



CLIENT UPDATE – MAY 15, 2024 INCREASE TO CAPITAL GAINS INCLUSION RATE

In the 2024 federal budget the government proposed an increase to the inclusion rate of capital gains, from 1/2 to 2/3 effective on June 25, 2024. While the budget did provide a summary of the Government's intentions, we do not know many details of the proposals as no draft legislation has been released yet. This communication will provide a discussion about the changes as we understand them now and provide strategies to consider in your tax planning.

Background

Prior to delving into the new provisions, it will be helpful to understand how capital gains are treated currently. Capital gains are profits from the sale of "capital assets" which are generally sales outside of the course of regular business. For example, an individual selling stocks in their portfolio or a manufacturer selling their plant would generally realize capital gains. Most countries tax capital gains at a lower rate than regular income to encourage investment and avoid taxing inflation.

In Canada, tax on capital gains was introduced in 1972 at a 1/2 inclusion rate, which means of the total capital gain, only half is included in a taxpayer's income. In 1988-1989 this was increased to 2/3 and from 1990-1999 to 3/4. It was reduced to 1/2 in 2000 and has remained at that level until now.

In addition to regular sales of assets, there are several "deemed dispositions" in the Income Tax Act (ITA) that can result in capital gains:

- 1) Gifts of assets, usually to family and charities;
- 2) On death all assets are deemed to be sold for fair value;
 - a) Exceptions for transfers to spouses and farm/fishing property to children;
- 3) On emigration from Canada all assets are deemed to be sold for fair value;
 - a) Exceptions include real estate in Canada.

The sale of a rental or vacation property not covered by the principal residence exemption would also result in a capital gain.

A capital loss can normally only be applied against a capital gain. It can be carried back 3 years or forward indefinitely. If the capital loss is a "Business Investment Loss" (BIL) from an investment in a "Small Business Corporation", the allowable portion can be claimed against any income.

Where sale proceeds are received over time, the gain can be included in income over that period providing at least 20% is recognized each year (a "reserve"). For certain small business and farm transfers a 10-year reserve is available. A reserve is not available for non-residents and dispositions to controlled or controlling corporations.

Proposed Legislation

The proposed legislation indicates the inclusion rate will be increased to 2/3 as of June 25, 2024. Individuals will have an annual limit of \$250,000 in capital gains that will be included at the 1/2 inclusion rate. This should mean there is no tax increase for a majority of individuals in any particular year.

The \$250,000 limit applies to gains in excess of losses from the current year or other years. The inclusion rate of the losses doesn't affect this offset (i.e. gross losses vs. gross gains). In addition, gains eligible for the following do not count against the \$250,000 limit:

- i) Lifetime Capital Gains Exemption (LCGE) on Small Business Corporations (SBC) and farm/fishing property – Proposed to be \$1.25 million;
- ii) Qualified sales to “Employee Ownership Trust” (up to \$10M, 2024 – 2026 taxation years)
- iii) Gains eligible for new “Canadian Entrepreneurs Incentive” (1/4 to 1/3 capital gains rate for active, founding owners of SBCs not earning income from services and other specific activities.)

There is **no** \$250,000 limit for corporations and trusts.

Using the highest marginal rates for Ontario this means the tax rates for capital gains will be:

- a) Ontario individuals and trusts: 26.76% to 35.69%
- b) Ontario Canadian Controlled Private Corporations: 25.09% to 33.45%
 - i) When capital and taxable dividends distributed to shareholders: 28.97% to 38.62%

Related to this change, certain employees eligible for stock options are currently entitled to a deduction of 1/2 of the benefit. This will change to a deduction of 1/3 of the benefit.

Due to the lack of legislation, we are unsure how these changes will affect various tax treatments. For instance, when a reserve is claimed on a pre-June 25, 2024 disposition, will the 1/2 or 2/3 inclusion rate apply to the inclusion of the reserve in future years?

Should Gains be Realized Prior to June 25, 2024?

"Is it better to pay less tax now or more tax in the future?" is a question we are often asked. As you may expect, the answer is: “it depends.” Generally, this increase will result in about 9% more tax on capital gains than it would now. While that is not an insignificant amount, paying tax early also means the funds used to pay the tax are not being invested to earn income, or used to pay debt and reduce interest.

Each case will need to be evaluated separately, but we expect it will only be beneficial to realize gains early, at the lower rate, if the capital gain would otherwise be realized within a few years. Also consider that some dispositions may have additional costs, such as land transfer tax for real estate.

Individuals should also consider if they can manage their gains and losses after June 25, 2024 so they will stay within the \$250,000 limit.

Strategies to Consider

To realize the gain on some assets like portfolio investments, it may be possible to sell the asset prior to June 25th and use the lower tax rate. In other cases you may want to realize the gain early and still control the asset. This may be the case for a sale transaction that will otherwise close after June 25th or the asset is expected to be sold within a few years.

The following strategies are general comments, and we strongly recommend that you discuss them with us prior to implementing them:

- 1) Realize gains by selling or gifting to your spouse and “electing out” of the automatic rollover;
 - a) This decision to elect out can be made when your 2024 return is filed;
 - b) To avoid income attribution after the transfer the recipient will need to pay fair value, but that may not be an objective;
 - c) Where your spouse pays with debt, a reserve could be claimed to defer tax while also using the \$250K limit in future years;
- 2) Realize gains on a sale to a related corporation;
 - a) You can often use an election to decide how much of the gain to realize after the actual transfer;
 - b) A reserve is not available if a recipient corporation is controlled by, or controls, the vendor;
 - c) No \$250k exemption on future gains from the assets now held by the corporation;
- 3) Transfer publicly traded investments to a trust for family members other than a spouse;
 - a) No rollover available so gain realized on transfer;
 - b) A reserve is available if debt is issued in consideration;
 - c) The trust can allocate future gains to beneficiaries to maximize \$250K limit;
 - d) Gains do not attribute, but other income may depending on the trust’s beneficiaries, so consider whether issuing interest bearing debt to avoid attribution is beneficial;
- 4) Estate planning
 - a) Many estate plans will need to be re-evaluated to account for higher terminal tax liabilities;
 - b) Especially a concern for owners of corporations, “pipeline” planning may not be as beneficial anymore.

Please do not hesitate to contact your advisor at Wilkinson & Company LLP if you have any questions.