2024 Federal Budget Review

Overview of the Proposed Changes to the Capital Gains Inclusion Rate

The 2024 Federal Budget proposed several important new measures impacting individuals and business owners, most notably the proposed increase in the capital gains inclusion rate. This article briefly outlines some key implications of this proposal for various taxpayers and offers potential planning considerations for those impacted. For more comprehensive details, refer to our full report, *2024 Federal Budget – A Deeper Dive into the Proposed Increase to the Capital Gains Inclusion Rate*.

Note that the measures introduced in the recent Federal Budget, including the changes to the capital gains inclusion rate, are only proposals and may not be enacted into law as described, if at all. Moreover, at the time of writing, no draft legislation has been released regarding the increase to the capital gains inclusion rate, leaving many specifics of these proposals uncertain.

General Commentary

Effective for capital gains realized on or after June 25, 2024, the 2024 Federal Budget proposes increasing the capital gains inclusion rate from one-half to two-thirds for corporations and trusts, and from one-half to two-thirds on the portion of capital gains realized annually in excess of $250,000 by individuals. The Ministere des Finances du Quebec recently announced that Quebec intends to amend its legislation to align with these proposed Federal changes to the capital gains inclusion rate.

Capital Losses

It is expected that a capital loss realized prior to the rate change would still fully offset an equivalent capital gain realized after the inclusion rate change.

Capital Gains Reserve

It is possible that the (deferred) capital gain would be taxed at the capital gains inclusion rate in effect at the time the reserve is subsequently included in income – however, this treatment remains uncertain until the draft legislation is released.

Planning Opportunities

Consider a possible sale of investments or real estate properties with significant accrued gains, before June 25, 2024, to capture the current 50% inclusion rate. While the main downside of triggering capital gains now is the acceleration of taxes owing, there are many other potential impacts to a higher taxable income – including the Alternative Minimum Tax (“AMT”) (discussed below).

Due to the ‘time value of money’, there will be a ‘break-even’ point after which it might be more advantageous to continue to hold an existing asset with accrued gain rather than liquidating it (before June 25, 2024) and immediately re-investing the proceeds, to benefit from the current 50% capital gains inclusion rate. The lower the expected return, the longer the timeframe before this ‘break-even’ point occurs. These calculations will differ between individuals and trusts/corporations because of the annual $250,000 threshold for individuals and nuances in the tax treatment for each type of taxpayer.

Individuals - Possible Implications and Planning Opportunities

$250,000 Threshold

Individuals will be allowed a $250,000 threshold below which the capital gains inclusion rate will remain at its current rate (50%). This threshold will not be prorated for 2024 and will only apply in respect of net capital gains realized on or after the effective date of June 25, 2024.

Many individuals will be able to avoid the proposed higher inclusion rate by timing their dispositions to remain below this threshold annually.

Consider income-splitting opportunities, as it is expected that all individuals will be eligible for their own $250,000 threshold.

Stock Options

The employee stock option deduction will decrease to 1/3, resulting in a 2/3 net taxable benefit as of June 25, 2024. However, stock options will be factored into the combined threshold of $250,000 to maintain the current 50% inclusion rate.

Tax Rates on Investment Income

An increased capital gains inclusion rate will reduce the discrepancy in the top marginal tax rates that currently exists for individuals earning eligible dividends versus capital gains, which will have implications to asset allocation and tax planning strategies (e.g., surplus stripping, post-mortem planning).

Tax-Loss Selling

Year-end tax loss selling will become increasingly important due to the higher effective rates on capital gains, necessitating optimized use of capital losses given the varying tax rates across different years.

Alternative Minimum Tax (AMT)

The 2023 Federal Budget proposed several changes to the AMT calculation, aiming to better target high–income individuals. Individuals contemplating the crystallization of significant capital gains in 2024 (particularly before June 25) should assess the potential impact of the proposed AMT on their particular situation.

Cottage / Real Estate

For property with significant capital gains that would otherwise be sold in the near future, there may be some benefit to accelerating the sale (or transfer to the next generation) to access the current 50% capital gains inclusion rate. However, given the long sales process and the short timeframe, it may be difficult for property owners contemplating a divestiture to complete the sale by June 25, 2024, unless the sale is currently in negotiation.

Death

The deemed disposition on death triggering the realization of accrued capital gains will cause the specific date of death of an individual to be relevant in the determination of the capital gains inclusion rate and could cause a higher ultimate tax liability. Therefore, individuals with a shortened life expectancy may wish to consider planning to realize accrued capital gains prior to the June 25, 2024 effective date, or plan to spread these gains over multiple years, to access the current lower capital gains inclusion rate.

Non-residents

As above, it is also expected that the "deemed disposition" of worldwide assets (with certain exceptions) at the time of the cessation of Canadian residency will also be relevant in the determination of the applicable capital gains inclusion rate.

Private Corporations - Possible Implications and Planning Opportunities

Capital Gain Crystallization

As noted above for individuals, there may be a benefit of liquidating corporate assets prior to June 25, 2024 to access the current 50% capital gains inclusion rate. However, additional considerations for corporations will include the lack of an annual $250,000 threshold to manage future capital gains, and complexities caused by the refundable tax system that applies to corporate investment income.

Integration

The "integration" system for Canadian-Controlled Private Corporations ("CCPCs"), that seeks to make an individual indifferent between earning investment income personally, or indirectly through a corporation, will be negatively impacted by the proposed higher inclusion rate. Specifically, it is expected that there will be a higher ultimate tax cost of earning capital gains through a corporate structure, particularly where the individual would otherwise be subject to the lower 50% capital gains inclusion rate (below the $250,000 threshold).

Potential Wind-up

As a result of the higher capital gains inclusion rate in corporations (without the $250,000 threshold) and the above concerns with integration, many shareholders of investment holding companies may consider a possible wind-up of their corporation to distribute the after-tax proceeds to invest personally, subject to consideration of the corporate and personal tax costs to wind-up the company and distribute the corporate assets.

Donation of Publicly-Traded Securities
Since the AMT does not apply to corporations and because corporations will be subject to the higher capital gains inclusion rate on all capital gains realized after June 24, 2024 (without the $250,000 threshold available to individuals), charitably-minded individuals with corporations owning publicly-traced securities may be inclined to donate through their corporation versus personally.

Additional Considerations for Investment Holding Companies (Holdcos)

Post-Mortem Planning
The proposed increase to the capital gains inclusion rate will further complicate the post-mortem planning for corporations – particularly investment holding companies - as a result of the changes to the integration system described above. Also, since these companies are more likely to be wound-up following death (vs. sold), the potential for double-taxation exists since the accrued capital gains would be subject to tax within the corporation (on wind-up) **and** to the shareholder personally (on the deemed disposition of their Holdco shares).

Capital Dividend Account (“CDA”)
The proposed increase in the capital gains inclusion rate is expected to reduce the CDA inclusion to private corporations from 1/2 to 1/3, which will have important ramifications to shareholders, subject to further guidance following the release of draft legislation.

Additional Considerations for Professional Corporations

Small Business Deduction
The higher inclusion rate on capital gains could result in a possible clawback of the small business deduction for some (professional) corporations, since the annual $50,000 investment income threshold allotted could be exceeded earlier, depending on the current asset allocation model.

Additional Considerations for Business Owners, Farmers and Fishers

Estate Freeze
A higher inclusion rate on capital gains realized on a future sale of a business (above the $250,000 threshold for individuals) will enhance the benefits of an estate freeze by reducing the tax liability on death and deferring taxes to the next generation.

Sale Transactions
The changes to the capital gains inclusion rate will have important ramifications for future business sales, for both share sales (eligible for the Lifetime Capital Gains Exemption (“LCGE”) and $250,000 personal threshold) and asset sales (ineligible for both).

Given the long sales process and the short timeframe it will be difficult for business owners not currently undertaking a sale transaction to access the current 50% capital gains inclusion rate by June 25, 2024. However, for business sales currently in negotiation, the sale date will be relevant in the determination of the capital gains inclusion rate and ultimate tax liability.

Otherwise, business owners may wish to consider possible internal crystallization strategies to realize capital gains at the current 50% inclusion rate prior to June 25, 2024, to reduce the future capital gains that could otherwise be subject to the higher inclusion rate proposed (subject to any available incentives for business owners, such as the LCGE or the new measures proposed in the 2024 Federal Budget).

Family Trusts - Possible Implications and Planning Opportunities

Capital Gain Crystallization
As noted above, there may be a benefit of liquidating assets prior to June 25, 2024 to access the current 50% capital gains inclusion rate. This is perhaps more significant for family trusts (and corporations), since there is no annual $250,000 threshold to manage future capital gains. Although a trust can reduce its taxable income through distributions to beneficiaries, in the absence of detailed draft legislation, it is unclear which inclusion rate will apply to capital gains realized by the trust and distributed (subsequently in 2024) to the trust beneficiaries.

Graduated Rate Estates and Qualified Disability Trusts
Although a trust is not provided with a $250,000 capital gain threshold, it is unclear if certain trusts will be accorded preferred treatment, such as Graduated Rate Estates and Qualified Disability Trusts.

Spousal, Alter-ego and Joint-Partner Trusts (Life Interest Trusts)
The proposed changes to the capital gains inclusion rate, which results in potentially different treatment between individuals and trusts, will have important implications for life-interest trusts, during both the lifetime of the beneficiary(ies) and upon their death, which will have important ramifications for existing trusts and future estate planning.

Other Considerations

Life Insurance
With rising income taxes, particularly on capital gains resulting from the deemed disposition of capital property at death, permanent life insurance can provide a tax-efficient solution to preserve your estate, or as an alternative investment, due to the tax-free accumulation and tax-free payout of the death benefit received by your heirs.

The General Anti–Avoidance Rule ("GAAR")
The government has recently proposed changes to modernize and strengthen the GAAR which could broaden its reach. Although a recent CRA Interpretation provided some comfort regarding potential "crystallization" planning transactions undertaken in advance of the potential increase in the capital gains inclusion rate, taxpayers should consult with their tax advisors for confirmation of the specific tax implications in their particular scenario.

Connect with Our Experts

The proposed increase in the capital gains inclusion rate announced in the recent 2024 Federal Budget has significant implications to many taxpayers, and introduces possible tax planning opportunities prior to the June 25, 2024 effective date. However, since the changes are only proposals at this stage and since no draft legislation has yet been released, caution is warranted before proceeding with any tax-motivated transactions until details regarding the specific application of these proposals are known. In light of this uncertainty, please consult with your tax advisors for specific advice and direction on how you may be affected by these proposals, as we await further announcements on these important developments.

For more information, please speak with your BMO Private Wealth professional.

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