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The Abacus

PROFESSIONAL **STRENGTH** PERSONAL **SERVICE** PRACTICAL **SOLUTIONS**

*Provisions in the **Income Tax Act** allow you to carry back or forward certain losses that cannot be used in a taxation year.*

Saving taxes with losses

There are rules governing 'non-capital' losses. Generally speaking, these are your losses from employment, business or property (but not capital losses) in excess of your positive income from all sources for a taxation year. You can carry these losses back three years or forward 20 years. (For non-capital losses that arose in 2004 or 2005, the carry-forward period is only 10 years, and for losses in years before 2004 had to be used before 2011.)

If you incur a capital loss in a year (from selling shares in the stock market, for example), half of it is an 'allowable capital loss'. This can be deducted only against taxable capital gains in the year, and not against other sources of income (except in the year of death and the preceding year). If your allowable capital losses for the year exceed taxable capital gains, the excess is called a 'net capital loss'. The net capital loss can be carried back three years or forward indefinitely, but can only be used against taxable capital gains of those other years.

Allowable business investment losses (ABILs) are one-half of capital losses from debt or shares in 'small business corporations' (and subject to certain conditions). Your ABILs in a taxation year can be used to offset all sources of income, not just taxable capital gains. To the extent they cannot be used in a taxation year, they can be carried back three years or forward 10 years (losses that arose in years before 2004 had to be used before 2011) to offset all sources of income in those years. If they are not utilized by that tenth (or seventh) carry-forward year, they become regular net capital losses and then can be deducted only against taxable capital gains in future taxation years.

As noted on the following page, there are separate rules carry-over periods for losses from 'listed personal use property'.

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Personal-use property

Gains and losses from the disposition of personal-use property are treated differently for income tax purposes. Gains above a certain threshold are recognized and taxed, while losses are generally deemed to be nil and therefore are not allowed (an exception is made for listed personal property, described below).

The rationale for denying the recognition of most personal-use property losses is that they generally reflect your previous personal consumption of the property. Personal consumption is generally not deductible for income tax purposes.

personal use property

n. DEFINED to include property that is used primarily for the personal use or enjoyment of you and/or individuals related to you.

Listed personal property

Special rules govern gains or losses from 'listed personal property' (LPP). Gains and losses from these properties in a year are netted together. If there is a:

- **net gain**, one-half of it is taxable.
- **net loss**, it cannot be used in that year. However, it can be carried back three years or forward seven years, and can be used to offset net gains from LPP in any of those years (but not any other gains). One-half of the net gain in that other year, if any, is then included in your income.

LPP includes the following properties:

- prints, etchings, drawings, paintings, sculptures, and similar works of art;
- jewellery;
- rare books, rare folios, and rare manuscripts; and
- stamps and coins.

EXAMPLE I **Your grandmother's diamond ring**

You dispose of a personal-use diamond ring at a gain, so one half of the gain will be a taxable capital gain and included in your income. (All personal-use property is subject to a minimum deemed cost and proceeds of $1,000, so if you have, say an old lamp you bought for $200 and you sell it for $800, there is no gain for tax purposes since both cost and proceeds will be deemed to be $1,000.)

However, if you sell the ring at a loss, you cannot claim the resulting capital loss against your gains on the stock market. Similarly, if you sell your furniture at a loss, you cannot claim the loss for tax purposes.

Replacement property rules

If you dispose of a capital property at a gain, the 'replacement property' rules in the *Income Tax Act* may allow you to defer recognizing the gain for tax purposes if you acquire a replacement property. Similarly, if you dispose of a depreciable property and realize 'recapture' (generally, where your proceeds exceed the undepreciated capital cost of the property), you may be able to defer the recognition of the recapture if you acquire a replacement property. The deferral is optional. If you want it to apply, you make an election in your tax return for the year in which you acquire the replacement property.

replacement property

n. Generally, property that is used in the same or similar manner as the former property. Assuming the former property was used by you for the purpose of earning income from a business, the replacement property must be used for the purpose of earning income from that or a similar business. Furthermore, it must be 'reasonable to conclude' that the replacement property was acquired to replace the former property.

Involuntary dispositions of property:

- If, for example, your property is stolen, destroyed or expropriated, the replacement property must be acquired by the end of the second taxation year following the year of disposition (or 24 months after the end of that year, whichever is later).
- Potentially, the rules apply to any capital property, other than a share of a corporation.

Voluntary dispositions of property:

- The timeline is shorter than for involuntary dispositions of property: you must acquire the replacement property by the end of the first taxation year following the year of disposition (or 12 months after the end of that year, whichever is later).
- The deferral applies only to capital properties that are land and buildings used in a business, other than a rental business.

EXAMPLE | **Mike's factory**

Mike ran a business in a factory located on some land outside of Toronto. The factory and the land each had a cost of $200,000. In 2011, he sold them for $300,000 each, for a total of $600,000. As such, his initial gain on the factory and land was $100,000 each.

If Mike buys a replacement factory and land by the end of 2012, he can defer the gain on both former properties if they cost at least $300,000 each. He will not report any gain in 2011.

However, if one of the replacement properties – say, the replacement factory – costs only $280,000, then only $80,000 of the initial gain would be deferred, such that $20,000 of the initial gain would be reported in 2011. Half of that, or $10,000, would be a taxable capital gain included in Mike's income in 2011.

Deferral of capital gain

As a general rule, if the cost of your replacement property is at least equal to your proceeds of disposition of the former property, the entire gain from the former property can be deferred.

If the cost of the replacement property is less than your proceeds from the former property, the amount of the deferred gain will be reduced proportionately, meaning you will include at least a portion of the gain.

SEE REPLACEMENT PROPERTY P. 4

REPLACEMENT PROPERTY CONT'D FROM P. 3

Reduction of cost of replacement property

Since the rules allow you to defer the gain on the former property, the cost of the replacement property is reduced by the amount of the deferred gain.

Thus, in Mike's example, *above*, if Mike acquired a new factory for $300,000, such that the entire $100,000 gain from the former factory was deferred, the cost of his new factory would be reduced by $100,000 to $200,000.

Deferral of recapture

The rules also allow you to defer any recapture on the sale of depreciable property. Generally speaking, recapture can occur where your proceeds of disposition (up to your initial cost of the property) exceed the undepreciated capital cost (UCC) of the property. The UCC generally reflects the cost of the property that has not yet been depreciated for income tax purposes under the capital cost allowance (CCA) provisions.

The rules allow the deferral of the recapture as long as the cost of the replacement property equals at least the amount of the recapture.

Thus, in Mike's example, *above*, if the factory (a depreciable property) had a UCC of $180,000, the initial recapture on Mike's sale would be $20,000 (excess of proceeds over UCC, but only up to original cost of $200,000). As long as the cost of the replacement property equaled or exceeded $20,000, he could defer the recognition of the recapture. (As noted above, in order to also defer the capital gain on the former factory, the cost of the replacement property would have to equal at least the amount of the proceeds of the former factory).

The amount of the deferred recapture then effectively reduces the UCC in respect of the replacement property.

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