Canada Revenue Agency
Agence du revenu du Canada

Capital Gains

2006

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Canada

Before you start

Is this guide for you?

We explain the most common income tax situations in this guide. Use this guide to get information on capital gains or capital losses in 2006. You generally have a capital gain or loss whenever you sell, or are considered to have sold, capital property. Capital property is defined on page 5. Use Schedule 3, *Capital Gains (or Losses) in 2006*, to calculate and report your taxable capital gains or net capital loss.

If your only capital gains or losses are those shown on information slips (T3, T4PS, T5, T5013 or T5013A), and you did not file Form T664 or T664(Seniors), *Election to Report a Capital Gain on Property Owned at the End of February 22, 1994*, you do not have to read the entire guide. See "Chart 1 – Reporting capital gains (or losses) and other amounts from information slips" on page 19 to find out how to report these amounts.

If you sell the units, shares, or securities for which you were issued an information slip, you will have to report a capital gain or loss. See "Publicly traded shares, mutual fund units and other shares" on page 13.

If you are a farmer and you sell eligible capital property that is qualified farm property or farmland in 2006 that includes your principal residence, see guide T4003, *Farming Income*, guide RC4060, *Farming Income and the CAIS Program,* or RC4408, *Farming Income and the CAIS Program Harmonized Guide.* Guide RC4060 is applicable to Canadian Agricultural Income Stabilization Program (CAIS) participants in Ontario, Alberta and Prince Edward Island while guide RC4408 applies to CAIS participants in all other provinces and Yukon.

If you are a non-resident, emigrant, or new resident of Canada, you should see whichever one of the following guides applies to your situation:

- T4055, *Newcomers to Canada*;
- T4056, *Emigrants and Income Tax*; or
- T4058, *Non-Residents and Income Tax*.

What if you need help?

If you need help after reading this guide, you can visit our Web site at **www.cra.gc.ca/capitalgains,** or you can contact us at **1-800-959-8281**.

Throughout this guide, we refer to other forms and publications that give more specific information related to capital gains and losses.

In the section called "References" on page 45, you will find a listing of the different types of forms and publications we refer to most often.

If you need any of these forms or publications, you can get them from our Web site at **www.cra.gc.ca/forms** or by calling **1-800-959-2221**.

What's new for 2006?

Capital gains of fishers – Under proposed legislation, the sale or transfer after May 1, 2006, of property used in a family fishing business will be eligible for the $500,000 capital gains exemption. For more information, see page 12.

Reserve Allowed on Certain Dispositions of Fishing Assets – Under proposed legislation, the 10-year reserve period is being extended to include transfers of fishing property by an individual to the individual's child. For more information on reserves, see page 11.

Donations of publicly-listed securities, stock options and ecologically sensitive land – For gifts made after May 1, 2006, of publicly-listed securities and ecologically sensitive land, the capital gains inclusion rate will be zero. This will include securities acquired under an option agreement. For more information, see page 10.

Non-capital losses – Non-capital losses, farm losses and restricted farm losses arising in taxation years ending after 2005 can be carried forward 20 years instead of 10. This extension to the carryforward period does not apply to a non-capital loss arising from an allowable business investment loss (ABIL) however. For more information, see page 36.

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La version française de cette publication est intitulée *Gains en capital*.

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Glossary

This glossary describes, in a general way, technical terms that we use in this guide. Whenever practical, we define technical terms in detail in the applicable chapters.

> **Note**
> Throughout this guide, we use the terms **sell**, **sold**, **buy**, and **bought** to describe most capital transactions. However, the information in this guide also applies to other dispositions or acquisitions, such as when you give or receive a gift. When reading this guide, you can substitute the terms **disposed of** or **acquired** for **sold** or **bought**, if they more accurately describe your situation.

Abbreviations – The following is a list of some of the abbreviations that we use in this guide:

ABIL – Allowable business investment loss
ACB – Adjusted cost base
CCA – Capital cost allowance
CNIL – Cumulative net investment loss
FMV – Fair market value
LPP – Listed personal property
RFL – Restricted farm loss
UCC – Undepreciated capital cost

Adjusted cost base (ACB) – usually the cost of a property plus any expenses to acquire it, such as commissions and legal fees.

The cost of a capital property is its actual or deemed cost, depending on the type of property and how you acquired it. It also includes capital expenditures, such as the cost of additions and improvements to the property. You cannot add current expenses, such as maintenance and repair costs, to the cost base of a property.

For more information on ACB, see Interpretation Bulletin IT-456, *Capital Property – Some Adjustments to Cost Base*, and its Special Release.

Advantage – see the definition of **Eligible amount of the gift** on page 6.

Allowable capital loss – is your capital loss for the year multiplied by the inclusion rate for that year. For 2001 and subsequent years, the inclusion rate is 1/2.

Arm's length transaction – a transaction between persons who each acts in his or her own self-interest. Related persons are not considered to deal with each other at arm's length. Related persons include individuals connected by a blood relationship, marriage or common-law partnership, or adoption (legal or in fact). Also, a corporation and a shareholder who controls the corporation are related.

Unrelated persons usually deal with each other at arm's length. However, this might not be the case if one person is under the influence or control of the other.

Business investment loss – see "Allowable business investment loss (ABIL)" on page 36.

Canadian-controlled private corporation – is a private corporation that is a Canadian corporation **other than**:

a) a corporation controlled, directly or indirectly in any way, by one or more non-resident persons, by one or more public corporations (other than a prescribed venture capital corporation), by one or more corporations described in paragraph c), or by any combination of the above;

b) a corporation that would be controlled by one person if that one person owned all the shares of any corporation that are owned by any non-resident person, by any public corporation (other than a prescribed venture capital corporation), or by a corporation described in paragraph c); or

c) a corporation, a class of the shares of capital stock of which is listed on a prescribed stock exchange.

Canadian security – is:

- a share of the capital stock of a corporation resident in Canada;
- a unit of a mutual fund trust; or
- a bond, debenture, bill, note, mortgage, hypothecary claim, or similar obligation issued by a person resident in Canada.

Prescribed securities (defined on page 7) are not considered to be Canadian securities.

Capital cost allowance (CCA) – in the year you buy a "depreciable property" (defined on page 6), such as a building, you cannot deduct its full cost. However, since this type of property wears out or becomes obsolete over time, you can deduct its capital cost over a period of several years. This deduction is called CCA. When we talk about CCA, a reference is often made to **class**. You usually group depreciable properties into classes. You have to base your CCA claim on the rate assigned to each class of property.

Capital gain – you have a capital gain when you sell, or are considered to have sold, a capital property for **more** than the total of its adjusted cost base and the outlays and expenses incurred to sell the property. The term "outlays and expenses" is defined on page 7.

Capital loss – you have a capital loss when you sell, or are considered to have sold, a capital property for **less** than the total of its adjusted cost base and the outlays and expenses incurred to sell the property. The term "outlays and expenses" is defined on page 7.

Capital property – includes depreciable property, and any property which, if sold, would result in a capital gain or a capital loss. You usually buy it for investment purposes or to earn income. Capital property **does not** include the trading assets of a business, such as inventory. Some common types of capital property include:

- cottages;
- securities, such as stocks, bonds, and units of a mutual fund trust; and
- land, buildings, and equipment you use in a business or a rental operation.

Common-law partner – this applies to a person who is **not your spouse,** with whom you are living and have a conjugal relationship, and to whom at least **one** of the following situations applies. He or she:

a) has been living with you in such a relationship for at least 12 continuous months;

b) is the parent of your child by birth or adoption; or

c) has custody and control of your child (or had custody and control immediately before the child turned 19 years of age) and your child is wholly dependent on that person for support.

In addition, an individual immediately becomes your common-law partner if you previously lived together in a conjugal relationship for at least twelve continuous months and you have resumed living together in such a relationship. **Under proposed changes**, this condition will no longer exist. The effect of this proposed change is that a person [other than a person described in condition b) or c) above] will be your common-law partner only after your **current** relationship with that person has lasted at least 12 continuous months. This proposed change will apply to 2001 and later years.

References to "12 continuous months" in this definition includes any period that you were separated for less than 90 days because of a breakdown in the relationship.

Deemed acquisition – expression used when you are considered to have acquired property, even though you did not actually buy it.

Deemed cost – refers to the price of property you are considered to have acquired, even though you did not actually buy it.

Deemed disposition – expression used when you are considered to have disposed of property, even though you did not actually sell it.

Deemed proceeds of disposition – expression used when you are considered to have received an amount for the disposition of property, even though you did not actually receive the amount.

Depreciable property – usually capital property used to earn income from a business or property. The capital cost can be written off as CCA over a number of years.

Disposition (dispose of) – usually an event or transaction where you give up possession, control, and all other aspects of property ownership.

Eligible amount of the gift – under proposed legislation, this is generally the amount by which the fair market value (FMV) of the gifted property exceeds the amount of an **advantage**, if any, received or receivable in the future for the gift. For more information, see pamphlet P113, *Gifts and Income Tax*.

Under proposed legislation, the **advantage** is generally the total value of all property, services, compensation, or other benefits that you are entitled to as partial consideration for, or in gratitude for, the gift. The **advantage** may be contingent or receivable in the future, either to you or a person or partnership not dealing at arm's length with you.

Under proposed legislation, for gifts made after February 18, 2003, the advantage also includes any limited-recourse debt in respect of the gift at the time it was made. For example, there may be a limited–recourse debt if the property was acquired through a tax shelter that is a gifting arrangement. In this case, the eligible amount of the gift will be reported in box 13 of Form T5003, *Statement of Tax Shelter Information*. For more information on gifting arrangements and tax shelters, see T4068, *Guide for the T5013 Partnership Information Return*.

Eligible active business corporation – generally, this is a taxable Canadian corporation, where all or substantially all of the fair market value (FMV) of its assets are used principally in an active business carried on primarily in Canada by the corporation or by a related active business corporation while the investor holds the shares, **or for at least 730 days of the ownership period**. It can also be shares of, and/or a debt issued by, other related active business corporations or a combination of such assets, shares, or debt.

> **Note**
> An eligible active business corporation **does not** include:
>
> - a professional corporation;
> - a specified financial institution;
> - a corporation whose principal business is leasing, renting, developing, or selling real property that it owns or any combination of these activities; and
> - a corporation where more than 50% of the FMV of its property (net of debts incurred to acquire the property) is attributable to real property.

Eligible capital property – property that does not physically exist but gives you a lasting economic benefit. Examples of this kind of property are goodwill, customer lists, trademarks, and milk quotas.

Eligible small business corporation – generally, this is a Canadian-controlled private corporation, where all or substantially all of the FMV of its assets are used principally in an active business that is carried on primarily in Canada by the corporation or an eligible small business corporation related to it. It can also be shares of, and/or a debt issued by, other related eligible small business corporations or a combination of such assets, shares, or debt. The issuing corporation must be an eligible small business corporation at the time the shares were issued.

> **Note**
> An eligible small business corporation **does not** include:
>
> - a professional corporation;
> - a specified financial institution;
> - a corporation whose principal business is leasing, renting, developing, or selling real property that it owns or any combination of these activities; and
> - a corporation where more than 50% of the FMV of its property (net of debts incurred to acquire the property) is attributable to real property.

Excepted gift – a gift of a share you made to someone (other than a private foundation) with whom you deal at

arm's length. If the donee is a charitable organization or public foundation, it will be an excepted gift if you deal at arm's length with each director, trustee, officer, and official of the donee.

Fair market value (FMV) – is usually the highest dollar value you can get for your property in an open and unrestricted market, between a willing buyer and a willing seller who are acting independently of each other.

Flow-through entity – we explain this term in the section called "What is a flow-through entity?" on page 27 in Chapter 4.

Inclusion rate – Generally, the inclusion rate for 2006 is 1/2. This means that you multiply your capital gain for the year by this rate to determine your taxable capital gain. Similarly, you multiply your capital loss for the year by 1/2 to determine your allowable capital loss. For a list of previous year inclusion rates, see "Inclusion rate (IR)" on page 28.

Listed personal property (LPP) – is a type of personal-use property. The principal difference between LPP and other personal-use properties is that LPP usually increases in value over time. LPP includes all or any part of any interest in or any right to the following properties:

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

Net capital loss – generally, if your allowable capital losses are more than your taxable capital gains, the difference between the two becomes part of the calculation of your net capital loss for the year.

Non-arm's length transaction – a transaction between persons who were not dealing with each other at arm's length at the time of the transaction.

Non-qualifying real property – generally, non-qualifying real property is real property that you or your partnership disposed of after February 1992 and before 1996.

It also generally includes the following property you or your partnership disposed of after February 1992 and before 1996, if its fair market value is derived principally (more than 50%) from real property:

- a share of a capital stock of a corporation;
- an interest in a partnership;
- an interest in a trust; or
- an interest or an option in any property described above.

Non-qualifying securities – are securities you or an individual's estate donated to a "qualified donee" (defined on this page). Non-qualifying securities include:

- a share of a corporation with which you or the estate does not deal at arm's length after the donation was made;
- an obligation of yours or the estate, or of any person or partnership with whom you or the estate does not deal at arm's length after the donation was made; or
- any other security issued by you or the estate or by any person or partnership with whom you or the estate does not deal at arm's length after the donation was made.

The above excludes:

- shares, obligations, and other securities listed on a prescribed stock exchange; and
- obligations of a financial institution to repay an amount deposited with the institution.

Outlays and expenses – are amounts that you incurred to sell a capital property. You can deduct outlays and expenses from your "proceeds of disposition" (defined on this page) when calculating your capital gain or loss. You cannot reduce your other income by claiming a deduction for these outlays and expenses. These types of expenses include fixing-up expenses, finders' fees, commissions, brokers' fees, surveyors' fees, legal fees, transfer taxes, and advertising costs.

Personal-use property – refers to items that you own primarily for the personal use or enjoyment of your family and yourself. It includes all personal and household items, such as furniture, automobiles, boats, a cottage, and other similar properties.

Prescribed security – generally includes:

- a share of a corporation (other than a public corporation) whose value at the time you dispose of it comes mainly from real estate, resource properties, or both;
- a bond, debenture, bill, note, mortgage, or similar obligation of a corporation (other than a public corporation) that you do not deal with at arm's length at any time before you dispose of the security; and
- a share, bond, debenture, bill, note, mortgage, or similar obligation you acquire from a person with whom you do not deal at arm's length.

A prescribed security is not considered to be a "Canadian security" (defined on page 5).

Proceeds of disposition – usually the amount you received or will receive for your property. In most cases, it refers to the sale price of the property. This could also include compensation you received for property that has been destroyed, expropriated, or stolen.

Public corporation – is a corporation that is resident in Canada and:

- has a class of shares listed on a prescribed Canadian stock exchange; or
- is a corporation (other than a prescribed labour-sponsored venture capital corporation) that has elected, or has been designated by the Minister of National Revenue, to be a public corporation. Also, at the time of the election or designation, the corporation complied with prescribed conditions concerning the number of its shareholders, the dispersal of ownership of its shares, and the public trading of its shares.

Qualified donee – generally includes:

- a registered Canadian charity;
- a registered Canadian amateur athletic association;
- a Canadian tax-exempt housing corporation that only provides low-cost housing for seniors;
- a municipality in Canada or, under proposed legislation, for gifts made after May 8, 2000, a municipal or public body performing a function of government in Canada;
- the United Nations and its related agencies;
- a prescribed university outside Canada;
- a charitable organization outside Canada to which the Government of Canada has made a donation in 2005 or 2006; and
- the Government of Canada, a province, or a territory.

Qualified farm property – is certain property you or your spouse or common-law partner owns. It is also certain property owned by a family-farm partnership in which you or your spouse or common-law partner holds an interest.

Qualified farm property includes:

- a share of the capital stock of a family-farm corporation that you or your spouse or common-law partner owns;
- an interest in a family-farm partnership that you or your spouse or common-law partner owns;
- real property, such as land and buildings; and
- eligible capital property, such as milk and egg quotas.

For more information on what is considered to be qualified farm property, see guide T4003, *Farming Income*, guide RC4060, *Farming Income and the CAIS Program*, or RC4408, *Farming Income and the CAIS Program Harmonized Guide*.

Qualified fishing property – is certain property you or your spouse or common-law partner owns. It is also certain property owned by a family fishing partnership in which you or your spouse or common-law partner holds an interest.

Qualified fishing property includes:

- a share of the capital stock of a family fishing corporation that you or your spouse or common-law partner owns;
- an interest in a family fishing partnership that you or your spouse or common-law partner owns;
- real property, such as land and fishing vessels; and
- eligible capital property, such as fishing licences.

For more information on what is considered to be qualified fishing property, see guide T4004, *Fishing Income*.

Qualified small business corporation shares – a share of a corporation will be considered to be a qualified small business corporation share if **all** the following conditions are met:

- at the time of sale, it was a share of the capital stock of a small business corporation, and it was owned by you, your spouse or common-law partner, or a partnership of which you were a member;
- throughout that part of the 24 months immediately before the share was disposed of, while the share was owned by you, a partnership of which you were a member, or a person related to you, it was a share of a Canadian-controlled private corporation and more than 50% of the fair market value of the assets of the corporation were:
  - used mainly in an active business carried on primarily in Canada by the Canadian-controlled private corporation, or by a related corporation;
  - certain shares or debts of connected corporations; or
  - a combination of these two types of assets; and
- throughout the 24 months immediately before the share was disposed of, no one owned the share other than you, a partnership of which you were a member, or a person related to you.

As a general rule, when a corporation has issued shares after June 13, 1988, either to you, to a partnership of which you are a member, or to a person related to you, a special situation exists. We consider that, immediately before the shares were issued, they were owned by an unrelated person. As a result, to meet the holding-period requirement, the shares cannot have been owned by any person other than you, a partnership of which you are a member, or a person related to you for a 24-month period that begins after the shares were issued and that ends when you sold them. However, this rule **does not apply** to shares issued:

- as payment for other shares;
- for dispositions of shares after June 17, 1987, as payment of a stock dividend; or
- in connection with a property that you, a partnership of which you were a member, or a person related to you disposed of to the corporation that issued the shares. The property disposed of must have consisted of either:
  - all or most (90% or more) of the assets used in an active business carried on either by you, the members of the partnership of which you were a member, or the person related to you; or
  - an interest in a partnership where all or most (90% or more) of the partnership's assets were used in an active business carried on by the members of the partnership.

Real property – property that cannot be moved, such as land or buildings. We commonly refer to such property as real estate.

Recapture – when you sell a depreciable property for less than its capital cost, but for more than the undepreciated capital cost (UCC) in its class, you do not have a capital gain. However, if there is a negative UCC balance at the end of the year, this balance is a recapture of capital cost allowance. You have to include this amount in income for that year. For more information on recapture, see page 16.

Small business corporation – is a Canadian-controlled private corporation in which all or most (90% or more) of the fair market value of its assets:

- are used mainly in an active business carried on primarily in Canada by the corporation or by a related corporation;
- are shares or debts of connected corporations that were small business corporations; or
- are a combination of these two types of assets.

Spouse – applies only to a person to whom you are legally married.

Taxable capital gain – is the portion of your capital gain that you have to report as income on your return.

If you realize a capital gain when you donate certain properties to a qualified donee (as defined on page 8) other than a private foundation or make a donation of ecologically sensitive land, special rules will apply. For more information, see pages 11 and 27.

Terminal loss – occurs when you have an undepreciated balance in a class of depreciable property at the end of the tax year or fiscal year, and you no longer own any property in that class. You can deduct the terminal loss when you calculate your income for the year. For more information on terminal losses, see page 16.

Undepreciated capital cost (UCC) – generally, UCC is equal to the total capital cost of all the properties of the class **minus** the capital cost allowance you claimed in previous years. If you sell depreciable property in a year, you also have to subtract from the UCC one of the following two amounts, **whichever is less**:

- the proceeds of disposition of the property (either actual or deemed) **minus** the outlays and expenses incurred to sell it; or
- the capital cost of the property.

Chapter 1 – General information

This chapter provides the general information you need to report a capital gain or loss.

Generally, when you dispose of a property and end up with a gain or a loss, it may be treated in one of two ways:

- as a capital gain or loss (**capital transaction**); or
- as an income gain or loss (**income transaction**).

When you dispose of a property, you need to determine if the transaction is a capital transaction or an income transaction. The facts surrounding the transaction determine the nature of the gain or loss.

For more information on the difference between capital and income transactions, see the following Interpretation Bulletins:

IT-218 *Profit, Capital Gains and Losses From the Sale of Real Estate, Including Farmland and Inherited Land and Conversion of Real Estate From Capital Property to Inventory and Vice Versa*;

IT-459 *Adventure or Concern in the Nature of Trade*; and

IT-479 *Transactions in Securities*, and its Special Release.

For information on how to report income transactions, see guide T4002, *Business and Professional Income*.

When do you have a capital gain or loss?

Usually, you have a capital gain or loss when you sell or are considered to have sold capital property. The following are examples of cases where you are considered to have sold capital property:

- you exchange one property for another;
- you give property (other than cash) as a gift;
- shares or other securities in your name are converted;
- you settle or cancel a debt owed to you;
- you transfer certain property to a trust;
- your property is expropriated;
- your property is stolen;
- your property is destroyed;
- an option that you hold to buy or sell property expires;
- a corporation redeems or cancels shares or other securities that you hold (you will usually be considered to have received a dividend, the amount of which will be shown on a T5 slip);
- you change all or part of the property's use (see "Changes in use" on page 40);
- you leave Canada (see guide T4056, *Emigrants and Income Tax*); or
- the owner dies (see guide T4011, *Preparing Returns for Deceased Persons*).

Disposing of Canadian securities

If you dispose of Canadian securities, you may have an income gain or loss. However, in the year you dispose of Canadian securities, you can elect to report your gain or loss as a capital gain or loss. If you make this election for a tax year, we will consider every Canadian security you owned in that year and later years to be capital properties. A trader or dealer in securities (other than a mutual fund trust or a mutual fund corporation) or anyone who was a non-resident of Canada when the security was sold cannot make this election.

If a partnership owns Canadian securities, each partner is treated as owning the security. When the partnership disposes of the security, each partner can elect to treat the security as capital property. An election by one partner will **not** result in each partner being treated as having made the election.

To make this election, complete Form T123, *Election on Disposition of Canadian Securities*, and attach it to your

2006 return. Once you make this election, you cannot reverse your decision.

Disposing of personal-use property (including your principal residence)

Most people are not affected by the capital gains rules because the property they own is for their personal use or enjoyment.

Personal-use property

When you sell personal-use property, such as cars and boats, in most cases you do not end up with a capital gain. This is because this type of property usually does not increase in value over the years. As a result, you may end up with a loss. Although you have to report any gain on the sale of personal-use property, generally you are not allowed to claim a loss. For more information, see "Personal-use property" on page 18.

Principal residence

If you sell your home for more than what it cost you, you usually do not have to report the sale on your return or pay tax on any gain as long as:

- your home is your principal residence; and
- you or a member of your family did not designate any other property as a principal residence while you owned your home. For more information, see Chapter 6.

When do you report a capital gain or loss?

Report the disposition of capital property in the calendar year (January to December) you sell, or are considered to have sold, the property.

> **Note**
> Regardless of whether or not the sale of a capital property results in a capital gain or loss, you have to file a return to report the transaction (even if you do not have to pay tax). This rule also applies when you report the taxable part of any capital gains reserve you deducted in 2005.

Do you own a business?

If you own a business that has a fiscal year end other than December 31, you still report the sale of a capital property in the calendar year the sale takes place.

Example
Pauline owns a small business. The fiscal year end for her business is June 30, 2006. In August 2006, she sold a capital property that she used in her business. As a result of the sale, she had a capital gain. Pauline has to report the capital gain on her return for 2006. She does this even though the sale took place after her business' fiscal year end date of June 30.

Are you a member of a partnership?

If you are a member of a partnership, it is possible that your partnership has a fiscal year end other than December 31. If the partnership sells capital property during its fiscal year, you generally report your share of any capital gain or loss in the calendar year in which that fiscal year ends.

Calculating your capital gain or loss

To calculate any capital gain or loss, you need to know the following three amounts:

- the proceeds of disposition;
- the adjusted cost base (ACB); and
- the outlays and expenses incurred to sell your property.

To calculate your capital gain or loss, subtract the total of your property's ACB, and any outlays and expenses incurred to sell your property, from the proceeds of disposition.

You have a capital gain when you sell, or are considered to have sold, a capital property for **more** than the total of its ACB and the outlays and expenses incurred to sell the property.

Example
In 2006, Mario sold 400 shares of XYZ Public Corporation of Canada for $6,500. He received the full proceeds at the time of the sale and paid a commission of $60. The adjusted cost base of the shares is $4,000. Mario calculates his capital gain as follows:

Proceeds of disposition				$ 6,500	A
Adjusted cost base	$ 4,000	B			
Outlays and expenses on disposition	+ 60	C			
Line B **plus** line C	= $ 4,060	▶	–	4,060	D
Capital gain (line A **minus** line D)				= $ 2,440	E

Because only 1/2 of the capital gain is taxable, Mario completes Schedule 3 and reports $1,220 as his taxable capital gain on line 127 on his return.

When you sell, or are considered to have sold, a capital property for **less** than its ACB plus the outlays and expenses incurred to sell the property, you have a capital loss. You can apply 1/2 of your capital losses against any taxable capital gains in the year. For more information on capital losses, see Chapter 5.

Use Schedule 3, *Capital Gains (or Losses) in 2006*, to calculate and report all your capital gains and losses. Do not include any capital gains or losses in your business or property income, even if you used the property for your business. For more information on how to complete Schedule 3, see Chapter 2.

Special rules may apply if you donate any of the following properties to a qualified donee (other than a private foundation):

- a share, debt obligation, or right listed on a prescribed stock exchange;
- a share of the capital stock of a mutual fund corporation;
- a unit of a mutual fund trust;

- an interest in a related segregated fund trust;
- a prescribed debt obligation; and
- ecologically sensitive land (including a covenant, an easement, or in the case of land in Quebec, a real servitude).

Use Form T1170, *Capital Gains on Gifts of Certain Capital Property*, if you donated any of these properties and you have a capital gain. Enter the amount you calculate on Schedule 3.

In most cases, for gifts made before May 2, 2006, you can calculate the taxable portion of the capital gain on donations to include in your income by multiplying the capital gain by 1/4.

For gifts of these properties made after May 1, 2006, the inclusion rate of 1/4 will be reduced to zero. Form T1170 should still be completed to report these gifts.

However, in all cases, if you received an advantage in respect of the gift, part of the capital gain on the gifted property will be subject to the 1/2 inclusion rate. In addition, the 1/4 inclusion rate does not apply to capital losses you may have from such donations. For more information, see pamphlet P113, *Gifts and Income Tax*.

> **Note**
> Before 1972, capital gains were not taxed. Therefore, if you sold capital property in 2006 that you owned before 1972, you have to apply special rules when you calculate your capital gain or loss to remove any capital gains accrued before 1972. We do not explain these rules in this guide. To calculate your gain or loss from selling property you owned before 1972, use Form T1105, *Supplementary Schedule for Dispositions of Capital Property Acquired Before 1972*.

What happens if you have a capital gain?

If you have a capital gain, you may be able to:

- defer part of the capital gain by claiming a reserve (see the next section); or
- reduce or offset all or a part of the gain by claiming a capital gains deduction (see "Claiming a capital gains deduction" on page 12).

Claiming a reserve

When you sell a capital property, you usually receive full payment at that time. However, sometimes you receive the amount over a number of years. For example, you sell a capital property for $50,000 and receive $10,000 when you sell it and the remaining $40,000 over the next four years. If this happens, you may be able to claim a reserve. Usually, a reserve allows you to report a portion of the capital gain in the year you receive the proceeds of disposition.

Who can claim a reserve?

Most people can claim a reserve when they dispose of a capital property. Generally, you **cannot** claim a reserve in a tax year if you:

- were not a resident of Canada at the end of the tax year, or at any time in the following year;
- were exempt from paying tax at the end of the tax year, or at any time in the following year; or
- sold the capital property to a corporation that you control in any way.

How do you calculate and report a reserve?

If you claim a reserve, you still calculate your capital gain for the year as the proceeds of disposition **minus** the adjusted cost base and the outlays and expenses incurred to sell the property. From this, you deduct the amount of your reserve for the year. What you end up with is the part of the capital gain that you have to report in the year of disposition.

To deduct a reserve in any year, you have to complete Form T2017, *Summary of Reserves on Dispositions of Capital Property*. The information on the back of Form T2017 explains the limits on the number of years for which you can claim a reserve and the amount of the reserve you can deduct.

Generally, the maximum period over which most reserves can be claimed is 5 years. However, a 10 year reserve period is provided to transfers to your child of family farm property and small business corporation shares, as well as gifts of non-qualifying securities made to a qualified donee.

Under proposed legislation, the 10 year reserve period has been extended to include transfers of fishing property to your child. See Form T2017 for more information.

If you claimed a reserve in the previous year, include that reserve in the calculation of your capital gains for the current year. For example, if you claimed a reserve in 2005, you have to include it in your capital gains calculation for 2006. Claim the new reserve that you have calculated for 2006 in the appropriate area on Form T2017. If you still have an amount that is payable to you after 2006, you may be able to calculate and claim a new reserve. However, you will have to include it in your capital gains calculation for 2007.

A capital gain from a reserve brought into income qualifies for the capital gains deduction **only** if the original capital gain was from a property eligible for the deduction. For a list of these properties, see the section called "Which capital gains are eligible for the capital gains deduction?" on page 12.

> **Note**
> You do not have to claim the maximum reserve in a tax year (Year A). However, the amount you claim in a later year (Year B) cannot be more than the amount you claimed for that property in the previous year (Year A).

Reserve for a gift of securities

If you donate a non-qualifying security (other than an excepted gift) to a qualified donee and have a capital gain, you may be able to claim a reserve in order to postpone the inclusion of the capital gain in income. For the definitions of "excepted gift," "non-qualifying security," and "qualified donee," see the Glossary beginning on page 5.

Under proposed legislation, for gifts of non-qualifying securities made after December 20, 2002, the reserve you can claim **cannot** be greater than the eligible amount of the gift. See the definition of "eligible amount of the gift" in the Glossary beginning on page 5.

You can claim this reserve for any tax year ending within 60 months of the time you donated the security. However, you **cannot** claim a reserve if the donee disposes of the security, or if the security ceases to be a non-qualifying security before the end of the tax year. If this happens, you will be considered to have made a charitable donation in that year, and you can claim the charitable donation tax credit.

If the security is not disposed of within the 60-month period, you will not be required to bring the reserve back into income in the year following the end of that period.

To deduct this type of reserve, you have to complete Form T2017, *Summary of Reserves on Dispositions of Capital Property*.

Claiming a capital gains deduction

If you have a capital gain on the sale of certain properties, you may be eligible for the $250,000 lifetime capital gains deduction (1/2 of the $500,000 capital gains exemption).

What is a capital gains deduction?

It is a deduction that you can claim against taxable capital gains you realized from the disposition of certain capital properties. You can reduce your taxable income by claiming this deduction.

Which capital gains are eligible for the capital gains deduction?

You may be able to claim the capital gains deduction on taxable capital gains you have in 2006 from:

- dispositions of qualified small business corporation shares;
- dispositions of qualified farm property;
- a reserve brought into income in 2006, from either of the above; and
- under proposed legislation, dispositions after May 1, 2006, of qualified fishing property.

Note
Any capital gains from the disposition of these properties while you were a non-resident of Canada **are not** eligible for the capital gains deduction unless you meet the requirements explained in the next section.

You will find the definitions of "qualified farm property", "qualified fishing property" and "qualified small business corporation shares" in the Glossary on page 8.

Who is eligible to claim the capital gains deduction?

You have to be a resident of Canada throughout 2006 to be eligible to claim the capital gains deduction. For the purposes of this deduction, we will also consider you to be a resident throughout 2006 if:

- you were a resident of Canada for at least part of 2006; and
- you were a resident of Canada throughout 2005 or 2007.

Residents of Canada include factual and deemed residents. For more information on factual and deemed residents, see "Before you start" in the *General Income Tax and Benefit Guide*, or see Interpretation Bulletin IT-221, *Determination of an Individual's Residence Status*.

What is the capital gains deduction limit?

For 2006, if you disposed of qualified small business corporation shares, qualified farm property, or, under proposed legislation, qualified fishing property after May 1, 2006, you may be eligible for the $500,000 capital gains exemption. Because you only include one-half of the capital gains from these properties in your taxable income, your cumulative capital gains deduction is $250,000 (1/2 of $500,000).

The total of your capital gains deductions from 1985 to 2006 for **all** types of capital properties cannot be more than your cumulative lifetime deduction of $250,000.

How do you claim the capital gains deduction?

Use Form T657, *Calculation of Capital Gains Deduction for 2006*, to calculate the capital gains deduction. If you have investment income or investment expenses in any years from 1988 to 2006, you will also have to complete Form T936, *Calculation of Cumulative Net Investment Loss (CNIL) to December 31, 2006*.

Tax Tip
You can claim any amount of the capital gains deduction you want to in a year, up to the maximum.

What happens if you have a capital loss?

If you have a capital loss in 2006, you can use it to reduce any capital gains you had in the year, to a balance of zero. If your capital losses are more than your capital gains, you may have a net capital loss for the year. Generally, you can apply your net capital losses to taxable capital gains of the three preceding years and to taxable capital gains of future years. For more information on capital losses, see Chapter 5 beginning on page 28.

What records do you have to keep?

You will need information from your records or vouchers to calculate your capital gains or capital losses for the year. You do not need to include these documents with your return as proof of any sale or purchase of capital property. However, it is important that you keep these documents in case we ask to see them later.

If you own qualified farm property, qualified fishing property or qualified small business corporation shares, you should also keep a record of your investment income and expenses in case you decide to claim a capital gains deduction in the year of sale. You will need these amounts to calculate the cumulative net investment loss (CNIL) component of the capital gains deduction. You can use Form T936, *Calculation of Cumulative Net Investment Loss (CNIL) to December 31, 2006*, for this purpose.

In addition, you should keep a record of the fair market value of the property on the date you:

- inherit it;
- receive it as a gift; or
- change its use.

Chapter 2 – Completing Schedule 3

This chapter gives you information about how and where you should report some of the more common capital transactions on Schedule 3, *Capital Gains (or Losses) in 2006*. Schedule 3 is included in the General income tax package.

Schedule 3 has five numbered columns and is divided into several sections for reporting the disposition of different types of properties. Report each disposition in the appropriate section and make sure you provide the information requested in all columns. Complete the bottom portion of the schedule to determine your taxable capital gain or your net capital loss. If you have a taxable capital gain, transfer the amount to line 127 of your return. If you have a net capital loss, see Chapter 5 beginning on page 28 for information on how you can apply the loss.

> **Note**
> You may need to refer to the Glossary on page 5 for the definition of certain terms used in this chapter.

Qualified small business corporation shares

Report dispositions on lines 106 and 107 of Schedule 3. See the definition of "qualified small business corporation shares" in the Glossary on page 8.

> **Note**
> **Do not report** the following transactions in this section of Schedule 3:
>
> - the sale of other shares, such as publicly traded shares or shares of a foreign corporation;
> - your losses when you sell any shares of small business corporations to a person with whom you deal at arm's length. For more information, see "Allowable business investment loss (ABIL)" on page 36; and
> - any disposition of qualified small business corporation shares if you elect to defer the capital gains that resulted from it. For more information on capital gains deferral for investment in small business, see page 24. Report these transactions on lines 131 and 132 of Schedule 3.

Capital gains deduction

If you have a capital gain when you sell qualified small business corporation shares, you may be eligible for the $250,000 lifetime capital gains deduction. For more information, see "Claiming a capital gains deduction" on page 12.

Qualified farm and fishing property

Generally, when you dispose of qualified farm or fishing property, you report any capital gain or loss in this section of Schedule 3. Report dispositions of qualified farm property and, under proposed legislation, dispositions of qualified fishing property after May 1, 2006, on lines 109 and 110 of Schedule 3. See the definitions of "qualified farm property" and "qualified fishing property" in the Glossary on page 8.

If the capital gain or loss is from a mortgage foreclosure or conditional sales repossession, report it on lines 123 and 124 of Schedule 3. For more information, see "Other mortgage foreclosures and conditional sales repossessions" on page 18.

If you dispose of farm or fishing property, other than qualified farm or fishing property, report it on lines 136 and 138 of Schedule 3. For more information, see "Real estate, depreciable property, and other properties" on page 15.

Special reporting instructions apply to the disposition of eligible capital property that is qualified farm or fishing property. For more information, see the chapter called "Eligible Capital Expenditures" in guide T4004, *Fishing Income*, in guide T4003, *Farming Income*, guide RC4060, *Farming Income and the CAIS Program* or Guide RC4408, *Farming Income and the CAIS Program Harmonized Guide*.

Capital gains deduction

If you have a capital gain when you sell qualified farm or fishing property, you may be eligible for the $250,000 lifetime capital gains deduction. For more information, see "Claiming a capital gains deduction" on page 12.

Publicly traded shares, mutual fund units and other shares

Use this section to report a capital gain or loss when you sell shares or securities that are not described in any other section of Schedule 3. These include:

- units in a mutual fund trust;
- publicly traded shares;
- shares that qualify as Canadian securities or prescribed securities, if they are not qualified small business corporation shares or qualified family farm corporation shares; and
- shares issued by foreign corporations.

Report dispositions of units or shares on lines 131 and 132 of Schedule 3.

You should also use this section if you donate any of the following properties:

- shares listed on a prescribed stock exchange;
- shares of the capital stock of a mutual fund corporation;
- units in a mutual fund trust; or
- interest in a related segregated fund trust.

If you donated any of these properties to a qualified donee (other than a private foundation), use Form T1170, *Capital Gains on Gifts of Certain Capital Property*, to calculate the capital gain to report on Schedule 3. For more information, see pamphlet P113, *Gifts and Income Tax*.

If you sold any of the items listed above in 2006, you will receive a T5008 slip, *Statement of Securities Transactions*, or an account statement.

You may buy and sell the same type of property (for example, units of a mutual fund trust or publicly traded shares) over a period of time. If so, you have to calculate the average cost of each property in the group at the time of each purchase to determine the adjusted cost base (ACB). For more information, see "Adjusted cost base (ACB)" on page 20.

If you report a capital gain from the disposition of shares or other securities for which you filed Form T664, *Election to Report a Capital Gain on Property Owned at the End of February 22, 1994*, see Chapter 4 on page 27.

Note
If you own shares or units of a mutual fund, you may have to report the following capital gains (or losses):

- capital gains (or losses) you realize when you sell your shares or units of the mutual fund (report these amounts in the "Publicly traded shares, mutual fund units, deferral of eligible small business corporation shares, and other shares" area of Schedule 3); and
- capital gains realized by the fund from its investment portfolio which are then flowed out to you. For information on how to report these amounts, see "Information slips – Capital gains (or losses)" on page 19.

For more information on mutual funds, see information sheet RC4169, *Tax Treatment of Mutual Funds for Individuals*.

Employee security options

When you get an option to buy securities through your employer, it does not immediately affect your tax situation. An option is an opportunity to buy securities at a certain price. The securities under the option agreement may be shares of a corporation or units of a mutual fund trust.

If you decide to exercise your option and buy the securities at less than the fair market value (FMV), you will have a taxable benefit received through employment. The taxable benefit is generally the difference between what you paid for the securities and the FMV at the time you exercised your option. You can reduce the amount of the benefit by any amount you paid to acquire the option rights.

Note
The taxable benefit included in your income in connection with an employee option agreement is **not** eligible for the capital gains deduction.

If you buy shares through an employee security option granted to you by a Canadian-controlled private corporation (CCPC) with which you deal at arm's length, you do not include the taxable benefit in your income in the year you acquire the securities. You wait until the year you sell the securities.

For eligible securities under option agreements exercised in 2006 that are not granted by a CCPC, an income deferral of the taxable benefit may be allowable so that you do not have to include the benefit in your income until the year you sell the securities. This deferral is subject to an annual $100,000 limit, which we explain in more detail below. To qualify for this deferral, you must be an eligible employee and receive options to acquire eligible securities.

Generally, an eligible employee is one who, right after the option is granted:

- deals at arm's-length with the employer, the entity granting the option, and the entity whose eligible securities could be acquired under the option agreement; and
- is not a specified shareholder of an entity above that is a corporation. A specified shareholder is generally one who owns 10% or more of any class of a corporation's shares.

Such an employee must also be a resident of Canada at the time the option is exercised to qualify for the deferral.

Generally, an eligible security is:

- a common share of a class listed on a prescribed stock exchange in or outside Canada; or
- a unit of a mutual fund trust.

Generally, the amount paid to acquire the eligible security, including any amount paid to acquire the rights under the option agreement, cannot be less than the FMV of the security at the time the option is granted. In addition, the eligible security must be a security in respect of which a security option deduction may be claimed on line 249 of your return.

If you qualify for a security option deduction on line 249 of your return, you can claim 1/2 of the amount recognized as an employment benefit from the sale of eligible securities in 2006.

Annual limit on deferred option benefits

If you are an eligible employee, you can defer the taxable benefit arising on the acquisition of eligible securities with a FMV of up to $100,000. You can do this annually by filing an election in the form of a letter, before January 16 of the year following the year you exercise your options, with your employer or the person who would be required to file an information return in respect of the acquisition. The letter must contain the following information:

- confirmation that you were a resident of Canada at the time of the acquisition;
- confirmation that the $100,000 annual vesting limit has not been exceeded; and
- the amount of the benefit related to eligible securities purchased under the option agreement after February 27, 2000, that you wish to defer.

You must also complete Form T1212, *Statement of Deferred Security Options Benefits*, and file it with your paper return each year.

The $100,000 limit applies to the value of the eligible security options that first become exercisable by you each year and across all eligible security option plans of your employer. The value of an eligible security option is the FMV of the eligible security at the time the option is granted.

The inclusion into income of the taxable benefit will be deferred until the earlier of the year in which the employee disposes of the eligible security, or the employee (or former employee) dies or becomes a non-resident.

Note
The deferral of the taxable benefit applies to any eligible security option exercised in 2006, regardless of when the option was granted or became exercisable.

Adjusted cost base (ACB) of eligible securities

Regardless of when the eligible security option was exercised, the ACB of the eligible security you purchased through an employee eligible security option agreement is not the actual price you paid for them. To calculate the ACB of your eligible securities, add the following two amounts:

- the actual purchase price; and
- any amount included in your income as a taxable employee option benefit for the securities (even if you claimed a security option deduction for them).

Disposition of eligible securities

Report the capital gain (or loss) in the year you exchange or sell the eligible securities purchased through an employee eligible security option agreement. If the eligible securities are qualified small business corporation shares (see page 13), report the transaction in the "Qualified small business corporation shares" area on Schedule 3. In all other cases, report the transaction in the "Publicly traded shares, mutual fund units, deferral of small business corporation shares, and other shares" area.

Example
In 2001, Emily, an eligible employee of Widget Corporation, received an option to buy 5,000 eligible shares at $9 each. Widget Corporation is not a Canadian-controlled private corporation. On February 1, 2006, Emily exercised her option to buy the shares. The FMV of the shares at that time was $15 each. In 2007, she sells her shares for $20 each.

Emily's tax implications are as follows:

In 2001, when she received the option, there were no tax implications.

In 2006, when she bought the shares, the taxable benefit on the entire 5,000 shares she purchased is calculated as follows:

FMV (5,000 × $15)	$	75,000
Minus: Amount paid (5,000 × $9)	–	45,000
Taxable benefit (shown in box 53 on T4 slip)	= $	30,000

There are no tax implications because she elected to defer the taxable benefit arising from the purchase of shares by filing Form T1212, *Statement of Deferred Security Options Benefits*, with $30,000 entered on line 2.

In 2007, when she sells the shares:

Proceeds of disposition (5,000 × $20)			$	100,000
Minus:				
Amount paid (5,000 × $9)	$	45,000		
Taxable benefit	+	30,000		
Total	= $	75,000 ▸	–	75,000
Capital gain			= $	25,000

The $30,000 taxable benefit that was deferred in 2006 will be included in income in 2007 on line 101 of her return. It will also be reported on line 4 of Form T1212. She will be able to claim a security option deduction of $15,000 ($30,000 × 1/2) on line 249 of her 2007 return. The capital gain of $25,000 will be reported on Schedule 3.

Donations under employee option agreements

If you donate shares or mutual fund units in 2006 under your employee option agreement to a qualified donee (other than a private foundation), use Form T1170, *Capital Gains on Gifts of Certain Capital Property*, to calculate your capital gain. For a donation made before May 2, 2006, you may qualify for an additional security option deduction equal to **1/4** of the taxable benefit.

For donations made after May 1, 2006, the additional deduction is equal to **1/2** of the taxable benefit.

For more information on these donations, see pamphlet P113, *Gifts and Income Tax*.

Real estate, depreciable property, and other properties

If you sold real estate or depreciable property in 2006, you have to report your capital gain or loss in this section. Report dispositions on lines 136 and 138 of Schedule 3.

Do not use this section to report the sale of personal-use property (such as a cottage) or the sale of mortgages and other similar debt obligations on real property. Report these transactions under the sections called "Personal-use property" and "Bonds, debentures, promissory notes, and other similar properties," respectively.

Real estate

Real estate includes:

- vacant land;
- rental property (both land and buildings);
- farm property, including both land and buildings (other than qualified farm property); and
- commercial and industrial land and buildings.

For each real property you sold in 2006 that includes land and a building, you must:

- determine how much of the selling price relates to the land and how much is for the building; and
- report the sale of your land and building separately on Schedule 3.

To help you understand how to report a disposition of real property that includes land and a building, see the example on page 42.

If you dispose of a building and end up with a loss, special rules may apply. Under these rules, you may have to consider your proceeds of disposition as an amount other than the actual proceeds. For more information, see "Selling a building in 2006" on page 23.

Special rules may also apply if you dispose of, or are considered to have disposed of, a property that was your principal residence for 1994 for which you or your spouse or common-law partner has filed Form T664 or T664(Seniors), *Election to Report a Capital Gain on Property Owned at the End of February 22, 1994*. If this is your situation, see "Disposing of your principal residence" on page 39.

Depreciable property

When you dispose of depreciable property, you may have a capital gain. In addition, certain rules on capital cost allowance (CCA) may require that you add a recapture of CCA to your income or allow you to claim a terminal loss. You can find definitions of these and other terms used in this section in the Glossary on page 5.

Capital gain

Usually, you will have a capital gain on depreciable property if you sell it for more than its adjusted cost base plus the outlays and expenses incurred to sell the property.

Note
A loss from the sale of depreciable property **is not considered** to be a capital loss. However, you may be able to claim a terminal loss.

Recapture of CCA and terminal losses

This section will provide you with a general look at the rules for the recapture of CCA and terminal losses.

Note
These rules do not apply to passenger vehicles in Class 10.1.

When you sell a depreciable property for less than its original capital cost, but for more than the undepreciated capital cost (UCC) in its class, you **do not have** a capital gain.

Generally, the UCC of a class is the total capital cost of all the properties of the class **minus** the CCA you claimed in previous years. If you sell depreciable property in a year, you also have to subtract from the UCC one of the following amounts, **whichever is less**:

- the proceeds of disposition of the property **minus** the related outlays and expenses; or
- the capital cost of the property at the time of sale.

If the UCC of a class has a **negative** balance at the end of the year, this amount is considered to be a recapture of CCA. Include this recapture in your income for the year of sale.

If the UCC of a class has a **positive** balance at the end of the year, and you do not have any properties left in that class, this amount is a terminal loss. Unlike a capital loss, you can deduct the full amount of the terminal loss from your income in that year.

If the balance for the UCC of a class is **zero** at the end of the year, then you do not have a recapture of CCA or a terminal loss.

For more information about CCA and how to report a recapture of CCA or a terminal loss, see the chapter called "Capital Cost Allowance (CCA)" in one of the following guides:

- T4002, *Business and Professional Income*;
- T4003, *Farming Income*;
- RC4060, *Farming Income and the CAIS Program*;
- RC4408, *Farming Income and the CAIS Program Harmonized Guide*
- T4004, *Fishing Income*; or
- T4036, *Rental Income*.

Example
In 1998, Peter bought a piece of machinery, at a cost of $10,000, for his business. It is the only property in its class at the beginning of 2006. The class has a UCC of $6,000. He sold the piece of machinery in 2006 and did not buy any other property in that class. The following chart gives you three different selling prices (proceeds of disposition) to show how Peter would handle each situation (A, B, and C).

Description	A ($)	B ($)	C ($)
Calculation of capital gain			
Proceeds of disposition	4,000	8,000	12,000
Minus: Capital cost	– 10,000	– 10,000	– 10,000
Capital gain	= 0	= 0	= 2,000
Calculation of terminal loss or (recapture of CCA)			
Capital cost	10,000	10,000	10,000
Minus: CCA 1998-2005	– 4,000	– 4,000	– 4,000
UCC at the beginning of 2006	= 6,000	= 6,000	= 6,000
Minus the lesser of:			
The capital cost of $10,000 and the proceeds of disposition	– 4,000	– 8,000	– 10,000
Terminal loss or (recapture of CCA)	= 2,000	= (2,000)	= (4,000)

In **situation A**, Peter does not have a capital gain. However, he does have a terminal loss of $2,000, which he can deduct from his business income.

In **situation B**, Peter does not have a capital gain. However, he does have a recapture of CCA of $2,000 that he has to include in his business income.

In **situation C**, Peter has a capital gain of $2,000. He also has a recapture of CCA of $4,000 that he has to include in his business income.

When you dispose of eligible capital property, you may qualify to make an election to treat the disposition as a capital gain, which you would report in this section of Schedule 3. For more information, see "Eligible capital property" on page 25.

Bonds, debentures, promissory notes, and other similar properties

Use this section to report capital gains or capital losses from the disposition of bonds, debentures, Treasury bills, promissory notes, and other properties. Other properties include bad debts, foreign exchange gains and losses, and options, as well as discounts, premiums, and bonuses on debt obligations. Report dispositions on lines 151 and 153 of Schedule 3.

Donations made to a qualified donee of a debt obligation or right listed on a prescribed stock exchange, or a prescribed debt obligation, are treated differently. If you made such a donation, use Form T1170, *Capital Gains on Gifts of Certain Capital Property.* If you have a capital gain, report the amount calculated on Form T1170 on Schedule 3. This does not apply to donations made to a private foundation. For more information, see pamphlet P113, *Gifts and Income Tax*.

If you sold any of the types of properties listed above in 2006, you will receive a T5008 slip, *Statement of Securities Transactions*, or an account statement.

If you have bought and sold the same type of property over a period of time, a special rule may affect your capital gain (or loss) calculation. For more information, see "Identical properties" on page 20.

Treasury bills (T-bills) and stripped bonds

When a T-bill or a stripped bond is issued at a discount and you keep it until it matures, the difference between the issue price and the amount you cash it in for is considered to be interest that accrued to you. However, if you sell the T-bill or stripped bond before it matures, you may have a capital gain or loss in addition to the interest accrued at that time.

Before you calculate your capital gain or loss, you have to determine the amount of interest accumulated to the date of disposition. Subtract the interest from the proceeds of disposition and calculate the capital gain or loss in the usual way.

Example
Jesse bought a T-bill on May 1, 2006, for $49,000. The T-bill's term is 91 days and its maturity value on August 1, 2006, is $50,000. However, he sold it on June 13, 2006, for $49,500. The effective yield rate was 8.19%.

Jesse calculates interest on the T-bill as follows:

Purchase price	×	Effective yield rate	×	Number of days T-bill held / Number of days in the year sold	=	Interest to be
$49,000	×	8.19%	×	44 / 365	=	$ 483.77

Jesse calculates his capital gain as follows:

Proceeds of disposition		$ 49,500.00
Minus: Interest	–	483.77
Net proceeds of disposition		$ 49,016.23
Minus: Adjusted cost base	–	49,000.00
Capital gain	=	$ 16.23

Bad debts

If a debt is owed to you (other than a debt under a mortgage or a debt resulting from a conditional sales agreement), and it remains unpaid after you have exhausted all means to collect it, it becomes a bad debt. The debt will be a capital loss if you acquired it:

- to earn income from a business or property; or
- as consideration or payment for the sale of capital property in an arm's length transaction.

In most cases, the capital loss is equal to the adjusted cost base of the debt.

To claim a capital loss on a bad debt, you have to file an election with your return. To make this election, write and sign a letter stating that you want **subsection 50(1)** of the *Income Tax Act* to apply to the bad debt. Attach this letter to your return.

If the debt is from the sale of personal-use property to a person with whom you deal at arm's length, the situation is different. You can claim the capital loss in the year that the debt becomes a bad debt. However, the capital loss cannot be more than the capital gain you previously reported on the sale of the property that created the debt.

The recovery of any bad debt claimed as a capital loss will be treated as a capital gain in the year of recovery.

Note
If the bad debt involves a small business corporation, see "Allowable business investment loss (ABIL)" on page 36.

Foreign exchange gains and losses

Foreign exchange gains or losses from capital transactions in foreign currencies are considered to be capital gains or losses. However, you only have to report the amount of your net gain or loss for the year that is **more than $200**. If the net amount is $200 or less:

- there is no capital gain or loss; and
- you do not have to report it on your return.

Other mortgage foreclosures and conditional sales repossessions

Report dispositions on lines 154 and 155 of Schedule 3.

You may have held a mortgage on a property but had to repossess the property later because you were not paid all or a part of the amount owed under the mortgage. In this case, you may have to report a capital gain or loss.

The following rules also apply when property is repossessed under a conditional sales agreement.

For clarity, a mortgagee is a person who **lends** money under a mortgage. A mortgagor is a person who **borrows** money under a mortgage. If, as a mortgagee, you repossess a property because the mortgagor failed to pay you the money owed under the mortgage, you are considered to have purchased the property. At the time of repossession, you do not have a capital gain or loss. Any gain or loss will be postponed until you sell the property.

If you are the mortgagor and your property is repossessed because you did not pay the money owed under the mortgage, you are considered to have sold the property. Depending on the amount you owed at the time of repossession, you may have a capital gain, a capital loss, or, in the case of depreciable property, a terminal loss. However, if the property is personal-use property, you cannot deduct the loss.

Note
If the capital gain or loss is from the disposition of qualified farm or fishing property, report the capital gain or loss on line 124 in the "Qualified farm property and qualified fishing property" section of Schedule 3.

Other tax implications

Capital gains from a mortgage foreclosure or a conditional sales repossession will be excluded from net income when calculating your claim for the goods and services tax/harmonized sales tax credit, the Canada Child Tax Benefit, credits allowed under certain related provincial or territorial programs, and the age amount. You should also exclude this income when calculating your social benefits repayment.

Personal-use property

Report dispositions on line 158 of Schedule 3.

When you dispose of personal-use property, you may have a capital gain or loss. To calculate this gain or loss, follow these rules:

- if the adjusted cost base (ACB) of the property is less than $1,000, its ACB is considered to be $1,000;
- if the proceeds of disposition are less than $1,000, the proceeds of disposition are considered to be $1,000; and
- if both the ACB and the proceeds of disposition are $1,000 or less, you do not have a capital gain or a capital loss. Do not report the sale on Schedule 3 when you file your return.

If you are disposing of your principal residence, see Chapter 6 beginning on page 38.

Note
If you acquire personal-use property for donation to a qualified donee (as defined in the Glossary on page 8) in circumstances where it is reasonable to conclude that the acquisition of the property relates to an arrangement, plan, or scheme promoted by another person or partnership, the above rules do not apply. If this situation applies to you, calculate your capital gain or loss using the actual ACB and proceeds of disposition as discussed in "Calculating your capital gain or loss" on page 10.

When you dispose of personal-use property that has an ACB or proceeds of disposition of **more than $1,000**, you may have a capital gain or loss. You have to report any capital gain from disposing of personal-use property. However, if you have a capital loss, you usually **cannot** deduct that loss when you calculate your income for the year. In addition, you cannot use the loss to decrease capital gains on other personal-use property. This is because if a property depreciates through personal use, the resulting loss on its disposition is a personal expense.

These loss restrictions **do not** apply:

- if you disposed of personal-use property that is listed personal property (see the next section); or
- to a bad debt owed to you from the sale of a personal-use property to a person with whom you deal at arm's length. For more information, see "Bad debts" on page 17.

Example
Jane sold the following personal-use properties in 2006.

Property sold	Proceeds of disposition	Adjusted cost base	Outlays and expenses
China cabinet	$ 900	$ 500	$ 0
Boat	$ 1,200	$ 850	$ 50
Personal computer	$ 1,500	$ 3,200	$ 30

Jane calculates the capital gain or loss for each transaction as follows:

Calculation of capital gain (or loss)	China cabinet ($)	Boat ($)	Personal computer ($)
Proceeds of disposition (**greater of** selling price and $1,000)	1,000	1,200	1,500
Minus: ACB (**greater of** cost and $1,000) **plus** outlays and expenses	– 1,000	– 1,050	– 3,230
Capital gain (loss)	= 0	= 150	= (1,730)

China cabinet – For the proceeds of disposition and the ACB, Jane uses $1,000, as both were less than that amount. As a result, there is no capital gain or loss for this transaction and Jane **does not** have to report it on Schedule 3.

Boat – Because the cost of the boat is less than $1,000, the ACB is considered to be $1,000. Jane reports $150 as a capital gain.

Personal computer – Jane's capital loss is not deductible. She also cannot use the loss to decrease any other capital gains realized in the year.

Listed personal property (LPP)

Report dispositions on line 159 of Schedule 3. See the definition of "listed personal property (LPP)" in the Glossary on page 7.

To determine the value of many LPP items, you can have them appraised by a dealer. You can also refer to catalogues for the value of the properties.

Note
LPP gains do not include gains from selling or donating certified Canadian cultural property to a designated institution. For more information, see "Selling or donating certified Canadian cultural property" on page 27.

Because LPP is a type of personal-use property, the capital gain or loss on the sale of the LPP item is calculated the same way as for personal-use property. For more information about these rules, see "Personal-use property" on page 18.

If your 2006 gains from dispositions of LPP are more than your 2006 losses from such dispositions, you can use unapplied LPP losses from 1998 and later years to reduce your 2006 gains. If you want to do this, **do not** enter these losses on line 253 of your return. Instead, subtract the unapplied LPP losses of previous years from your 2006 LLP gains. You should only complete the "Listed personal property" area of Schedule 3 if, after doing these calculations, you still have a net LPP gain in 2006.

If your 2006 losses from dispositions of LPP are more than your 2006 gains from such dispositions, the difference represents your LPP loss for the year. Keep a record of your LPP losses that have not expired so you can apply these losses against LPP gains in other years. An unapplied LPP loss expires when you do not use it by the end of the seventh year after you incurred it. For more information on applying LPP losses, see page 34.

Information slips – Capital gains (or losses)

Most capital gains and capital losses reported on Schedule 3 come from amounts shown on information slips.

Although you report most of these amounts on line 174 or line 176 (in the case of T3 slips) of Schedule 3, there are exceptions. For example, capital gains from qualified small business corporation shares and qualified farm or fishing property are eligible for the $250,000 lifetime capital gains deduction. Therefore, you have to report those gains on lines 107 or 110, whichever applies.

The following chart explains how to report the capital gains (or losses) and other amounts shown on certain information slips.

Chart 1 – Reporting capital gains (or losses) and other amounts from information slips

Please read the instructions on the back of your slips to ensure that you claim all deductions and credits that you may be entitled to.

Type of slip	Description of amounts to report	Line on Schedule 3	Other information
T3	**Box 21, Capital gains** – This is your total capital gain from a trust. Report the difference between this amount and the amount in box 30. The "Footnotes" area may also show that all or part of the amount in box 21 is non-business income for the foreign tax credit. Enter the footnoted amount on line 433 of Schedule 1, and use it to calculate your foreign tax credit.	Line 176	
	Box 26, Other income – If there is an asterisk in this box, the "Footnotes" area may show that all or part of the amount is income from eligible capital property/qualified farm or fishing property. This amount is eligible for the capital gains deduction.	Line 173	See note 2

Continued on next page

Chart 1 – Reporting capital gains (or losses) and other amounts from information slips (continued)			
T3 (cont'd)	**Box 30, Capital gains eligible for deduction** – If there is an amount in this box, the "Footnotes" area will show that all or part of your gain is from dispositions of:		
	■ qualified small business corporation shares; or	Line 107	See note 1
	■ qualified farm or fishing property.	Line 110	See note 1
	Box 37, Insurance segregated fund capital losses	Line 176	See note 3
	Box 42, Amount resulting in cost base adjustment	N/A	See note 6
T4PS	**Box 34, Capital gains or losses**	Line 174	See note 4
T5	**Box 18, Capital gains dividends**	Line 174	
T5013 or T5013A	**Box 20, Limited partnership farming income (loss)** – This amount may include farming income eligible for the capital gains deduction from disposing of eligible capital property/qualified farm property (QFP).	Line 173	See note 2
	Box 21, Limited partnership fishing income (loss) – This amount may include fishing income eligible for the capital gains deduction from disposing of eligible capital property/qualified fishing property after May 1, 2006.	Line 173	See note 2
	Box 70, Capital gains (losses)	Line 174	See note 2 See note 7
	Box 70-4, Capital gains (losses) from QFP or qualified fishing property mortgage foreclosures and conditional sales repossessions eligible for the capital gains deduction	Line 124	See note 1
	Box 70-16, Capital gains (losses) from a subsection 14(1.01) or proposed subsection 14(1.02) election	Line 138	
	Box 70-17, Farming or fishing income eligible for the capital gains deduction from the disposition of eligible capital property that is QFP or qualified fishing property	Line 173	See note 1 See note 2
	Boxes 71 to 71-8, Capital gains reserves – These are your 2006 capital gains reserves from the partnership.	N/A	See note 5

Notes

1. These amounts are eligible for the $250,000 capital gains deduction. For more information, see "Claiming a capital gains deduction" on page 12.
2. Complete line 173 if you want to claim a capital gains deduction. For more information, see "Claiming a capital gains deduction" on page 12.
3. If this is your only entry on line 176, put brackets around the amount. If it is not your only entry, subtract it from the total of all other amounts you enter on line 176.
4. If the amount is in brackets, it is a capital loss. If you have a capital loss and it is your only entry on line 174, put brackets around it. Otherwise, subtract the amount from the total of all other amounts you enter on line 174.
5. Enter any reserve on Form T2017, *Summary of Reserves on Dispositions of Capital Property*. The instructions provided with the T5013 slip should indicate where to enter the amounts on Form T2017.
6. For details, read the section below entitled "Identical properties".
7. A footnote may indicate that a part of the amount in box 70 should be reported on a different line(s) of Schedule 3. If this is the case, make sure to subtract this amount(s) from the total in box 70 and only report the remainder on line 174 of Schedule 3.

Chapter 3 – Special rules and other transactions

This chapter explains some of the special rules that may apply when you calculate your capital gain or loss. It also explains how to report some of the less common capital transactions.

Note
You may need to refer to the Glossary on page 5 for the definition of certain terms used in this chapter.

Adjusted cost base (ACB)

In some cases, special rules may apply that will allow you to consider the cost of a property to be an amount other than its actual cost. This section explains these rules.

Identical properties

Properties of a group are considered to be identical if each property in the group is the same as all the others. The most common examples of identical properties are shares of the same class of the capital stock of a corporation or units of a mutual fund trust.

You may buy and sell several identical properties at different prices over a period of time. If you do this, you have to calculate the average cost of each property in the group at the time of each purchase to determine your ACB (dispositions of identical properties do not affect the ACB). The average cost is calculated by dividing the total cost of identical properties purchased (this is usually the cost of the property plus any expenses involved in acquiring it) by the total number of identical properties owned.

Any amount reported in Box 42 – Amount resulting in cost base adjustment, of the T3 slip represents a change in the capital balance of the mutual fund trust identified on the slip. This amount is used when calculating the ACB reported on Schedule 3, *Capital Gains or (Losses) in 2006* for the property in the year of disposition. For more information and an example of the calculation, see information sheet RC4169, *Tax Treatment of Mutual Funds for Individuals*.

If Box 42 contains a negative amount, add this amount to the adjusted cost base (ACB) of the units of the trust identified on the slip.

If Box 42 contains a positive amount, subtract this amount from the ACB of the units of the trust identified on the slip.

If the ACB of the trust units is reduced below zero during the taxation year, the negative amount is deemed to be a capital gain in the year. The ACB of the trust units is deemed to be zero. Enter the amount of the capital gain on line 132 of your Schedule 3. (Place a zero on line 131 since there is no actual sale of units.)

Note
Generally, the following properties are **not** considered identical properties:

- securities acquired under an employee option agreement that are subject to the benefit deferral or are designated and disposed of within 30 days; and
- certain employer shares received by an employee as part of a lump-sum payment upon withdrawal from a deferred profit sharing plan.

As a result, the ACB averaging rule described above does **not** apply to these types of securities. Each of these securities will have its own ACB determined in the usual way.

You also use this method to calculate the average cost of identical bonds or debentures you bought after 1971. However, the average cost is based on the principal amount for each identical property, that is, the amount before any interest or premiums are added.

A bond, debenture, or similar debt obligation that a debtor issues is considered to be identical to another if:

- the same debtor issues both; and
- all the attached rights are the same.

The principal amount of individual debt obligations being the same is not enough for such debts to be considered identical properties. They must still meet the two conditions listed above.

Example 1
Over the years, Stephanie has bought and sold common shares of STU Ltd. The following chart shows how, after each purchase, the ACB of her shares changes.

Transaction	A Cost ($)	B Number of shares	A ÷ B ACB ($)
Purchase in 1996: $15.00/share	1,500	100	**15.00**
Purchase in 1997: $20.00/share	+ 3,000	+ 150	
New average cost	= 4,500	= 250	**18.00**
Sale in 2006	– 3,600	– 200	
Average cost	= 900	= 50	**18.00**
Purchase in 2006: $21.00/share	+ 7,350	+ 350	
New average cost	= 8,250	= 400	**20.63**

Example 2
In 1999, Pearl bought units of a mutual fund trust. When she bought them, Pearl chose to reinvest her annual income distributions in more units. The following chart shows how the ACB of her units changes after each purchase.

Transaction	A Cost ($)	B Number of units	A ÷ B ACB ($)
Purchase in 1999: $18.00/unit	15,000.00	833.3333	**18.00**
Reinvested distributions in 1999: $19.55/unit	+ 1,170.00	+ 59.8466	
New average cost	= 16,170.00	= 893.1799	**18.10**
Reinvested distributions in 2000: $20.63/unit	+ 1,455.30	+ 70.5429	
New average cost	= 17,625.30	= 963.7228	**18.29**
Sale in 2006	– 7,316.00	– 400.0000	
Average cost	= 10,309.30	= 563.7228	**18.29**
Reinvested distributions in 2006: $19.89/unit	+ 721.65	+ 36.2821	
New average cost	= 11,030.95	= 600.0049	**18.38**

Property for which you filed Form T664 or T664(Seniors)

Special rules also apply to determine the adjusted cost base (ACB) of a property for which you filed Form T664 or T664(Seniors), *Election to Report a Capital Gain on Property Owned at the End of February 22, 1994*.

In most cases, if you filed Form T664 or T664(Seniors), you are considered to have sold your capital property at the end of February 22, 1994, and to have immediately reacquired it on February 23, 1994. The ACB of your property on February 23, 1994, depends on the type of property for

which you filed an election. For example, if you filed an election for your interest in, or your shares of, a flow-through entity (see page 27), in most cases the ACB of your interest or shares will not change. If you filed an election for capital property, other than a flow-through entity, your ACB is usually the amount you designated as proceeds of disposition on Form T664 or T664(Seniors). If the property is a cottage, rental property, or other non-qualifying real property, your ACB is your designated proceeds of disposition **minus** the reduction for non-qualifying real property.

Also, if your designated proceeds of disposition were **more** than the fair market value of the property at the end of February 22, 1994, your ACB on February 23, 1994, may be reduced. In this case, complete Chart 2 or 3 to determine your ACB on February 23, 1994.

Chart 2 – Calculating the revised adjusted cost base (ACB) of a flow-through entity

Complete this chart to calculate the ACB of your shares of, or interest in, the flow-through entity **only** if the proceeds of disposition you designated on Form T664 for the property were **more** than its fair market value (FMV) at the end of February 22, 1994. If the flow-through entity is a trust (other than a mutual fund trust), do not complete this chart as you do not have to reduce the ACB of your interest.

Step 1 – Reduction of the ACB

1.	Designated proceeds of disposition (column 2, Chart A of Form T664)		$ ______	1
2.	FMV at the end of February 22, 1994 (Step 1 of Form T664)	$ ______ 2		
3.	Amount from line 2 $ ______ × 1.1	▶	– ______	3
4.	Line 1 **minus** line 3 (if negative, enter "0")		= $ ______	4

If the amount on line 4 is zero, do not complete the rest of this chart.

5.	ACB at the end of February 22, 1994 (column 1, Chart A of Form T664)	– ______ 5		
6.	Line 2 **minus** line 5	= $ ______ 6		

If you entered an amount in column 4, Chart A of Form T664, complete line 7.
Otherwise, enter the amount from line 6 on line 8.

7. (Amount from column 4, Chart A of Form T664 $ ______ / Amount from column 3, Chart A of Form T664 $ ______) × line 6 $ ______ ▶ – ______ 7

8.	Line 6 **minus** line 7	= $ ______ ▶	– ______	8
9.	Reduction (line 4 **minus** line 8)		= $ ______	9

If the amount on line 9 is negative, do not complete the rest of this chart.

Step 2 – Revised ACB

10.	ACB at the end of February 22, 1994 (line 5)	$ ______	10
11.	Reduction (line 9)	– ______	11
12.	**Revised ACB on February 23, 1994** (line 10 **minus** line 11; if negative, enter "0")	= $ ______	12

Use the amount on line 12 to calculate the capital gain or loss when you sell your shares of, or interest in, the flow-through entity.

Chart 3 – Calculating the revised adjusted cost base (ACB) of capital property (other than a flow-through entity)

Complete this chart to calculate the ACB of the property **only** if the proceeds of disposition you designated on Form T664 or T664(Seniors) for the property were **more** than its fair market value (FMV) at the end of February 22, 1994.

1. FMV of the property at the end of February 22, 1994 [from Step 1 of Form T664 or T664(Seniors)]			$	1
2. Designated proceeds of disposition [column 2, Chart B of Form T664, or column 2, Step 2 of Form T664(Seniors)]	$	2		
3. Amount from line 1 $ × 1.1	–	3		
4. Line 2 **minus** line 3 (if negative, enter "0")	= $		–	4
5. Line 1 **minus** line 4 (if negative, enter "0")			= $	5
6. If the property is non-qualifying real property, enter the amount from column 4, Chart B of Form T664, or column 4, Step 2 of Form T664(Seniors). Otherwise, enter "0."			–	6
7. **Revised ACB on February 23, 1994** (line 5 **minus** line 6; if negative, enter "0")			= $	7

Use the amount on line 7 to calculate the capital gain or loss when you sell the property.

Property you inherit or receive as a gift

If you receive property as a gift, you are generally considered to have acquired the property at its fair market value (FMV) on the date you acquired it. Similarly, if you win property in a lottery, you are considered to have acquired this prize at its FMV at the time you won it.

Generally, when you inherit property, the property's cost to you is equal to the deemed proceeds of disposition for the deceased. Usually, this amount is the FMV of the property right before the person's death. However, there are exceptions to this rule. For example, property that you inherit because your spouse or common-law partner died, or farm property or a woodlot transferred on death to a child, may be treated differently. See the chapter called "Deemed disposition of property" in guide T4011, *Preparing Returns for Deceased Persons*, to find out which rules apply to your situation.

Selling a building in 2006

If you sold a building of a prescribed class in 2006, special rules may make the selling price an amount other than the actual selling price. This happens when you meet **both** of the following conditions:

- you, or a person with whom you do not deal at arm's length, own the land on which the building is located, or the land adjoining the building if you need the land to use the building; and
- you sold the building for less than its **cost amount** and its capital cost.

Calculate the **cost amount** as follows:

- If the building was the only property in the class, the cost amount is the undepreciated capital cost (UCC) of the class before the sale.
- If more than one property is in the same class, you have to calculate the cost amount of each building as follows:

$$\frac{\text{Capital cost of the building}}{\text{Capital cost of all properties in the class that have not been previously disposed of}} \times \text{UCC of the class} = \text{Cost amount of the building}$$

Note
You may have to recalculate the capital cost of a property to determine its cost amount if:

- you acquired a property directly or indirectly from a person or partnership with whom you did not deal at arm's length; or
- you acquired the property for some other purpose and later began to use it, or increased its use, to earn rental or business income.

For more information, contact us.

If you sold a building under these conditions, this may restrict the terminal loss on the building and reduce the capital gain on the land. For more information, see guide T4036, *Rental Income*, or Interpretation Bulletin IT-220, *Capital Cost Allowance – Proceeds of Disposition of Depreciable Property*, and its Special Release.

Selling part of a property

When you sell only part of a property, you have to divide the adjusted cost base (ACB) of the property between the part you sell and the part you keep.

Example
Lily owns 100 hectares of vacant land of equal quality. She decides to sell 25 hectares of this land. Since 25 is one quarter of 100, Lily calculates one quarter of the total ACB as follows:

Total ACB		$	100,000
Minus:	The ACB of the part she sold ($100,000 × 1/4)	–	25,000
The ACB of the part she kept		= $	75,000

Therefore, Lily's ACB is $25,000 for the 25 hectares she sold.

For more information on selling part of a property, see Interpretation Bulletin IT-264, *Part Dispositions*, and its Special Release.

Capital gains deferral for investment in small business

Individuals (other than trusts) may defer capital gains incurred on certain small business investments disposed of in 2006. This deferral applies to dispositions where you use the proceeds to acquire another small business investment. The adjusted cost base (ACB) of the new investment is reduced by the capital gain deferred from the initial investment.

You may acquire shares from a spouse, common-law partner, or parent due to circumstances such as a death or the breakdown of a marriage or common-law partnership. For the purposes of the capital gains deferral, we consider you to have acquired such shares at the time and under the same circumstances that the related individual originally acquired them.

The capital gains deferral is also available to individuals involved in pooling their investments with another person or partnership. If you are part of such a qualifying pooling arrangement, call us for more information.

To qualify for the capital gains deferral for investment in small business, the investment must be in an eligible small business corporation.

Eligible small business corporation shares

The capital gains deferral applies only to eligible small business corporation shares. Eligible small business corporation shares have the following characteristics:

- They consist of common shares issued by the corporation to you, the investor.
- The issuing corporation must be an **eligible small business corporation** (as defined in the Glossary on page 6) at the time the shares were issued.
- The total carrying value of the assets of the corporation (that is, the amount at which the assets of the corporation would be valued for the purpose of the corporation's balance sheet as of that time if it was prepared in accordance with generally accepted accounting principles used in Canada at that time, except that an asset of a corporation that is a share or debt issued by a related corporation is deemed to have a carrying value of nil) and related corporations cannot exceed $50 million immediately before, and immediately after, the share was issued.
- While you hold the shares, the issuing corporation is an **eligible active business corporation** (as defined in the Glossary on page 6).

To be able to defer the capital gain, you must have held the eligible small business corporation shares for more than 185 days from the date you acquired them.

The replacement shares have to be acquired at any time in the year in which the disposition is made or within 120 days after the end of that year.

For example, you acquire eligible small business corporation shares in October 2002 and dispose of them on June 9, 2006. You may acquire the replacement shares on or before April 30, 2007, which is within 120 days after the end of the taxation year of the original disposition.

Calculating the capital gains deferral

The capital gains deferral is available for the disposition of eligible small business corporation shares made in 2006. The investment can be made by an individual in any particular corporation (or related group).

The permitted deferral of the capital gain from the disposition of eligible small business corporation shares is determined by the following formula:

Capital gains deferral = B × (D ÷ E)

where

B = the total capital gain from the original sale

E = the proceeds of disposition

D = the lesser of E and the total cost of all replacement shares

For dispositions in 2006, report the total capital gain on lines 131 and 132 of Schedule 3 and the capital gains deferral on line 161 of Schedule 3. The capital gain you must report in the year of disposition will be determined by **subtracting** the capital gain deferral from the total capital gain realized from the disposition.

Note
Deferred capital gains **do not qualify** for the capital gains deduction (line 254). Therefore, **do not report** on lines 106 and 107 of Schedule 3 any disposition of qualified small business corporation shares if you elect to defer the capital gains that resulted from the disposition of those shares. Instead, report such disposition on lines 131 and 132 of Schedule 3.

ACB reduction

You must use the capital gains deferral to reduce the ACB of **each** of the eligible replacement shares by the amount determined by the following formula:

ACB reduction = F × (G ÷ H)

where

F = capital gains deferral

G = the cost of replacement shares

H = the total cost of all the replacement shares

Other transactions

The remaining sections in this chapter have information on less common transactions.

Eligible capital property

If you disposed of eligible capital property (as defined in the Glossary on page 6) that is qualified farm or fishing property, you may be able to claim the capital gains deduction, up to a maximum of $250,000.

For details on how to report the disposition of this type of property and what amounts are eligible for the capital gains deduction, see guide T4004, *Fishing Income*, guide T4003, *Farming Income*, guide RC4060, *Farming Income and the CAIS Program* or RC4408, *Farming Income and the CAIS Program Harmonized Guide*. Read the chapter called "Eligible Capital Expenditures" in those guides.

Election on dispositions of eligible capital property

If you disposed of property from your cumulative eligible capital account, you may qualify to make an election for tax years ending after February 27, 2000. The election allows qualified individuals to treat dispositions of this type of property as capital gains instead of business income. Report the capital gain in the "Real estate, depreciable property, and other properties" section of the Schedule 3.

For details on how to calculate the capital gain as well as the conditions that must be met in order to qualify to make this election, see the chapter called "Eligible Capital Expenditures" in one of the following guides:

- T4003, *Farming Income*;
- RC4060, *Farming Income and the CAIS Program*;
- RC4408, *Farming Income and the CAIS Program Harmonized Guide*;
- T4002, *Business and Professional Income*; or
- T4004, *Fishing Income*.

Note
If you disposed of eligible capital property after you ceased to carry on business, you cannot claim a reserve on the capital gains on the sale of that property. This is because the property is not considered to be sold in the course of your business.

Partnerships

A partnership does not pay tax on its capital gains or losses, and it does not report them on a return. Instead, members of the partnership report their share of the partnership's capital gains or losses on their own return.

Certain partnerships may have to file a T5013 Summary, *Partnership Information Return*, and send copies of the T5013, *Statement of Partnership Income*, or T5013A, *Statement of Partnership Income for Tax Shelters and Renounced Resource Expenses*, to report amounts flowed out to their members.

If you receive a T5013 or T5013A slip, see Chart 1 beginning on page 19 to find out how to report your share of the capital gain or loss from the partnership.

However, if you are a member of a partnership that does not have to file a T5013 Summary, *Partnership Information Return* for 2006, you have to report your share of any capital gain or loss from each disposition of capital property shown on the partnership financial statements in the appropriate area of Schedule 3. For example, if the capital gain is from disposing of depreciable property, report the gain in the "Real estate, depreciable property, and other properties" section.

If the partnership disposed of eligible capital property that is qualified fishing property after May 1, 2006 or that is qualified farm property, part of the business income from the transaction may be a taxable capital gain. This amount qualifies for the capital gains deduction, up to a maximum of $250,000. The chapter called "Eligible Capital Expenditures" in guide T4004, *Fishing Income*, guide T4003, *Farming Income*, guide RC4060, *Farming Income and the CAIS Program*, or RC4408, *Farming Income and the CAIS Program Harmonized Guide,* explains how to calculate and report this amount.

Capital gains reduction (flow-through entity)

A partnership is considered a flow-through entity. The last year in which you could claim the capital gains reduction was the 2004 tax year. To find out the special rules for 2005 and subsequent tax years and for more information on flow-through entities, see Chapter 4 on page 27.

Capital gains deduction

You may be eligible for the capital gains deduction, up to a lifetime maximum of $250,000, if you are reporting any of the following amounts:

- a capital gain from disposing of qualified small business corporation shares;
- a capital gain from disposing of qualified farm property;
- farming income from the disposition of eligible capital property that is qualified farm property;

under proposed legislation,

- a capital gain from disposing of qualified fishing property after May 1, 2006; or
- fishing income from the disposition after May 1, 2006, of eligible capital property that is qualified fishing property.

For more information, see "Claiming a capital gains deduction" on page 12.

Purchase of replacement property

In certain situations, you can elect to postpone or defer reporting the capital gain, recapture of capital allowance, or business income from disposing of property. Provided you meet certain conditions, you may want to do this when you use the proceeds of disposition of the property to purchase a replacement property. The election may defer the tax consequences on the above amounts until you sell the replacement property. You can make this election when you sell a business property or when a property you own is expropriated, destroyed, or stolen.

For more information on the election, see Interpretation Bulletin IT-491, *Former Business Property*, and its Special Release.

Transfers of property to your spouse or common-law partner or to a trust for your spouse or common-law partner

Before reading this section, you may want to read the definition of "spouse" in the Glossary on page 9 and the definition of "common-law partner" on page 6.

If you give capital property to your spouse or common-law partner, a spousal or common-law partner trust, or a joint spousal or common-law partner trust or an alter ego trust (for definitions of these trusts, see guide T4013, *T3 Trust Guide*), you generally do not have a capital gain or loss at that time. At the time you give the gift, depending on the type of property you give, you are considered to receive an amount equal to:

- the undepreciated capital cost for depreciable property; or
- the adjusted cost base for other types of capital property.

Your spouse or common-law partner, or the trust for your spouse or common-law partner or for yourself, is considered to have bought the capital property for the same amount that you are considered to have sold it for.

You may have transferred or loaned property to your spouse or common-law partner, a person who has since become your spouse or common-law partner, or a trust for your spouse or common-law partner. If that person or the trust sells the property during your lifetime, you usually have to report any capital gain or loss from the sale. You usually have to do this if, at the time of the sale:

- you are a resident of Canada; and
- you are both still married or living in a common-law relationship.

If you are living apart because of a breakdown in the relationship, you may not have to report the capital gain or loss when your spouse or common-law partner sells the property. In such a case, you have to file an election with your return.

For transfers of property made **after May 22, 1985**, you can file this election with your return for any tax year ending after the time you separated. However, for the election to be valid, you have to file it no later than the year your spouse or common-law partner disposes of the property. To make this election, attach to your return a letter signed by you and your spouse or common-law partner. State that you do not want **section 74.2** of the *Income Tax Act* to apply.

For transfers of property made **before May 23, 1985**, you have to file the election with your return for the tax year in which the separation occurred. To make this election, attach to your return a letter signed by you and your spouse or common-law partner. State that you do not want **subsection 74(2)** of the *Income Tax Act* to apply.

If you sold the property to your spouse or common-law partner or a trust for your spouse or common-law partner and you were paid an amount equal to the fair market value (FMV) of the property, there is another way to report the sale. Generally, you can list the sale at the property's FMV, and report any capital gain or loss for the year you sold the property. To do this, you have to file an election with your return. To make this election, attach to your return a letter signed by you and your spouse or common-law partner. State that you are reporting the property as being sold to your spouse or common-law partner at its FMV, and that you do not want **subsection 73(1)** of the *Income Tax Act* to apply.

If your spouse or common-law partner or the trust later sells the property, your spouse or common-law partner or the trust has to report any capital gain or loss from the sale.

A special situation exists if all of the following apply to you:

- you owned capital property (other than depreciable property or a partnership interest) on June 18, 1971;
- you gave the property to your spouse or common-law partner after 1971; and
- your spouse or common-law partner later sold the property.

In this case, certain rules apply when calculating your and your spouse's or common-law partner's capital gain or loss to remove any capital gains accrued before 1972. For more information, see Interpretation Bulletin IT-209, *Inter-Vivos Gifts of Capital Property to Individuals Directly or Through Trusts*, and its Special Release.

Other transfers of property

If you give capital property as a gift, you are considered to have sold it at its FMV at the time you give the gift. Include any taxable capital gain or allowable capital loss on your return for the year that you give the gift.

If you sell property to someone with whom you do not deal at arm's length and the selling price is **less** than its FMV, your selling price is considered to be the FMV. Similarly, if you buy property from someone with whom you do not deal at arm's length, and the purchase price is **more** than the FMV, your purchase price is considered to be the FMV.

Special rules allow you to transfer property at an amount other than the property's FMV. If these rules apply to you, you may be able to postpone paying tax on any capital gains you had from the transfer. We note some of the more common transfers below.

Farm or fishing property

Under proposed legislation, the disposition after May 1, 2006, of property used in a family fishing business will have similar rules to those for dispositions of farm property.

When you sell or transfer farm or fishing property, you may have a capital gain. Many special rules apply to these types of capital gains. For example, if you transfer farm or fishing property to a spouse, common-law partner, or child, these rules may apply. For more information on these types of transfers and other rules that apply to farm or fishing property, see guide T4004, *Fishing Income,* guide T4003, *Farming Income*, guide RC4060, *Farming Income and the CAIS*

Program, or guide RC4408, *Farming Income and the CAIS Program Harmonized Guide*.

Elections

You can postpone reporting a capital gain when you transfer property:

- from an individual or partnership to a Canadian corporation; or
- from an individual to a Canadian partnership.

For information on transfers to a Canadian corporation, see Information Circular 76-19, *Transfer of Property to a Corporation Under Section 85*.

For information on transfers to a Canadian partnership, see Interpretation Bulletin IT-413, *Election by Members of a Partnership Under Subsection 97(2)*.

Selling or donating certified Canadian cultural property

You do not have to report a capital gain when you sell or donate certified Canadian cultural property (national treasures) to an institution or public authority designated by the Minister of Canadian Heritage. The Canadian Cultural Property Export Review Board certifies this property as cultural property and will give you a certificate for tax purposes. Cultural property can include paintings, sculptures, books, manuscripts, or other objects.

If you sell or donate certified cultural property to a designated institution, you may have a capital loss. The tax treatment of the loss will depend on what type of property you sold or donated. For example, the certified cultural property may be listed personal property. If this is the case, the rules for listed personal property losses will apply. For information on how to apply capital losses, see Chapter 5 on page 28.

For more information, see Interpretation Bulletin IT-407, *Dispositions of Cultural Property to Designated Canadian Institutions*, or pamphlet P113, *Gifts and Income Tax*.

Gifts of ecologically sensitive land

If you made a gift of ecologically sensitive land to a qualified donee before May 2, 2006, and you realized a capital gain, you will have to include the gain in income for the year of disposition.

For gifts of these properties made after May 1, 2006, the net capital gain is zero. Use Form T1170, *Capital Gains on Gifts of Certain Capital Property,* to report the amounts.

For gifts (other than gifts to a private foundation) made before May 2, 2006, complete Form T1170 to calculate the amount to include in your income, and attach it to your return.

To qualify for this tax treatment, you must meet certain conditions. Under proposed legislation, if you make a gift of ecologically sensitive land to a qualified donee, other special rules may apply. For more information, see pamphlet P113, *Gifts and Income Tax*.

Chapter 4 – Flow-through entities

The information in this chapter applies to you if, for the 1994 tax year, you filed Form T664, *Election to Report a Capital Gain on Property Owned at the End of February 22, 1994*, for your shares of, or interest in, a flow-through entity. This chapter provides information on the types of investments that are considered flow-through entities as well as what you can do with any remaining exempt capital gains balance that you may have at the end of 2004.

What is a flow-through entity?

You are a member of, or investor in, a flow-through entity if you own shares or units of, or an interest in, one of the following:

1. an investment corporation;
2. a mortgage investment corporation;
3. a mutual fund corporation;
4. a mutual fund trust;
5. a related segregated fund trust;
6. a partnership;
7. a trust governed by an employees' profit-sharing plan;
8. a trust maintained primarily for the benefit of employees of a corporation or two or more corporations that do not deal at arm's length with each other, where one of the main purposes of the trust is to hold interests in shares of the capital stock of the corporation or corporations, as the case may be, or any corporation not dealing at arm's length therewith;
9. a trust established for the benefit of creditors in order to secure certain debt obligations; or
10. a trust established to hold shares of the capital stock of a corporation in order to exercise the voting rights attached to such shares.

Exempt capital gains balance (ECGB)

When you filed Form T664 for your shares of, or interest in, a flow-through entity, the elected capital gain you reported created an ECGB for that entity.

Note
Generally, your ECGB expired after 2004. If you did not use all of your ECGB by the end of 2004, you can add the unused balance to the adjusted cost base of your shares of, or interest in, the flow-through entity.

For 2004 and previous taxation years, if you received property from a trust in satisfaction of all or a part of your interest in the trust (a flow-through entity described in items 7 to 10 above), you could elect to use the ECGB for the entity to increase the cost of property you received from the trust. For 2005 and future years, the election is no longer necessary because any unused ECGB can only be added to the cost of your interest in the flow-through entity.

Example
Andrew filed Form T664 for his 800 units in a mutual fund trust with his 1994 return. He designated the fair market value of the units at the end of February 22, 1994, as his proceeds of disposition. Andrew claimed capital gains reductions of $500 in 1997 and $600 in 1998. At the end of 2003, his exempt capital gains balance was $2,250. In 2004, he had a $935 capital gain from the sale of 300 units. This left him with an unused balance of $1,315 at the end of 2004. In 2005 and future years, he can only add the unused ECGB to the cost of any remaining units:

1.	ECGB carryforward to 2004				$ 2,250	1
2.	Capital gains flowed out		$ ____	2		
3.	Capital gains from dispositions	+	935	3		
4.	Line 2 **plus** line 3	=	$ 935	4		
5.	Capital gains reduction			–	935	5
6.	Unused ECGB at the end of 2004			=	$ 1,315	6

The unused ECGB expired after 2004 so Andrew can add this amount to the adjusted cost base of his shares of, or interest in, the flow-through entity.

Disposing of your shares of, or interest in, a flow-through entity

When you dispose of your shares of, or interest in, a flow-through entity, calculate the capital gain or loss in the same way as with any other disposition of capital property [proceeds of disposition minus the adjusted cost base (ACB) and outlays and expenses].

Report these dispositions on Schedule 3 as follows:

- for shares of a flow-through entity, use the "Publicly traded shares, mutual fund units and other shares" section; or
- for an interest in a flow-through entity, use the "Bonds, debentures, promissory notes, and other similar properties" section.

For more information, see Chapter 2 on page 13.

If you filed Form T664 for your shares of, or interest in, a flow-through entity, and the proceeds of disposition were more than the fair market value, the ACB of your investments may be affected. For information, see "Property for which you filed Form T664 or T664(Seniors)" on page 21.

Certain circumstances may create a special situation for a flow-through entity described in items 1 to 6 of the section called "What is a flow-through entity?" on this page. This happens if you dispose of your remaining shares of, or interest in, such an entity in the 1994 to 2006 tax years and have filed Form T664. If this is the case, in the year you dispose of the shares, use the ECGB available for the entity immediately before the disposition to increase the ACB of the shares or interests.

The ACB adjustment will either reduce your capital gain or will create or increase your capital loss from disposing of the shares or interest in the flow-through entity.

Chapter 5 – Capital losses

You have a capital loss when you sell, or are considered to have sold, a capital property for less than its adjusted cost base plus the outlays and expenses involved in selling the property. This chapter explains how to:

- determine your adjustment factor;
- report your 2006 net capital losses;
- apply your unused 2006 net capital losses against your taxable capital gains of other years; and
- apply your unused net capital losses of other years against your 2006 taxable capital gains.

It also explains the special rules that apply to listed personal property losses, superficial losses, restricted farm losses, and allowable business investment losses.

You will find a summary of the loss application rules on page 38.

Generally, if you had an allowable capital loss in a year, you have to apply it against your taxable capital gain for that year. If you still have a loss, it becomes part of the computation of your net capital loss for the year. You can use a net capital loss to reduce your taxable capital gain in any of the three preceding years or in any future year.

Example
In 2006, Leah sold two different securities, which resulted in a taxable capital gain of $300 (1/2 × $600) and an allowable capital loss of $500 (1/2 × $1,000). After applying her allowable capital loss against her taxable capital gain, Leah has $200 ($500 **–** $300) of unapplied allowable capital losses.

While she cannot deduct the $200 from other sources of income in 2006, the $200 becomes part of the computation of her net capital loss for 2006. She can apply the net capital loss against her taxable capital gains in any of the three preceding years or in any future year.

Leah completes Schedule 3 and attaches it to her 2006 return. This will ensure that her net capital loss is updated on our records.

Note
When determining your capital losses, special rules apply if you disposed of:

- depreciable property (for details, see page 16); or
- personal-use property (for details, see page 18).

Inclusion rate (IR)

The rate used to determine "taxable capital gains" and "allowable capital losses" (as defined in the Glossary on page 5), called an **inclusion rate**, has changed over the

years. As a result, the amount of net capital losses of other years that you can claim against your taxable capital gain depends on the inclusion rate that was in effect when the loss and the gain were incurred. Also, the way you apply these losses may differ if you incurred them before May 23, 1985. For more information, see "How do you apply your net capital losses of other years to 2006?" on page 29.

Period net capital loss incurred	Inclusion rate
Before May 23, 1985	1/2 (50%)
After May 22, 1985, and before 1988	1/2 (50%)
In 1988 and 1989	2/3 (66.6666%)
From 1990 to 1999	3/4 (75%)
In 2000	IR*
From 2001 to 2006	1/2 (50%)

* This rate is from line 16 in Part 4 of Schedule 3 for 2000, or from your *Notice of Assessment* or latest *Notice of Reassessment* for 2000.

If you had a capital loss or gain in 2006, you should have completed Schedule 3, *Capital Gains (or Losses) in 2006*.

How do you apply your 2006 net capital loss to previous years?

You can carry your 2006 net capital loss back to 2003, 2004, and 2005 and use it to reduce your taxable capital gains in any of these years. When you carry back your net capital loss, you can choose the year(s) to which you apply the loss.

Note
When you apply a net capital loss back to a previous year's taxable capital gain, it will reduce your taxable income for that previous year. However, your net income, which is used to calculate certain credits and benefits, will not change.

If you carry your 2006 net capital loss back to 2003, 2004, or 2005, you **do not** have to adjust the amount of the 2006 net capital loss since the inclusion rate is the same for these years.

To apply a 2006 net capital loss to 2003, 2004, or 2005, complete "Area III – Net capital loss for carryback" on Form T1A, *Request for Loss Carryback*. It will also help you determine the amount you have left to carry forward to future years. You can get Form T1A from us (see the section called "What if you need help?" on page 2). **Do not** file an amended return for the year to which you want to apply the loss.

Note
If you apply a 2006 net capital loss to a previous year, any capital gains deduction that you claimed in that year, or a following year, may be reduced.

How do you apply your net capital losses of other years to 2006?

You can apply your net capital losses of other years to your taxable capital gains in 2006. To do this, claim a deduction on line 253 of your 2006 return. However, the amount you claim depends on when you incurred the loss. This is because the inclusion rate used to determine taxable capital gains and allowable capital losses has changed over the years. The different inclusion rates are listed earlier on this page.

Note
When you apply a net capital loss from a previous year to the current year's taxable capital gain, it will reduce your taxable income for the current year. However, your net income, which is used to calculate certain credits and benefits, will not change.

You have to apply net capital losses of earlier years before you apply net capital losses of later years. For example, if you have net capital losses in 1994 and 1996 and want to apply them against your taxable capital gains in 2006, you have to follow a certain order. First, apply your 1994 net capital loss against your taxable capital gain. Then apply your 1996 net capital loss against it. Keep separate balances of unapplied net capital losses for each year. This will help you keep track of your capital losses.

You can use a net capital loss of a previous year to reduce a taxable capital gain in 2006. If the inclusion rates for the two years are different, you must adjust the amount of the net capital loss to match the inclusion rate for 2006. Determine the adjustment factor by dividing the inclusion rate for 2006 by the inclusion rate for the year in which the loss arose.

Example
Andrew realized a capital gain of $5,000 in 2006. Andrew's taxable capital gain for 2006 is $2,500 ($5,000 × 50%). Andrew has a net capital loss of $1,000 from 1999 to apply against his taxable capital gain of $2,500. Since the inclusion rate in 1999 was 75%, he calculates the adjustment factor as follows:

$$\frac{\text{Inclusion rate for the year to which the loss is applied}}{\text{Inclusion rate for the year in which the loss arose}} = \frac{50\%}{75\%} = 66.6666\%$$

To determine the net capital loss he can carry forward to 2006, Andrew multiplies the adjustment factor by the net capital loss for 1999:

Net capital loss for carryforward = Adjustment factor × net capital loss
= 66.6666% × $1,000
= $666.66

Andrew claims the adjusted net capital loss of $666.66 on line 253 against his taxable capital gain of $2,500 reported on line 127 of his 2006 return.

Use Chart 5 on page 31 to determine your net capital losses of other years that you can apply to 2006 and to determine your unapplied balance that you can carry forward to future years.

Complete Chart 5 if you have a balance of unapplied net capital losses from before May 23, 1985, or you want to

keep a breakdown of your unapplied net capital losses by year.

However, if you do not have a balance of unapplied net capital losses from before May 23, 1985, and your 2005 *Notice of Assessment* or *Reassessment* shows that you have unapplied net capital losses of other years and/or a 2005 net capital loss, you can use the following chart to determine your net capital losses of other years that you can apply to 2006:

Chart 4 – Applying net capital losses of other years to 2006

1.	Total unapplied net capital losses available from before 2005 (from your 2005 *Notice of Assessment* or *Reassessment*)		$ ______	1
2.	Your 2005 net capital loss (from your 2005 *Notice of Assessment* or *Reassessment*)		+ ______	2
3.	Line 1 **plus** Line 2		= $ ______	3
4.	Your 2006 taxable capital gains (from line 127 of your 2006 return)	$ ______ 4		
5.	Enter the amount from line 3 or line 4, **whichever is less**	______ 5		
6.	You can apply all, or part of, the amount on line 5 against your taxable capital gains in 2006. Enter on line 6 the amount of losses you want to claim and enter this amount on line 253 of your 2006 return.		– ______	6
7.	Balance of unapplied net capital losses of other years not used to reduce taxable capital gains and available to carry forward to future years (line 3 **minus** line 6)		= $ ______	7

Losses incurred before May 23, 1985

Special rules apply to losses you incurred before May 23, 1985. This also includes losses you incurred after May 22, 1985, on any disposition of capital property made under an agreement of sale you entered into before May 23, 1985.

Usually, you can apply net capital losses of other years only against taxable capital gains. However, if you incurred the losses before May 23, 1985, you may use them to offset other income. Once you have applied your net capital losses of other years against taxable capital gains, you can use any excess to offset other income. The amount you can use is limited to the **least** of:

- the excess amount, $2,000; **or**
- your **pre-1986 capital loss balance** available for 2006.

Your **pre-1986 capital loss balance** available for 2006 is:

- the unapplied balance of your total net capital losses that you had at any time before May 23, 1985;

  minus

- the total adjusted amount of capital gains deductions that you claimed before 2006.

If you had a net capital loss during the period from January 1, 1985, to May 22, 1985, and you had taxable capital gains later in 1985, your taxable capital gains will reduce your pre-1986 capital loss balance.

Chart 5 – Applying net capital losses of other years to 2006 (for clients with a pre-1986 capital loss balance)

Use this chart to apply your net capital losses of other years to 2006 and to calculate your balance of unapplied losses you can carry forward to a future year.

When you complete this chart, replace "**IR**" with your inclusion rate for 2000. This rate is from line 16 in Part 4 of Schedule 3 for 2000, or from your *Notice of Assessment* or latest *Notice of Reassessment* for 2000.

Step 1 – Pre-1986 capital loss balance available for 2006

Complete this step only if you have a balance of unapplied net capital losses from before May 23, 1985. Otherwise, enter "0" on line 3 and go to Step 2.

1. Balance of unapplied net capital losses you had before May 23, 1985 .... $ ______ **1**
2. Capital gains deductions you claimed:

Before 1988			$		
In 1988 and 1989	$	× 3/4 =	+		
From 1990 to 1999	$	× 2/3 =	+		
In 2000	$	× [1 ÷ (2 × IR)] =	+		
From 2001 to 2005			+		
Total capital gains deductions after adjustment			= $	► − $	**2**

3. Pre-1986 capital loss balance available for 2006 (line 1 **minus** line 2) .... = $ ______ **3**

Step 2 – Applying net capital losses of other years to 2006

Complete lines A to C of the table in Step 3 (on the next page) before proceeding.

4. Total unapplied adjusted net capital losses of other years (total from line C in Step 3 on the next page) .... $ ______ **4**
5. Taxable capital gains from line 127 of your 2006 return .... $ ______ **5**
6. Enter the amount from line 4 or line 5, **whichever is less** .... $ ______ **6**
7. You can apply all, or part, of the amount on line 6 against your taxable capital gains in 2006. Enter on line 7 the amount of losses you want to claim .... − $ ______ **7**

   If you did not complete Step 1, enter the amount from line 7 on line 253 of your 2006 return. This is your deduction in 2006 for net capital losses of other years. Do not complete lines 8 to 15 and enter this same amount on line 16 in Step 3. However, complete lines D to G in Step 3 of this table (on the next page) to calculate the net capital losses available to carry forward to future years.

   If you completed Step 1, complete lines 8 to 16 and lines D to G in Step 3 of this table (on the next page) to calculate the net capital losses available to carry forward to future years.

8. Balance of unapplied adjusted net capital losses of other years not used to reduce taxable capital gains (line 4 **minus** line 7) .... = $ ______ **8**
9. Amount from line 8 .... $ ______ **9**
10. Amount from line 3 .... $ ______ **10**
11. Pre-1986 deductible amount .... $ **2,000** **11**
12. Line 9, 10, or 11, **whichever is less** .... + $ ______ **12**
13. Deduction in 2006 for net capital losses of other years (line 7 **plus** line 12). Enter this amount on line 253 of your 2006 return and complete the rest of the chart (on the next page) to determine your balance of unapplied net capital losses available to carry forward. .... = $ ______ **13**

(continued on next page)

Chart 5 – Applying net capital losses of other years to 2006 (continued)

Step 3 – Calculating your balance of unapplied net capital losses of other years available to carry forward

14. Amount from line 7 .... $ ________ **14**
15. Amount from line 12 .... + $ ________ **15**
16. Total adjusted net capital losses of other years applied in 2006 (line 14 **plus** line 15)........................ = $ ________ **16**

When you complete this table, replace "**IR**" with your inclusion rate for 2000. This rate is from line 16 in Part 4 of Schedule 3 for 2000, or from your *Notice of Assessment* or latest *Notice of Reassessment* for 2000.

(Do not complete the shaded areas)	**Before May 23, 1985**	**After May 22, 1985, and before 1988**	**In 1988 and 1989**	**After 1989 and before 2000**	**In 2000**	**After 2000 and before 2006**	**Total**
A Amount of your unapplied net capital losses							
B Adjustment factor	**1**	**1**	$\frac{3}{4}$	$\frac{2}{3}$	$\frac{1}{2 \times IR}$	**1**	
C (Line A × line B)							
D Total adjusted net capital losses applied against taxable capital gains in 2006 (the total must equal the amount on line 16)							
E (Line C – line D)							*
F Adjustment factor	**1**	**1**	$\frac{4}{3}$	$\frac{3}{2}$	**2 × IR**	**1**	
G Net capital losses available to carry forward to future years (Line E × line F)							

* **The total for line E should be equal to the amount shown on your *Notice of Assessment* or *Reassessment* for net capital losses of other years available for 2007.**

Example

Jerry has unapplied net capital losses of $6,000 he incurred before May 23, 1985. He claimed a capital gains deduction of $500 in 1986 and of $300 in 2000 (Jerry's inclusion rate in 2000 was 2/3 or 66.6666%). Jerry also has the following unapplied net capital losses: $4,000 from 1988 and $6,000 from 1990. He reported a taxable capital gain of $10,000 on line 127 of his 2006 return. He completes Chart 5 to calculate the maximum deduction he can claim for his unapplied net capital losses of other years in 2006 and to determine the loss balance that he can carry forward to a future year.

Step 1 – Pre-1986 capital loss balance available for 2006

Complete this step **only** if you have a balance of unapplied net capital losses from before May 23, 1985. Otherwise, enter "0" on line 3 and go to Step 2.

1.	Balance of unapplied net capital losses you had before May 23, 1985				$ 6,000	1
2.	Capital gains deductions you claimed:					
	Before 1988			$ 500		
	In 1988 and 1989	$	× 3/4 =	+		
	From 1990 to 1999	$	× 2/3 =	+		
	In 2000	$ 300	× [1 ÷ (2 × 2/3)] =	+ 225		
	From 2001 to 2005			+		
	Total capital gains deductions after adjustment			= $ 725 ▶	– $ 725	2
3.	Pre-1986 capital loss balance available for 2006 (line 1 **minus** line 2)				= $ 5,275	3

Step 2 – Applying net capital losses of other years to 2006

Complete lines A to C of the table in Step 3 (on the next page) before proceeding.

4.	Total unapplied adjusted net capital losses of other years (total from line C in Step 3 on the next page)		$ 13,000	4
5.	Taxable capital gains from line 127 of your 2006 return	$ 10,000 5		
6.	Enter the amount from line 4 or line 5, **whichever is less**	$ 10,000 6		
7.	You can apply all, or part, of the amount on line 6 against your taxable capital gains in 2006. Enter on line 7 the amount of losses you want to claim		– $ 10,000	7

If you did not complete Step 1, enter the amount from line 7 on line 253 of your 2006 return. This is your deduction in 2006 for net capital losses of other years. Do not complete lines 8 to 15 and enter this same amount on line 16 in Step 3. However, complete lines D to G in Step 3 of this table (on the next page) to calculate the net capital losses available to carry forward to future years.

If you completed Step 1, complete lines 8 to 16 and lines D to G in Step 3 of this table (on the next page) to calculate the net capital losses available to carry forward to future years.

8.	Balance of unapplied adjusted net capital losses of other years not used to reduce taxable capital gains (line 4 **minus** line 7)		= $ 3,000	8
9.	Amount from line 8	$ 3,000 9		
10.	Amount from line 3	$ 5,275 10		
11.	Pre-1986 deductible amount	$ **2,000** 11		
12.	Line 9, 10, or 11, **whichever is less**		+ $ 2,000	12
13.	Deduction in 2006 for net capital losses of other years (line 7 **plus** line 12). Enter this amount on line 253 of your 2006 return and complete the rest of the chart (on the next page) to determine your balance of unapplied net capital losses available to carry forward.		= $ 12,000	13

(continued on next page)

Example (continued)

Step 3 – Calculating your balance of unapplied net capital losses of other years available to carry forward

14. Amount from line 7	$	10,000	14
15. Amount from line 12	+ $	2,000	15
16. Total adjusted net capital losses of other years applied in 2006 (line 14 **plus** line 15)	= $	12,000	16

When you complete this table, replace "**IR**" with your inclusion rate for 2000. This rate is from line 16 in Part 4 of Schedule 3 for 2000, or from your *Notice of Assessment* or latest *Notice of Reassessment* for 2000.

(Do not complete the shaded areas)	Before May 23, 1985	After May 22, 1985, and before 1988	In 1988 and 1989	After 1989 and before 2000	In 2000	After 2000 and before 2006	Total
A Amount of your unapplied net capital losses	$6,000	$0	$4,000	$6,000	$0	$0	
B Adjustment factor	**1**	**1**	$\frac{3}{4}$	$\frac{2}{3}$	$\frac{1}{2 \times IR}$	**1**	
C (Line A × line B)	$6,000	$0	$3,000	$4,000	$0	$0	$13,000
D Total adjusted net capital losses applied against taxable capital gains in 2006 (the total must equal the amount on line 16)	$6,000	$0	$3,000	$3,000	$0	$0	$12,000
E (Line C – line D)	$0	$0	$0	$1,000	$0	$0	* $1,000
F Adjustment factor	**1**	**1**	$\frac{4}{3}$	$\frac{3}{2}$	**2 × IR**	**1**	
G Net capital losses available to carry forward to future years (Line E × line F)	$0	$0	$0	$1,500	$0	$0	$1,500

Jerry has to apply his older losses first. Because the total amount of adjusted losses that he used in 2006 was $12,000 (from line 16 above), he applies $6,000 of his adjusted net capital losses incurred before May 23, 1985, and $3,000 of his adjusted net capital loss incurred in 1988. He then uses $3,000 ($12,000 – $6,000 – $3,000) of his adjusted net capital loss incurred in 1990. Jerry has unapplied net capital losses of $1,500 that he can carry forward to a future year.

* **The total for line E should be equal to the amount shown on your *Notice of Assessment* or *Reassessment* for net capital losses of other years available for 2007.**

Applying listed personal property (LPP) losses

You have an LPP loss if, in a particular year, your losses from dispositions of LPP are more than your gains from such dispositions. If you have an LPP loss, read this section. Applying this type of loss is different from applying other capital losses because:

- you can only deduct losses from the disposition of LPP from any gains you had from selling other LPP;
- the LPP losses you deduct in the year cannot be more than your LPP gains from such dispositions for that year; and
- you cannot use this type of loss to reduce any capital gains you had from selling other types of property.

If you have an LPP loss in 2006, you can use the loss to reduce gains from dispositions of LPP you had in any of the three years before 2006 or the seven years after.

For information on how to apply a prior-year LPP loss to 2006 gains from dispositions of LPP, see "Listed personal property (LPP)" on page 19.

To carry back your 2006 LPP losses to reduce your LPP net gains from 2003, 2004, and 2005, complete Form T1A, *Request for Loss Carryback,* and include it with your 2006 return. You can get Form T1A from us (see the section called "What if you need help?" on page 2). **Do not** file an amended return for the year to which you want to apply the loss.

Example
Nathan bought some jewellery in 1996 for $5,800. In 2006, he sold it for $6,000. He ended up with a gain of $200. He also sold a coin collection for $2,000 in 2006. Nathan had originally bought this collection in 1999 for $1,700. He ended up with a gain of $300 when he sold the coin collection. In addition, he sold a painting in 2006 for $8,000. However, Nathan bought the painting in 2000 for $12,000. Therefore, he had a loss of $4,000. He had no outlays and expenses for these three transactions.

Nathan's loss from selling LPP in 2006 was more than his gain: his loss was $4,000; his total gain was $500 ($200 + $300). As a result, his net loss was $3,500 ($4,000 – $500). Nathan cannot use the difference to offset his capital gain on the sale of a property other than on LPP

in the year. In addition, he cannot offset any income he had from other sources. However, he can apply his LPP loss against his gains from dispositions of LPP in any of the three preceding years or the seven years following 2006.

Nathan should not complete Schedule 3 for 2006. However, he should keep a record of his LPP loss in case he wants to apply the loss against LPP gains in another year.

Superficial loss

A superficial loss can occur when you dispose of capital property for a loss and:

- you, or a person affiliated with you, buys, or has a right to buy, the same or identical property (called "substituted property") during the period starting 30 calendar days before the sale and ending 30 calendar days after the sale; and
- you, or a person affiliated with you, still owns, or has a right to buy, the substituted property 30 calendar days after the sale.

Some examples of affiliated persons are:

- you and your spouse or common-law partner;
- you and a corporation that is controlled by you or your spouse or common-law partner;
- a partnership and a majority-interest partner of the partnership; and
- after March 22, 2004, a trust and its majority interest beneficiary (generally, a beneficiary who enjoys a majority of the trust income or capital) or one who is affiliated with such a beneficiary.

If you have a superficial loss in 2006, you cannot deduct it when you calculate your income for the year. However, if you are the person who acquires the substituted property, you can usually add the amount of the superficial loss to the adjusted cost base of the substituted property. This will either decrease your capital gain or increase your capital loss when you sell the substituted property.

In certain situations, when you dispose of capital property, the loss may not be considered a superficial loss. Some of the more common situations include the following:

- you are considered to have sold the capital property because you became or ceased to be a resident of Canada;
- you are considered to have sold the property because you changed its use;
- you disposed of the property and within 30 calendar days after the disposition you became or ceased to be exempt from income tax;
- the property is considered to have been sold because the owner died;
- the disposition results from the expiry of an option;
- the property is appropriated by a shareholder on the winding-up of a corporation; or
- non-depreciable capital property is disposed of by a corporation, partnership, or trust. In this situation, although the loss is not added to the adjusted cost base of the transferred property, it is not claimed immediately but its recognition is deferred pending the occurrence of certain events. For more information, contact us.

Restricted farm loss (RFL)

If you run your farm as a business, you may be able to deduct a farm loss in the year. However, if your chief source of income is neither from farming nor from a combination of farming and some other source of income, you can only deduct a portion of your farm loss for the year. The portion of the loss that you cannot deduct becomes an RFL. You can carry an RFL incurred in taxation years ending before 2006 back 3 years and forward up to 10 years.

You can now carry an RFL incurred in taxation years ending after 2005, back 3 years and forward up to **20** years.

However, the amount you can deduct in any year cannot be more than your net farming income for that year. For more information on determining your chief source of income and how to calculate an RFL, see guide T4003, *Farming Income*, guide RC4060, *Farming Income and the CAIS Program*, or RC4408, *Farming Income and the CAIS Program Harmonized Guide*.

You may have RFLs that you incurred in your farming operation that you could not deduct when you calculated your income for previous years. You can apply part of these RFLs against any capital gain you may have when you sell your farmland. The amount of RFLs that you can apply cannot be more than the property taxes and the interest on money you borrowed to buy the farmland that were included in the calculation of the RFLs for each year. Reduce your capital gain by adding these amounts to the adjusted cost base (ACB) of your farmland. Also, you have to reduce your RFL balance by these amounts.

You can only use RFLs to reduce any capital gain from selling your farmland to zero. You cannot use an RFL to create or increase a capital loss from selling farmland.

Example

Fritz sold his farmland in 2006 for $200,000. The ACB of the property was $160,000. Fritz has an unapplied RFL of $20,000 from 1996. This amount includes $5,000 for property taxes, $5,000 for interest, and $10,000 for other expenses.

Fritz wants to reduce his capital gain from selling his farmland by applying his RFL against the capital gain. He calculates his capital gain as follows:

Proceeds of disposition				$ 200,000	A
Adjusted cost base		$ 160,000	B		
Plus: Property taxes	+	5,000	C		
Interest	+	5,000	D		
Total	=	$ 170,000 ▶		– 170,000	E
Capital gain (line A **minus** line E)				= $ 30,000	F

Fritz can only apply the portion of his RFL that relates to property taxes and interest on the money he borrowed to buy the farmland.

Allowable business investment loss (ABIL)

If you had a business investment loss in 2006, you can deduct 1/2 of the loss from income. The amount of the loss you can deduct from your income is called your allowable business investment loss (ABIL). Complete Chart 6 on page 37 to determine your ABIL and, if applicable, your business investment loss reduction. Claim the deduction for the ABIL on line 217 of your return. Enter the gross business investment loss on line 228 of your return.

What is a business investment loss?

A business investment loss results from the actual or deemed disposition of certain capital properties. It can happen when you dispose of one of the following to a person you deal with at arm's length:

- a share of a small business corporation; or
- a debt owed to you by a small business corporation.

For business investment loss purposes, a small business corporation includes a corporation that was a small business corporation at any time during the 12 months before the disposition.

You may also have such a loss if you are deemed to have disposed of, for nil proceeds of disposition, a debt or a share of a small business corporation under any of the following circumstances:

- A small business corporation owes you a debt (other than a debt from the sale of personal-use property) that is considered to be a bad debt at the end of the year.
- At the end of the year, you own a share (other than a share you received as consideration from the sale of personal-use property) of a small business corporation that:
  - has gone bankrupt in the year;
  - is insolvent, and a winding-up order has been made in the year under the *Winding-up Act*; or
  - is insolvent at the end of the year and neither the corporation, nor a corporation it controls, carries on business. Also, at that time, the share in the corporation has a fair market value of nil, and it is reasonable to expect that the corporation will be dissolved or wound up and will not start to carry on business*.

    * You or a person that you do not deal with at arm's length will be deemed to have realized an offsetting capital gain if the corporation, or a corporation it controls, carries on business within 24 months following the end of the year in which the disposition occurred. You or that person will have to report the capital gain in the tax year the corporation starts to carry on business. This applies if you or the person owned the share in the corporation at the time the business started.

You can elect to be deemed to have disposed of the debt or the share of the small business corporation at the end of the year for nil proceeds of disposition, and to have immediately reacquired the debt or the share after the end of the year at a cost equal to nil. To do this, you have to file an election with your return. To make this election, attach to your return a letter signed by you. State that you want **subsection 50(1)** of the *Income Tax Act* to apply.

What happens when you incur an ABIL?

You can deduct your ABIL from your other sources of income for the year. If your ABIL is more than your other sources of income for the year, include the difference as part of your non-capital loss. You can carry a non-capital loss arising in 2003 or prior years, back three years and forward seven years.

You can carry a non-capital loss arising in taxation years ending after March 22, 2004 back three years and forward 10 years.

Although you can generally carry a non-capital loss arising in taxation years ending after 2005, back three years and forward 20 years, this extension does **not** apply to a non-capital loss resulting from an ABIL. Instead, an ABIL that has not been used within ten tax years will continue to become a net capital loss in the eleventh year.

To carry a non-capital loss back to 2003, 2004, or 2005, complete Form T1A, *Request for Loss Carryback*, and include it with your 2006 return. You can get Form T1A from us (see the section called "What if you need help?" on page 2). **Do not** file an amended return for the year to which you want to apply the loss.

If you cannot deduct your ABIL arising in 2003 or prior years as a non-capital loss by the end of the seventh year, the unapplied part becomes a **net** capital loss. You can use this loss to reduce your taxable capital gains in the eighth year or any year after.

For example, Cathy had an ABIL in 1997 that became a non-capital loss and that she was not able to deduct in the three years before 1997 or the seven years after 1997. She can now use the loss to reduce her taxable capital gains in 2006 or any year after.

The unapplied part of your non-capital loss resulting from an ABIL arising in 2004 or future years will become a net capital loss in the eleventh year.

Note
Any ABIL that you claim for 2006 will reduce the capital gains deduction you can claim in 2006 and in future years.

Chart 6 – How to claim an allowable business investment loss

Step 1 Business investment loss in 2006 (enter this amount on line 228 of your return) .... $ ________ **A**

Step 2 If you claimed a capital gains deduction in a previous year, you have to reduce your business investment loss. To determine the reduction, complete the calculation below and enter the result from line 15. Otherwise, enter "0." .... – ________ **B**

Line A **minus** line B .... = $ ________ **C**

Step 3 Allowable business investment loss .... Amount from line C $ ________ × 1/2 = $ ________ **D**

Enter the amount from line D on line 217 of your return.

Step 4 Attach a note to your return that states the:

- name of the small business corporation;
- number and class of shares, or the type of debt you disposed of;
- insolvency, bankruptcy, or wind-up date;
- date you bought the shares, or the date you acquired the debt;
- amount of the proceeds of disposition;
- adjusted cost base of the shares or debt;
- outlays and expenses on the disposition; and
- amount of the loss.

Calculation of the business investment loss reduction

The reduction calculated below is considered to be a capital loss for the year.

Total of all capital gains deductions claimed from 1985 to 2005

		Amount		Factor		Result	
1.	For 1985 to 1987, total of the amounts from line 254 of your returns for these years	$		× 2	▶	$	**1**
2.	For 1988 and 1989 (other than for eligible capital property gains), total of the amounts from line 254 of your returns **minus** any amounts reported on lines 543 and 544 on Schedule 3; if negative enter "0"	$	**(a)**	× 3/2	▶	+	**2**
3.	For 1988 and 1989 for eligible capital property gains, total of the amounts from line 254 of your returns **minus** the amount calculated at line (a) above; not to exceed lines 543 and 544 on Schedule 3	$		× 4/3	▶	+	**3**
4.	For 1990 to 1999, total of the amounts from line 254 of your returns for these years	$		× 4/3	▶	+	**4**
5.	For 2000, amount from line 254 of your return	$		× 1/IR*	▶	+	**5**
6.	For 2001 to 2005, total of the amounts from line 254 of your returns for these years	$		× 2	▶	+	**6**
7.	Total of lines 1 to 6					= $	**7**

Total of all other business investment loss reductions for 1986 to 2005

8.	Total of amounts reported on line 535 of Schedule 3 of your 1986 to 1994 returns	$	**8**	
9.	Total of amounts reported on line 034 of Schedule 3 of your 1994 to 1996 returns	+	**9**	
10.	Total of amounts reported on line 178 of Schedule 3 of your 1997 to 1999 returns	+	**10**	
11.	Total of amounts reported on lines 293, 178, and 5668 of Schedule 3 of your 2000 return	+	**11**	
12.	Total of amounts reported on line 178 of Schedule 3 of your 2001 to 2005 returns	+	**12**	
13.	Total of lines 8 to 12	= $	▶	– $ ________ **13**
14.	Line 7 **minus** line 13			= $ ________ **14**

Business investment loss reduction

15. Line 14 or line A from Step 1 above, **whichever is less**.
Enter this amount on line B in Step 2 above and on line 178 of Schedule 3 .... $ ________ **15**

* **This rate is from line 16 in Part 4 of Schedule 3 for 2000, or from your *Notice of Assessment* or latest *Notice of Reassessment* for 2000.**

Summary of loss application rules

Type of loss	Application rules	Limit to annual deduction
Allowable business investment loss (see page 36)	Any unapplied portion of an ABIL incurred in 2004 or future years becomes a non-capital loss that can be carried back three years and forward 10 years. The unapplied portion of the non-capital loss will become a net capital loss that can be used to reduce taxable capital gains in the eleventh year or any year after.*	No limit Limited to taxable capital gains in the year.
Net capital loss (see page 28)	■ Carry back three years ■ Carry forward indefinitely	Limited to taxable capital gains in the year.**
Farm loss***	■ Carry back three years ■ For a loss incurred after 2005, carry forward 20 years. For a loss incurred before 2006, carry forward 10 years	No limit
Listed personal property (LPP) loss (see page 34)	■ Carry back three years ■ Carry forward seven years	Limited to net gains from LPP in the year.
Personal-use property loss (see page 18)	No loss allowed.****	Not applicable
Restricted farm loss (see page 35)	■ Carry back three years ■ For a loss incurred after 2005, carry forward 20 years. For a loss incurred before 2006, carry forward 10 years You can use part of any unapplied loss to reduce your capital gains from the sale of the farmland that was used in a farming business.	Limited to net farming income in the year. Cannot be more than the property taxes and the interest on money you borrowed to buy the farmland that you included in the calculation of the restricted farm losses for each year. You cannot use it to create or increase a capital loss.
Superficial loss (see page 35)	No loss allowed You can usually add the amount of the loss to the adjusted cost base of the substituted property.	Not applicable

* Any unapplied portion of an ABIL incurred in 2003 or prior years became a non-capital loss that could be carried back three years and forward seven years. The unapplied portion of the non-capital loss will become a net capital loss that can be used to reduce taxable capital gains in the eighth year or any year after.

** For net capital losses incurred before May 23, 1985, you may deduct an additional amount (up to $2,000) from other income. For more information, see "How do you apply your net capital losses of other years to 2006?" on page 29.

*** See guide T4003, *Farming Income*, guide RC4060, *Farming Income and the CAIS Program*, or RC4408, *Farming Income and the CAIS Program Harmonized Guide*, for more information on farming losses.

**** For exceptions to this rule, see "Personal-use property" on page 18.

Chapter 6 – Principal residence

When you sell your home, you may realize a capital gain. If the property was your principal residence for every year you owned it, you do not have to report the sale on your return. However, if at any time during the period you owned the property it was not your principal residence, you may have to report all or part of the capital gain.

This chapter explains the meaning of a principal residence, how you designate a property as such, and what happens when you sell it. It also explains what to do in other special tax situations.

If after reading this chapter you need more information, see Interpretation Bulletin IT-120, *Principal Residence*.

What is your principal residence?

Your principal residence can be any of the following types of housing units:

- a house;
- a cottage;
- a condominium;
- an apartment in an apartment building;
- an apartment in a duplex; or
- a trailer, mobile home, or houseboat.

A property qualifies as your principal residence for any year if it meets the following four conditions:

- it is a housing unit, a leasehold interest in a housing unit, or a share of the capital stock of a co-operative housing

corporation you acquire only to get the right to inhabit a housing unit owned by that corporation;

- you own the property alone or jointly with another person;
- you, your current or former spouse or common-law partner, or any of your children lived in it at some time during the year; and
- you designate the property as your principal residence.

The land on which your home is located can be part of your principal residence. Usually, the amount of land that you can consider as part of your principal residence is limited to 1/2 hectare (1.24 acres). However, if you can show that you need more land to use and enjoy your home, you can consider more than this amount as part of your principal residence. For example, this may happen if the minimum lot size imposed by a municipality at the time you bought the property is larger than 1/2 hectare.

Designating a principal residence

You designate your home as your principal residence when you sell or are considered to have sold all or part of it. You can designate your home as your principal residence for the years that you own and use it as your principal residence. However, you do not have to designate it each year. For more information, see "Form T2091(IND), *Designation of a Property as a Principal Residence by an Individual (Other Than a Personal Trust)*" on this page.

Can you have more than one principal residence?

For 1982 and later years, you can only designate one home as your family's principal residence for each year.

For 1982 to 2000, your family included:

- you;
- a person who, throughout the year, was your spouse (unless you were separated for the entire year under the terms of a court order or a written agreement); and
- your children (other than a child who had a spouse during the year or who was 18 or older).

If you **did not have a spouse and were not 18 or older**, your family **also** included:

- your mother and your father; and
- your brothers and sisters (who did not have spouses and were not 18 or older during the year).

For 2001 to 2006, the above definition applies except that the reference to spouse is replaced by "spouse or common-law partner." These terms are defined in the Glossary on page 5.

For 1993 to 2000, a spouse included a common-law spouse. Therefore, common-law spouses could not designate different housing units as their principal residence for any of those years.

> **Note**
> If you made an election to have your same-sex partner considered your common-law partner for 1998, 1999, and/or 2000, then, for those years, your common-law partner also could not designate a different housing unit as his or her principal residence.

For years before 1982, more than one housing unit per family can be designated as a principal residence. Therefore, a husband and wife can designate different principal residences for these years. However, a special rule applies if members of a family designate more than one home as a principal residence. For more information, see Interpretation Bulletin IT-120, *Principal Residence*.

Disposing of your principal residence

When you sell your home or when you are considered to have sold it, usually you do not have to report the sale on your return and you do not have to pay tax on any gain from the sale. This is the case if the home was your principal residence for every year you owned it.

If your home was **not** your principal residence for every year that you owned it, you have to report the part of the capital gain on the property that relates to the years for which you did not designate the property as your principal residence. To do this, complete Form T2091(IND) (see the next section).

> **Note**
> Because your home is considered personal-use property, if you have a loss at the time you sell or are considered to have sold your home, you are not allowed to claim the loss.

If only a part of your home qualifies as your principal residence and you used the other part to earn or produce income, you have to split the selling price and the adjusted cost base between the part you used for your principal residence and the part you used for other purposes (for example, rental or business). You can do this by using square metres or the number of rooms, as long as the split is reasonable. Report only the gain on the part you used to produce income. For more information, see "Real estate, depreciable property, and other properties" on page 15 and Interpretation Bulletin IT-120, *Principal Residence*.

Form T2091(IND), *Designation of a Property as a Principal Residence by an Individual (Other Than a Personal Trust)*

Use Form T2091(IND) to designate a property as a principal residence. This form will help you calculate the number of years that you can designate your home as your principal residence, as well as the part of the capital gain, if any, that you have to report. Complete Form T2091(IND), if you:

- sold, or were considered to have sold, your principal residence, or any part of it; or
- granted someone an option to buy your principal residence, or any part of it.

You only have to include Form T2091(IND) with your return if you have to report a capital gain.

A legal representative (executor, administrator, or a liquidator in Quebec) of a deceased person should use Form T1255, *Designation of a Property as a Principal Residence by the Legal Representative of a Deceased Individual*, to

designate a property as a principle residence for the deceased.

Did you or your spouse or common-law partner file Form T664 or T664(Seniors)?

Use Form T2091(IND) to calculate the capital gain if you sell, or are considered to have sold, a property for which you or your spouse or common-law partner filed Form T664 or T664(Seniors), *Election to Report a Capital Gain on Property Owned at the End of February 22, 1994*, and:

- the property was your principal residence for 1994; or
- you are designating it in 2006 as your principal residence for any tax year.

Use Form T2091(IND)-WS, *Principal Residence Worksheet*, to calculate a reduction due to the capital gains election. In this case, if the property was designated as a principal residence for the purpose of the capital gains election, you have to include those previously designated tax years as part of your principal residence designation in 2006.

> **Note**
> If, at the time of the election, the property was designated as a principal residence for any tax year other than 1994, you can choose whether or not to designate it again as your principal residence when you sell it or are considered to have sold it. Remember, if you choose to designate it again, you have to include those previously designated tax years as part of your principal residence designation in 2006.

If the property was not your principal residence for 1994 and you are not designating it in 2006 as your principal residence for any tax year, do not use Form T2091(IND) and Form T2091(IND)-WS to calculate your capital gain. Instead, calculate your capital gain, if any, in the regular way (proceeds of disposition **minus** the adjusted cost base and outlays and expenses). For more information on how to calculate your adjusted cost base as a result of the capital gains election, see "Property for which you filed Form T664 or T664(Seniors)" on page 21.

Changes in use

You can be considered to have sold all or part of your property even though you did not actually sell it. The following are some sample situations:

- you change all or part of your principal residence to a rental or business operation; or
- you change your rental or business operation to a principal residence.

Every time you change the use of a property, you are considered to have sold the property at its fair market value and to have immediately reacquired the property for the same amount. You have to report the resulting capital gain or loss (in certain situations) in the year the change of use occurs.

If the property was your principal residence for any year you owned it before you changed its use, you do not have to pay tax on any gain that relates to those years. You only have to report the gain that relates to the years your home was not your principal residence. For information on how to calculate and report the gain, if any, see "Disposing of your principal residence" on page 39.

If you were using the property to earn or produce income before you changed its use, see "Real estate, depreciable property, and other properties" on page 15 for information on how to report any capital gain or loss.

Special situations

In certain situations, the rules stated above for changes in use do not apply. The following are some of the more common situations.

Changing all your principal residence to a rental or business property

When you change your principal residence to a rental or business property, you can make an election not to be considered as having started to use your principal residence as a rental or business property. This means you do not have to report any capital gain when you change its use. If you make this election:

- you have to report the net rental or business income you earn; and
- you cannot claim capital cost allowance (CCA) on the property.

While your election is in effect, you can designate the property as your principal residence for up to four years, even if you do not use your property as your principal residence. However, you can only do this if you do not designate any other property as your principal residence for this time.

You can extend the four-year limit indefinitely if all of the following conditions are met:

- you live away from your principal residence because your employer, or your spouse's or common-law partner's employer wants you to relocate;
- you and your spouse or common-law partner are not related to the employer;
- you return to your original home while you or your spouse or common-law partner are still with the same employer, **or** before the end of the year following the year in which this employment ends, **or** you die during the term of employment; and
- your original home is at least 40 kilometres (by the shortest public route) farther than your temporary residence from your, or your spouse's or common-law partner's, new place of employment.

If you make this election, there is no immediate effect on your income tax situation when you move back into your residence. However, if you change the use of the property again and do not make this election again, any gain you have from selling the property may be subject to tax.

To make this election, attach to your return a letter signed by you. Describe the property and state that you want **subsection 45(2)** of the *Income Tax Act* to apply.

If you started to use your principal residence as a rental or business property in the year, you may want information on how you should report your business or property

income. If so, see guide T4002, *Business and Professional Income* or guide T4036, *Rental Income*.

Changing your rental or business property to a principal residence

When you change your rental or business property to a principal residence, you can elect to postpone reporting the disposition of your property until you actually sell it. However, you cannot make this election if you, your spouse or common-law partner, or a trust under which you or your spouse or common-law partner is a beneficiary has deducted CCA on the property for any tax year after 1984, and on or before the day you change its use.

This election only applies to a capital gain. If you claimed CCA on the property before 1985, you have to include any recapture of CCA in your business or rental income. Include the income in the year you changed the use of the property. If you need more information on the recapture of CCA, see guide T4002, *Business and Professional Income* or guide T4036, *Rental Income*.

If you make this election, you can designate the property as your principal residence for up to four years before you actually occupy it as your principal residence.

To make this election, attach to your return a letter signed by you. Describe the property and state that you want **subsection 45(3)** of the *Income Tax Act* to apply. You have to make this election by whichever of the following dates is earlier:

- 90 days after the date we ask you to make the election; or
- the date you are required to file your return for the year in which you actually sell the property.

Changing part of your principal residence to a rental or business property

You are usually considered to have changed the use of part of your principal residence when you start to use that part for rental or business purposes. However, you are not considered to have changed its use if:

- your rental or business use of the property is relatively small in relation to its use as your principal residence;
- you do not make any structural changes to the property to make it more suitable for rental or business purposes; and
- you do not deduct any CCA on the part you are using for rental or business purposes.

If you meet all of the above conditions, the whole property may qualify as your principal residence, even though you are using part of it for rental or business purposes.

However, if you do not meet all of the above conditions, when you actually sell the property you have to:

- split the selling price between the part you used for your principal residence and the part you used for rental or business purposes. We will accept a split based on square metres or the number of rooms as long as the split is reasonable; and
- report any capital gain on the part you used for rental or business purposes. For more information, see "Real estate, depreciable property, and other properties" on page 15. You do not have to report any capital gain for the part you used for your principal residence.

Note
You cannot file an election under **subsection 45(2)** of the *Income Tax Act*, as discussed in the previous section, if there is only a partial change in use of a property.

Farm and fishing property

If you are a farmer or fisher and you sell land in 2006 used principally in a farming or fishing business that includes your principal residence, you can choose one of two methods to calculate your capital gain. We explain these two methods in guide T4004, *Fishing Income*, guide T4003, *Farming Income*, guide RC4060, *Farming Income and the CAIS Program*, and RC4408, *Farming Income and the CAIS Program Harmonized Guide.*

Example – Disposing of a principal residence partly used for earning income

In this example, we illustrate some of the topics that we discuss in this guide. We show you how to:

- treat the sale of property that was used partly as a principal residence and partly for earning income;
- report a capital gain on the disposition of property that includes land and a building (see "Real estate" on page 15); and
- calculate a recapture of capital cost allowance (CCA) or a terminal loss on the disposition of depreciable property (see "Recapture of CCA and terminal losses" on page 16).

In November 1988, John bought a duplex for $125,000. According to a municipal assessment completed just before the purchase, the entire property was valued at $100,000. The land was valued at $25,000 and the building was valued at $75,000. From the date he purchased the duplex, John lived in the lower half and rented out the upper half. Based on the property's total number of square metres, he determined that the portion he used to earn rental income was 40%.

On July 28, 2006, John sold the property for $175,000. He incurred expenses of $10,500 to make the sale. According to a recent municipal assessment, the entire property was now valued at $150,000. The land was worth $30,000 and the building was worth $120,000.

Any gain on the part of the property that John used as his principal residence will not be taxed because he used that part of the property as his principal residence for all the years he owned it. Because John does not have to report the gain, he does not have to complete Form T2091(IND), *Designation of a Property as a Principal Residence by an Individual (Other Than a Personal Trust)*.

John has to calculate the capital gain on the part of the property that he rented out. He also has to determine if he has a recapture of CCA or a terminal loss on the rented portion of the building. For this reason, he will break down the rental portion of the purchase price, the selling price, and the related expenses between the land and the building. Keeping in mind that 40% of the property was used for rental purposes, John completes the following calculations:

1. **He divides the rental portion of the purchase price between the land and the building, based on the municipal assessment at the time of the purchase:**

   a) Building: 40% $\times \frac{\$75,000}{\$100,000} \times \$125,000 = \$37,500$

   b) Land: 40% $\times \frac{\$25,000}{\$100,000} \times \$125,000 = \$12,500$

   Because the breakdown between the land and the building was not shown on his purchase agreement, John uses the municipal assessment in effect at the time of the purchase. John would have completed this calculation at the time he purchased the property to determine the amount of CCA he could claim on the part of the building he rented out.

2. **He divides the rental portion of the selling price between the land and the building, based on the municipal assessment at the time of the sale:**

   a) Building: 40% $\times \frac{\$120,000}{\$150,000} \times \$175,000 = \$56,000$

   b) Land: 40% $\times \frac{\$30,000}{\$150,000} \times \$175,000 = \$14,000$

   The breakdown between the land and the building was not shown on John's sale agreement. Because no renovations were made to the building since the last municipal assessment, John can use the municipal assessment that was in effect at the time of the sale.

3. **He divides the rental portion of the expenses relating to the sale between the land and the building, based on the municipal assessment at the time of the sale:**

   a) Building: 40% $\times \frac{\$120,000}{\$150,000} \times \$10,500 = \$3,360$

   b) Land: 40% $\times \frac{\$30,000}{\$150,000} \times \$10,500 = \$840$

(continued on next page)

Example – Disposing of a principal residence partly used for earning income (continued)

John can now determine if he has a recapture of CCA or a terminal loss on the rented part of the building. The undepreciated capital cost (UCC) of the portion of the building used for rental purposes at the beginning of 2006 was $34,728. From the UCC, he subtracts one of the following amounts, whichever is less:

- the selling price of the rented part of the building minus the related outlays and expenses: $52,640 ($56,000 – $3,360); or
- the purchase price of the rented part of the building: $37,500.

UCC at the beginning of 2006	$	34,728
Minus: Purchase price	–	37,500
Recapture of CCA	= $	(2,772)

To help him complete the above calculations, John uses the CCA schedule on the back of Form T776, *Statement of Real Estate Rentals*.

John can now calculate his capital gain. To do this, he completes the section called "Real estate, depreciable property, and other properties" in Schedule 3, *Capital Gains (or Losses) in 2006.* He reports the sale of the rental property as follows:

Real estate, depreciable property, and other properties

Address or legal description									Gain (or loss)	
Street, City, Province (building)	1988	56,000	00	37,500	00	3,360	00		15,140	00
Street, City, Province (land)	1988	14,000	00	12,500	00	840	00		660	00
	Total 136	70,000	00		Gain (or loss) 138			+	15,800	00

Index

In addition to listing topics, this index provides references to any Interpretation Bulletin (IT) and Information Circular (IC) related to each topic mentioned. If after reading the explanations provided in this guide, you still need more information, get a copy of these publications. We provide a complete list of references on page 45.

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References

The following publications are available by visiting our Web site at **www.cra.gc.ca/forms** or by calling **1-800-959-2221**.

Forms

T1A *Request for Loss Carryback*

T123 *Election on Disposition of Canadian Securities*

T657 *Calculation of Capital Gains Deduction for 2006*

T936 *Calculation of Cumulative Net Investment Loss (CNIL) to December 31, 2006*

T1105 *Supplementary Schedule for Dispositions of Capital Property Acquired Before 1972*

T1170 *Capital Gains on Gifts of Certain Capital Property*

T1212 *Statement of Deferred Security Options Benefit*

T1255 *Designation of a Property as a Principal Residence by the Legal Representative of a Deceased Individual*

T2017 *Summary of Reserves on Dispositions of Capital Property*

T2091(IND) *Designation of a Property as a Principal Residence by an Individual (Other Than a Personal Trust)*

T2091(IND)-WS *Principal Residence Worksheet*

Information Circulars

IC 76-19 *Transfer of Property to a Corporation Under Section 85*

IC 78-10 *Books and Records Retention/Destruction*

Information Document

RC4169 *Tax Treatment of Mutual Funds for Individuals*

Interpretation Bulletins

IT-95 *Foreign Exchange Gains and Losses*

IT-96 *Options Granted by Corporations To Acquire Shares, Bonds, or Debentures and by Trusts To Acquire Trust Units*

IT-113 *Benefits to Employees – Stock Options*

IT-120 *Principal Residence*

IT-123 *Transactions Involving Eligible Capital Property*

IT-125 *Dispositions of Resource Properties*

IT-128 *Capital Cost Allowance – Depreciable Property*

IT-139 *Capital Property Owned on December 31, 1971 – Fair Market Value*

IT-159 *Capital Debts Established To Be Bad Debts*

IT-209 *Inter-Vivos Gifts of Capital Property to Individuals Directly or Through Trusts*, and its Special Release

IT-213 *Prizes From Lottery Schemes, Pool System Betting and Giveaway Contests*

IT-218 *Profit, Capital Gains and Losses From the Sale of Real Estate, Including Farmland and Inherited Land and Conversion of Real Estate From Capital Property to Inventory and Vice Versa*

IT-220 *Capital Cost Allowance – Proceeds of Disposition of Depreciable Property*, and its Special Release

IT-221 *Determination of an Individual's Residence Status*, and its Special Release

IT-232 *Losses – Their Deductibility in the Loss Year or in Other Years*

IT-264 *Part Dispositions*, and its Special Release

IT-391 *Status of Corporations*

IT-407 *Dispositions of Cultural Property to Designated Canadian Institutions*

IT-413 *Election by Members of a Partnership Under Subsection 97(2)*

IT-419 *Meaning of Arm's Length*

IT-456 *Capital Property – Some Adjustments to Cost Base*, and its Special Release

IT-458 *Canadian-Controlled Private Corporation*

IT-459 *Adventure or Concern in the Nature of Trade*

IT-478 *Capital Cost Allowance – Recapture and Terminal Loss*

IT-479 *Transactions in Securities*, and its Special Release

IT-484 *Business Investment Losses*

IT-491 *Former Business Property*, and its Special Release

IT-511 *Interspousal and Certain Other Transfers and Loans of Property*

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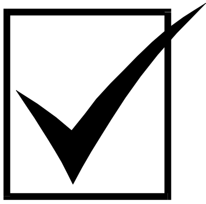

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