from carrying on a business in the 1996 taxation year. When calculating her 1996 taxable income, the exception rule in paragraph 111(1.1)(b) permits her to deduct, against this $40,000 income, the least of three amounts:

- $2,000;
- her pre-1986 capital loss balance for 1996 = her $6,000 1984 net capital loss minus the $2,000 section 110.6 capital gains deduction she claimed in 1986 = $4,000; and
- her $6,000 1984 net capital loss minus the portion thereof that she has already used in 1996 to offset the $4,500 net taxable portion of her capital gains for 1996 = $6,000 – $3,000 = $3,000.

She therefore claims $2,000 under the exception rule in paragraph 111(1.1)(b). Note that this $2,000 is not subject to an inclusion rate adjustment. To summarize, Sarah ends up using $5,000 of her $6,000 1984 net capital loss in 1996:

	Amount Used	**Amount Deducted**
Against her 1996 net taxable portion of capital gains	$ 3,000	$ 4,500
Against her 1996 business income	2,000	2,000
	--------	--------
Total reduction to 1996 taxable income		$ 6,500
		=====
Total used in 1996	5,000	
Available to be used in other years	1,000	

	$ 6,000	
	=====	

Use of losses to reduce Part IV tax base

¶ 22. If a corporation is subject to Part IV tax (on taxable dividends received), paragraphs 186(1)(c) and (d) allow the corporation to use all or any portion of its **non-capital loss** for a particular taxation year to reduce or eliminate its base for Part IV taxes for

- that year;
- the three immediately preceding years; or
- the seven immediately following years.

Paragraphs 186(1)(c) and (d) also allow the corporation to use all or any portion of its **farm loss** for a particular year to reduce or eliminate its base for Part IV taxes for

- that year;
- the three immediately preceding years; or
- the 10 immediately following years.

Using a corporation's non-capital loss or farm loss as described above is generally not as advantageous as using the loss to reduce or eliminate the corporation's taxable income, because the Part IV tax rate is lower than the Part I tax rate (the same amount of loss cannot be used for both purposes—see the rule in ¶ 23(a) below). A corporation might nevertheless decide to use a non-capital loss or farm loss to reduce or eliminate its Part IV tax base for a particular taxation year because, for example, the corporation might not otherwise be able to use up all of the loss before the end of its carry-forward period. Further information regarding Part IV tax may be found in the current version of IT-269, *Part IV Tax on Taxable Dividends Received by a Private Corporation or a Subject Corporation*.

Other loss application rules

¶ 23. When following the rules in ¶s 18 to 22 above, carried-over losses do not have to be used to the maximum extent possible when calculating a taxpayer's

- taxable income for a particular year or years of loss application, or
- Part IV tax for a year or years mentioned in ¶ 22 above.

Nor does one type of carried-over loss have to be used before any other type. However, the following rules in subsection 111(3) must be observed:

(a) An amount of carried-over loss cannot be used more than once.

(b) A carried-over loss of a particular type (e.g., a non-capital loss) for a particular loss year cannot be used until the deductible (i.e., unused) carried-over losses of the same type for all previous loss years have been deducted.

Example:

XYZ Co. Ltd. (which files on a calendar year basis) has section 3 income of $100,000 for 1996, consisting of a taxable capital gain of $30,000 and income from its business of $70,000. The company has the following unused carried-over losses:

- a non-capital loss for 1994 of $100,000,
- a net capital loss for 1994 of $10,000, and
- a net capital loss for 1995 of $40,000.

Because the inclusion rate for capital gains and losses is 3/4 for all years in this example, the inclusion rate adjustment discussed in ¶ 20 above does not apply to the net capital losses. As long as XYZ Co. Ltd. uses all of its 1994 net capital loss before it uses any part of its 1995 net capital loss, it can

- use its 1994 net capital loss before its 1994 non-capital loss, or vice versa, and
- use its 1995 net capital loss before its 1994 non-capital loss, or vice versa.

Because XYZ Co. Ltd.'s net capital losses can be used only against the net taxable portion of its capital gains (see the subparagraph 111(1.1)(*a*)(i) limitation rule discussed in ¶ 20 above), the company decides to use its net capital losses to the maximum extent possible in 1996 before using its non-capital loss in 1996, as follows:

Taxable capital gain		$ 30,000
Income from business		70,000

Section 3 income for 1996		100,000
		=======
Deduct: All of 1994 net capital loss	$ 10,000	
Portion of 1995 net capital loss	20,000	

Maximum amount of net capital losses that can be used in 1996 = 1996 taxable capital gain	30,000	
Portion of 1994 non-capital loss	70,000	100,000
	-----------	------------
Taxable income for 1996		$ nil
		=======

If XYZ Co. Ltd. applied its carried-over losses as above, it would be left with $30,000 of its 1994 non-capital loss and $20,000 of its 1995 net capital loss still unused.

However, if the non-capital loss originated in 1989 instead of 1994, XYZ Co. Ltd. would in all likelihood use the non-capital loss in 1996 before using any amount of the net capital losses in that year—because of the expiry of the seven-year carry-forward period for the non-capital loss at the end of the year. XYZ Co. Ltd.'s calculations would therefore be as follows:

Section 3 income for 1996 (as above)	$ 100,000
Deduct: All of 1989 non-capital loss (carry-forward period expires at the end of 1996)	100,000

Taxable income for 1996	$ nil
	=======

XYZ Co. Ltd. would then be left with all $50,000 of its 1994 and 1995 net capital losses (which can be carried forward indefinitely) still unused.

Other Adjustments to Carried-Over Loss Amounts

¶ 24. As indicated in ¶ 13 above, there are adjustments to carried-over loss amounts that take into account differences in the loss application rules (see ¶s 18 to 23 above) for certain types of carried-over losses. These adjustments are discussed in ¶s 25 to 27 below. Note that the loss application rules described in ¶s 18 to 23 above are not applied with respect to a particular carried-over loss until the final amount of that carried-over loss is determined after making all the adjustments discussed in ¶s 14 to 17 above and ¶s 25 to 27 below that are applicable to its determination.

Reinstating a loss from an office, employment, business or property, or an ABIL, as a non-capital loss when a net capital loss of another year is used

¶ 25. As indicated in ¶ 14 above, certain deducted or deductible amounts are included in variable E of "E – F", a formula that is part of the calculation of a **non-capital loss** for a particular year. Also included in variable E of that formula is the amount of any net capital loss that is carried over from another year and deducted in the year. If a taxpayer was required to use a loss from an office, employment, business or property, or an ABIL, in the loss year to offset a taxable capital gain for the year (because of the rule described in ¶ 5 above that to the extent that these losses can be used in the loss year, they must be so used or forfeited), the above-mentioned adjusting item allows the taxpayer to reinstate that loss as a non-capital loss for the year to the extent that a net capital loss of another year is used in the year. The significance of this rule becomes apparent when considered in light of the limitation rule contained in subparagraph 111(1.1)(a)(i) (i.e., that net capital losses can only be deducted to the extent of the net taxable portion of capital gains for the year of loss application—see ¶ 20 above), which applies when a net capital loss is used but not when a non-capital loss is used.

Example:

For the 1996 taxation year, Widget Makers Ltd. has a taxable capital gain of $40,000 and a loss from its business of $30,000. There are no subdivision e deductions for the year. The company also has a net capital loss of $30,000 from the previous year.

The company calculates its section 3 income for 1996 as follows:

Taxable capital gain = paragraph 3(c) income for 1996	$ 40,000
Deduct: Business loss for 1996	30,000

Section 3 income for 1996	$ 10,000
	=====

The limitation rule contained in subparagraph 111(1.1)(a)(i), as discussed in ¶ 20 above, allows the company to deduct up to $40,000 of net capital losses from other years in 1996 because of the $40,000 taxable capital gain in 1996. If the company decided to deduct $10,000 of its 1995 net capital loss in 1996, this would bring the 1996 taxable income down to nil (there is no inclusion rate adjustment, as discussed in ¶ 20 above, because the 1995 and 1996 inclusion rates are the same) and the company would be left with $20,000 of the 1995 net capital loss for use in other years. The company decides, instead, to deduct all $30,000 of the 1995 net capital loss in 1996. While this does not reduce the 1996 taxable income below nil, it enables the company to reinstate $20,000 of its 1996 business loss as a non-capital loss for 1996. The 1996 non-capital loss is calculated as follows:

Business loss for 1996		$	30,000
Add:	Amount of 1995 net capital loss deducted in 1996		30,000

Total =	variable E		60,000
Less:	Variable F = paragraph 3(c) income for 1996 (see above)		40,000

Non-capital loss for 1996		$	20,000
			=======

To summarize, instead of being left with a net capital loss from 1995 of $20,000, the company deducts all $30,000 of its 1995 net capital loss in 1996 and uses the above-mentioned adjusting item for variable E to effectively reinstate $20,000 of its 1996 business loss as a non-capital loss for 1996. The company decides that this is the result it wants because a net capital loss is always subject to the above-mentioned subparagraph 111(1.1)(a)(i) limitation rule in the loss application year or years in which it is used, whereas a non-capital loss is not.

Adjustments to non-capital loss and farm loss amounts because of addition to taxable income under the forward averaging rules

¶ 26. As indicated in ¶ 5 above, losses from an office, employment, business or property, as well as ABILs, are deducted in the loss year from paragraph 3(c) income for the year. The losses that cannot be used in the loss year are then included in either the taxpayer's non-capital loss or farm loss for the loss year, as the case may be (see ¶s 10 and 11 above). For a taxation year ending before 1998, an individual

- who was resident in Canada throughout the year (or from the beginning of the year until the date of the individual's death, if it is in the year—see subsection 110.4(4)), and
- who previously has otherwise qualified for and been using the forward averaging rules

can elect under subsection 110.4(2) to add an amount in computing taxable income for the year. For purposes of determining the amount that is added in computing taxable income for the year under subsection 110.4(2), the individual specifies all or a portion of his or her "accumulated averaging amount" at the end of the immediately preceding taxation year (the individual then gets a section 120.1 forward averaging tax credit for the current year on the amount so specified for purposes of subsection 110.4(2)—note that the subsection 110.4(2) election will no longer be available for any taxation year after 1997). The individual's losses from an office, employment, business or property, and ABILs, for the year would not otherwise be deducted from the individual's subsection 110.4(2) specified amount because it is not part of paragraph 3(c) income (the individual elects under subsection 110.4(2) to add an amount in computing taxable income, not income). However, there are inter-related adjustments made in the calculation of

- the **non-capital loss** for the year,
- the **farm loss** for the year, and
- the amount added in computing taxable income for the year by virtue of the subsection 110.4(2) election.

The effects of these adjustments are as follows:

- After the total of the individual's losses from an office, employment, business or property, and ABILs, are deducted from paragraph 3(c) income for the loss year, any unused portion of those losses (referred to in this bulletin as the "initially calculated unused losses") is applied against (i.e., subtracted from) the individual's subsection 110.4(2) specified amount in order to determine the amount that actually gets added in computing taxable income for the year under subsection 110.4(2) (the result cannot be less than nil).
- If the total of the initially calculated unused losses is less than the subsection 110.4(2) specified amount, the losses will be totally used up in the loss year (i.e., there will not be any non-capital loss or farm loss for the loss year).
- If, on the other hand, the total of the initially calculated unused losses is greater than the subsection 110.4(2) specified amount, no amount will actually be added under subsection 110.4(2) in computing taxable income for the loss year and the subsection 110.4(2) specified amount will be applied against (i.e., subtracted from) what would otherwise be the non-capital loss for the loss year (as calculated using the rules in ¶s 10 and 11 above) in order to arrive at the final amount of the non-capital loss for the loss year (the result cannot be less than nil). If this application of the subsection 110.4(2) specified amount reduces the non-capital loss for the year to nil, any unused portion of the subsection 110.4(2) specified amount will then be applied against (i.e., subtracted from) what would otherwise be the farm loss for the loss year (as calculated using the rules in ¶s 10 and 11 above) in order to arrive at the final amount of the farm loss for the loss year. The reason that the subsection 110.4(2) specified amount is first applied in the calculation of the non-capital loss is that the carry-forward period for the non-capital loss is not as favourable as the carry-forward period for the farm loss (compare ¶ 18(a) with ¶ 18(d) above and also compare the carry-forward treatment for a "non-capital loss" and a "farm loss" in ¶ 22 above.)

Example:

In the 1996 taxation year, Jack incurs a loss of $7,000 from his farming business (section 31 does not apply). He also has an ABIL of $3,000. He has income from property of $1,000, but no subdivision e deductions for the year. He makes a subsection 110.4(2) election for the year and specifies for that purpose the balance of his accumulated averaging amount at the end of the 1995 year, $5,000.

Since Jack's losses are greater than his income from property of $1,000, his section 3 income for the 1996 year is nil. He determines the amount of his initially calculated unused losses for the year as follows:

Loss from farming business	$	7,000
ABIL		3,000

Losses available for use in the loss year		10,000
Less: Losses used to reduce section 3 income to nil = paragraph 3(c) income (see rules in ¶ 5 above)		1,000

Initially calculated unused losses	$	9,000
		=======

Since the $9,000 amount of initially calculated unused losses is greater than the subsection 110.4(2) specified amount of $5,000, Jack ends up adding no amount under subsection 110.4(2) in computing taxable income for 1996. (He would still, however, get a section 120.1 forward averaging tax credit for the year based on the $5,000 amount specified for purposes of subsection 110.4(2).)

Following the rules in ¶s 10 and 11 above, Jack calculates that

- the amount that would otherwise be his farm loss for the 1996 year is $7,000 (i.e., the lesser of $7,000 and $9,000); and
- the amount that would otherwise be his non-capital loss for the 1996 year is $9,000 – $7,000 = $2,000.

Jack then applies the subsection 110.4(2) specified amount of $5,000, for purposes of calculating the final amount of his non-capital loss and farm loss for the 1996 year, as follows:

Amount that would otherwise be the non-capital loss for the yea	$ 2,000
Less: Application of portion of subsection 110.4(2) specified amount	2,000

Final amount of non-capital loss for the year	$ nil
	====
Amount that would otherwise be the farm loss for the year	$ 7,000
Less: Application of remainder of subsection 110.4(2) specified amount	3,000

Final amount of farm loss for the year (which can be carried over to and used in other years in accordance with the rules discussed in ¶s 18(d), 19, 22 and 23 above)	$ 4,000
	====

Transfer of unused ABILs from an expired non-capital loss to a net capital loss

¶ 27. As indicated in ¶ 1 above, ABILs can be applied in the loss year against all types of income for the year. In order to ensure that unused ABILs receive essentially the same preferential treatment in other years as ABILs that are used in the loss year, unused ABILs are included in the non-capital loss for the loss year, as indicated in ¶ 10 above. However, the amount of unused ABILs included in a loss year's non-capital loss for which the seven-year carry-forward period has expired at the end of a particular taxation year (the "expiry year") generally becomes an addition in the calculation of the **net capital loss** for the expiry year. This is done to preserve the availability of these unused ABILs—as indicated in ¶ 18(b) above, the carry-forward period of a net capital loss cannot expire. The amount that is added in the calculation of the net capital loss of the expiry year is calculated as the lesser of two amounts:

(a) the total amount of ABILs for the loss year (i.e., regardless of the extent to which they were used in the loss year or included in the non-capital loss for the loss year); and

(b) the amount of the non-capital loss for the loss year less the total of all amounts out of that non-capital loss that

- have been deducted in calculating the taxpayer's taxable income, or
- have been claimed by the taxpayer under paragraph 186(1)(c) or (d) (see ¶ 22 above),

in the expiry year or any preceding year.

Example:

For its 1989 taxation year, ABC Ltd. had a non-capital loss of $50,000, which resulted from a $40,000 business loss and a $10,000 ABIL. (The corporation had no income for 1989 against which it could apply any portion of these losses.) As of the end of the 1996 taxation year (i.e., the expiry year in the seven-year carry-forward period for the 1989 non-capital loss), only $35,000 of the 1989 non-capital loss had been used either as deductions in calculating taxable income or claimed under paragraph 186(1)(c) or (d). Since the 1989 non-capital loss could not be carried forward to the 1997 or any subsequent taxation year, ABC Ltd. included in its net capital loss for the 1996 taxation year the lesser of

- the $10,000 ABIL that was incurred in the 1989 taxation year; and
- the unused portion, as of the end of the 1996 taxation year, of the non-capital loss for the 1989 year = $50,000 – $35,000 = $15,000.

The corporation therefore included $10,000 in its net capital loss for the 1996 year.

The above example demonstrates that uses of a non-capital loss (in other years) are considered to come first out of the losses other than ABILs (because such other losses can expire) and then, only after all such other losses have been used, out of the ABILs (because they can be transferred to a net capital loss when the non-capital loss in which they are included expires).

Amended Return for Year of Loss Application When Loss Carried Back From Subsequent Year

¶ 28. A taxpayer claiming a deduction for a particular taxation year (i.e., year of loss application) in respect of a loss incurred in a subsequent year is, by virtue of subsection 152(6), required to file a prescribed form amending the return filed for the year of loss application. Such form is to be filed no later than the day on which the taxpayer's return for the subsequent loss year would, by virtue of section 150, be required to be filed if the taxpayer had Part I tax to pay for that year. This means that a taxpayer, at the time of filing the prescribed form, is required to decide how much, if any, of the loss is to be used in each of the taxation years preceding the loss year to which a loss may be carried back. The prescribed form for requesting a loss carry-back is form T1A for individuals, T2A for corporations and T3A for trusts.

Separate Taxpayers

¶ 29. Unless otherwise expressly permitted by the Act (see the current version of IT-302R2, Losses of a Corporation – The Effect That Acquisitions of Control, Amalgamations, and Windings-Up Have on Their Deductibility – After January 15, 1987), the taxpayer entitled to use a loss is the person that incurred the loss. If, for example, an individual operating an unincorporated business incorporates the business, the individual and the corporation are separate taxpayers. Consequently, a carried-over loss incurred by the individual prior to incorporation can be carried forward (or back) and used only by the individual; it cannot be used by the corporation.

Death of an Individual

¶ 30. If an individual dies, subsection 111(2) modifies paragraph 111(1)(b) and subsection 111(1.1) for purposes of calculating the individual's taxable income for the year of death and the immediately preceding year (the "last two years"). The effect of subsection 111(2) is that the rules described in ¶s 18(b), 20 and 21 above are modified for purposes of applying net capital losses in the last two years. Under these modified rules, all unused net capital losses arising in years up to and including the year of death may be used to the extent needed to fully offset any net taxable portion of capital gains for the last two years. The inclusion rate adjustment described in ¶ 20 above still applies for this purpose. Thus, for example, only $5,000 of a net capital loss from the 1986 taxation year would be needed to fully offset a $7,500 taxable capital gain for 1996. After this use (if any) of the individual's net capital losses against the net taxable portion of capital gains for the last two years, any portion of the net capital losses that is still unused must first be reduced by the full amount of all section 110.6 capital gains deductions claimed by the individual for any taxation year. Any remaining amount can then be deducted in full against any other income for the last two years.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

Reasons for the Revision

This bulletin has been revised to make it more user friendly by

- expanding on the explanations of the basic loss rules contained in the *Income Tax Act* in order for readers to better understand the effect of, or the rationale behind, each particular rule; and
- providing numerous examples to illustrate the explanations given.

This bulletin has also been revised to reflect amendments to the Act that were enacted under

- S.C. 1988, c. 55 (formerly Bill C-139);
- the 5th Supplement to the Revised Statutes of Canada, 1985;
- S.C. 1994, c. 7, Schedules II, VI and VIII (formerly Bill C-15, Schedules II, VI and VIII); and
- S.C. 1995, c. 21 (formerly Bill C-70).

The bulletin also contains a note regarding a proposed amendment to the *Income Tax Act* contained in Bill C-69. The comments in the bulletin are not affected by any other draft legislation released as of the date of the bulletin's publication.

Legislative and Other Changes

In the new bulletin, we have

- added an explanation of the rules pertaining to the use of each type of loss in the year in which the loss was incurred (and, accordingly, changed the title of the bulletin);
- added a discussion on the use of a "listed-personal-property loss";
- added explanations regarding the **effect** of the adjustments that are made when calculating the various carried-over loss amounts;
- added a number of examples to illustrate the rules discussed in the bulletin;
- provided other additional information;
- removed the discussion of rules that have little or no relevance to current taxation years;
- removed the discussion of topics that are outside the scope of the bulletin—the topics discussed in ¶ 10, the second part of ¶s 15, 29 (and the second half of ¶ 24), 31, 32 and 33 of the former bulletin are outside the scope of the new bulletin; and
- otherwise rearranged to a large extent the order of discussion of the bulletin's topics.

As a result of these changes, the structure of the new bulletin differs considerably from that of the former bulletin. Therefore, the explanations given below do not refer to the paragraph numbers of the former bulletin.

Various paragraphs throughout the bulletin deal with the calculation of a taxpayer's "net capital loss," "non-capital loss," "farm loss" and "pre-1986 capital loss." Under the current *Income Tax Act*,

- the definitions of these losses are no longer contained in paragraphs 111(8)(a), 111(8)(b), 111(8)(b.1) and 111(8)(b.2) of the Act, respectively, but instead are in alphabetical order in subsection 111(8); and
- each of these definitions is in the form of an algebraic formula.

In **step 1 of ¶ 4**, there is a note regarding the proposed repeal of section 37.1.

In **step 3 of ¶ 4**, the amount $6,250 was changed from $2,500 for fiscal periods commencing after 1988.

¶s 6, 7 and 20 refer to the inclusion rate that is used for determining the taxable portion of capital gains and the allowable portion of capital losses. The inclusion rate changed from 1/2 to 2/3 to 3/4. The 2/3 rate generally took effect for 1988 and 1989 and the 3/4 rate generally took effect after 1989.

¶ 14 discusses a number of adjustments to the "non-capital loss":

- The adjustment to the "non-capital loss" with respect to section 110.6 of the Act was changed from the amount "deductible" to the amount "deducted" under that section. This amendment was made to ensure that a non-capital loss can be preserved by means of this adjustment only to the extent that the taxpayer in fact claims a section 110.6 capital gains deduction (see *Example 2* in ¶ 14). This amendment took effect for the 1988 and subsequent taxation years.
- The adjustment to the "non-capital loss" with respect to paragraph 110(1)(k) of the Act came into existence for the 1988 and subsequent taxation years (with certain transitional rules for the 1988 taxation year).

¶ 16 discusses an adjustment to the "non-capital loss" resulting from the receipt of fuel tax rebates. This adjustment, as well as the addition to the *Income Tax Act* of subsection 111(10) (which is related to the adjustment), first took effect with respect to amounts received after 1991. ¶ 16 also refers to another related provision, paragraph 12(1)(x.1), which was added to the Act for the 1992 and subsequent taxation years.

In **¶ 17**, the rule that a taxpayer's "restricted farm loss," "farm loss," "net capital loss" and "non-capital loss" be reduced as required by section 80 has been specifically provided for in the definitions for those losses for taxation years ending after February 21, 1994. (It should be noted, however, that the amendments to these definitions for this purpose were clarifying amendments because section 80 itself currently provides, and did provide as it read for taxation years ending before February 22, 1994, for reductions to these losses.)

¶ 19 discusses the ordering rule in section 111.1. For the 1987 and subsequent taxation years, section 111.1 was amended to add a reference to section 110.7 (the northern residents deduction). For the 1988 and subsequent taxation years, section 111.1 was amended to remove the references to deduction provisions that were no longer available (some of these deduction provisions, such as those for personal exemptions, were replaced by non-refundable tax credits).

The first half of ¶ 20 discusses the "inclusion rate adjustment" rule. That rule was added to the Act since the issuance of the last bulletin and was made retroactively applicable with respect to computations of taxable incomes for the 1985 and subsequent taxation years.

In **¶ 21**, items (a), (b) and (c) reflect a rule that, when calculating an individual's "pre-1986 capital loss balance," the reduction for prior years' section 110.6 capital gains deductions must be adjusted to take into account the differences in the capital gains inclusion rates over the years. This adjustment rule results from an amendment to the definition of an individual's "pre-1986 capital loss balance" that took effect for the 1988 and subsequent taxation years.

In **¶ 25**, the rule that a non-capital loss for a particular year be increased by any net capital loss of another year that is carried over to and deducted in the particular year took effect for the 1991 and subsequent taxation years. As explained in ¶ 25, this rule provides the means for a loss (e.g., a business loss) that must be used in the loss year against taxable capital gains for the year, to be reinstated as a non-capital loss for the year to the extent that a net capital loss of another year is used in the year.

As mentioned in **¶ 26**, the subsection 110.4(2) election will no longer be available for any taxation year after 1997.

¶ 30 discusses subsection 111(2), as amended retroactively for the computation of taxable income for the 1985 and subsequent taxation years (this was a technical amendment to make the subsection work more properly).