June 11, 2024

Capital Gains Tax Update:

What You Need to Know Now

As outlined in our *2024 Federal Budget Review* publication, Budget 2024 proposed several important new measures impacting individuals and business owners, most notably the proposed increase in the capital gains inclusion rate (i.e., the amount of a capital gain that is included in income for tax purposes). Specifically, effective for capital gains realized on or after June 25, 2024, Budget 2024 proposed an increase in 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.[1]

Notice of Ways and Means Motion

On June 10, 2024, the Federal government tabled a Notice of Ways and Means Motion (NWMM) to introduce legislation to formally implement the measures to increase the capital gains inclusion rate, largely consistent with the proposals released in Budget 2024. In an accompanying release, the government also provided details on the main features of the proposed legislation and the mechanisms to implement the change to the inclusion rate. Despite concerns raised with the original proposals, the measures remain largely unchanged and the government explicitly stated that many of the amendments suggested by the tax community (such as providing a tax election to realize capital gains, capital gains averaging over multiple years, splitting the individual $250,000 annual threshold with corporations, exemptions for specific assets or corporations, or special rules based on how long an asset is held) will not be forthcoming.

The release also noted that further technical amendments will be released later, but these changes will not materially affect the design or introduce new features to the measure. Moreover, the NWMM, which contains initial legislative details of the capital gains tax changes, will be followed by the release of updated draft legislation in July, which will be accompanied by implementation details on the new Canadian Entrepreneurs' Incentive, which was also proposed in Budget 2024.

The most significant new details in the June 10, 2024 NWMM affecting individuals, family trusts, and private corporations are summarized herein.

$250,000 Threshold for Individuals (and Certain Trusts)

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.

As anticipated, the release noted that Graduated Rate Estates (GREs) and Qualified Disability Trusts (QDTs) would also now be eligible for the $250,000 threshold available to individuals in respect of capital gains that are not allocated to a beneficiary in the year, reflecting that these trusts are subject to the same progressive personal income tax rate structure.

Many individuals (and GREs, QDTs) will be able to avoid the proposed higher inclusion rate by timing their dispositions to remain below this threshold annually.

[1] The Ministère des Finances du Québec subsequently announced that Quebec intends to amend its legislation to align with these proposed Federal changes to the capital gains inclusion rate.

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Capital Losses

Net capital losses may be carried back three years and forward indefinitely to offset capital gains of other years. Net capital losses of other years are deductible against current-year taxable capital gains by adjusting their value to reflect the inclusion rate of the capital gains being offset. This means that a capital loss realized when a different inclusion rate applied can still fully offset an equivalent capital gain realized in a year during which another inclusion rate applied, as noted in the following example provided in the release:

Example 1

Assume an individual has the following circumstances in the 2025 tax year.

- Realizes a capital gain of $450,000.
- Realizes a capital loss of $50,000.
- Has an unused net capital loss carryforward balance of $150,000 from 2017 (capital loss of $300,000).

They have a net capital gain of $400,000 for the 2025 tax year. The first $250,000 would effectively be included at a one-half inclusion rate (taxable capital gain of $125,000). The remaining $150,000 would be included at the basic two-thirds inclusion rate (taxable capital gain of $100,000). These taxable capital gains would therefore increase their total income by $225,000.

When calculating taxable income, they would be allowed to deduct $175,000 in respect of the net capital loss from 2017. This represents a deduction of $100,000 in respect of the portion of the net capital loss that offsets the portion of the taxable capital gain included in income at two-thirds ($75,000 × adjustment factor 4/3), and a deduction of $75,000 in respect of the portion of the net capital loss that offsets the portion of the taxable capital gain effectively included in income at one-half ($75,000 x adjustment factor 1).

This effectively results in $50,000 ($225,000 – $175,000) of taxable capital gain remaining to be included in taxable income. The result is as if the remaining $100,000 capital gain ($450,000 capital gain less the $50,000 current-year and $300,000 prior-year capital losses) was included in income at the lower one-half inclusion rate. Put differently, net capital losses are effectively applied first to offset capital gains subject to the higher inclusion rate.

2024 Transition Year

For taxation years that begin before and end on or after June 25, 2024, two different basic inclusion rates would apply. As a result, taxpayers would be required to separately identify capital gains and losses realized before June 25, 2024 (Period 1) and those realized on or after June 25, 2024 (Period 2). Gains and losses from the same period would first be netted against each other. Taxpayers would be subject to the higher inclusion rate in respect of their net gains arising in Period 2 (excluding the portion that does not exceed the $250,000 threshold in the case of individuals), to the extent that these net gains are not offset by a net loss incurred in Period 1.

The annual $250,000 threshold for individuals would be fully available in 2024 (i.e., it would not be prorated) and would apply only in respect of net capital gains realized in Period 2 less any net capital loss from Period 1.

The following example from the release illustrates this methodology:

Example 2

- Robert realizes a capital gain of $600,000 on June 1, 2024, a capital loss of $75,000 on July 25, 2024, and a capital gain of $475,000 on October 1, 2024.
- Robert has a capital gain of $600,000 in Period 1 on which the one-half inclusion rate would apply, resulting in a taxable capital gain of $300,000.
- Robert has a net capital gain of $400,000 in Period 2. A one-half inclusion rate would effectively apply to the first $250,000, and a two-thirds inclusion rate would apply to the remaining $150,000, resulting in a taxable capital gain of $225,000 in Period 2.
- The total taxable capital gain for the 2024 tax year would be $525,000.

Employee Stock Option Deduction

When an employee exercises a stock option, the difference between the fair market value of the stock at exercise and the amount paid for the stock, known as the employee stock option benefit, is included in the employee's income. Historically, this benefit has been treated as similar to a capital gain, with one-half of the benefit deductible from income (provided certain conditions are met). Where the stock option is in respect of a share of a Canadian-controlled private corporation (CCPC), the inclusion of the stock option benefit is normally deferred until the taxation year in which the employee disposes of or exchanges the share.

As a result of the proposed changes to the inclusion rate, claimants of the employee stock option deduction would be provided with a basic one-third deduction of the taxable benefit for stock options exercised on or after June 25, 2024, or, in the case of a CCPC share, where the share is disposed of or exchanged on or after June 25, 2024. This deduction could be increased to one-half on up to a combined annual limit of $250,000 for both employee stock option benefits and capital gains. When the total employee stock option benefits

and capital gains exceed $250,000, the allocation of the preferential treatment would be at the taxpayer's discretion (e.g., to apply unused net capital losses from other years which can offset net capital gains, but not the employee stock option benefit).

Lifetime Capital Gains Exemption

The tax legislation currently provides an indexed Lifetime Capital Gains Exemption (LCGE) on up to $1,016,836 of capital gains realized on the disposition of qualified farm and fishing property or qualified small business corporation shares. Budget 2024 proposed to increase the LCGE limit to $1.25 million of eligible capital gains for dispositions that occur on or after June 25, 2024. Indexation of the LCGE would resume in 2026.

In practice, the lifetime capital gains exemption is provided in the form of a deduction when calculating an individual's taxable income. As of January 1, 2024, the maximum lifetime deduction is $508,418 (i.e., $1,016,836 x the current ½ inclusion rate). Starting on June 25, 2024, the new maximum lifetime deduction would be $833,333 ($1,250,000 × ⅔) to reflect the new basic inclusion rate of two-thirds and the increased lifetime limit of $1.25 million.

If an individual claims the LCGE in respect of a capital gain realized on or after June 25, 2024 that was effectively included in income at the one-half inclusion rate, the amount of the deduction would effectively be reduced to reflect the lower effective inclusion rate. This mechanism would allow for the exemption of $1.25 million in eligible gains regardless of the effective rate at which those gains would have otherwise been included in income.

Capital Gains Reserves

If proceeds from a disposition trigger a capital gain, but not all proceeds are received in the year of the sale, it may be possible to defer taxation of a "reasonable" portion of the gain until the year when the remaining proceeds become receivable (generally up to 5 years with a minimum (cumulative) 20% income inclusion each year).

The government release confirms that when a capital gain is brought out of reserve in a subsequent year, it is included in income at the inclusion rate applicable for that subsequent year. For example, if a reserve is claimed in respect of a capital gain realized in 2023, any portion of the gain that is brought into income in 2025 would be included at the basic two-thirds inclusion rate (which could effectively be reduced, for example, to one-half if under the $250,000 threshold for individuals).

For taxation years that include June 25, 2024, the amount of a capital gain that is brought out of reserve would be deemed to be a capital gain of the taxpayer from a disposition of property on the first day of the taxpayer's taxation year for the purpose of determining the inclusion rate. For example, for an individual taxpayer (with a 2024 calendar taxation year), any capital gain brought out of reserve into 2024 income would not be subject to the higher basic inclusion rate. The following example from the government release outlines the updated capital gains reserve mechanism:

Example 3

On April 1, 2024, Mio closed a deal to sell a property to an arm's length corporation for $20 million. Under the terms of the deal, the buyer will pay $4 million on April 1, 2024, and will make four additional payments of $4 million on April 1 of 2025 through 2028. The capital gain arising on the sale is $10 million.

If Mio chooses to include the full amount of the capital gain in income in 2024, the entire $10 million capital gain would be included in income at a one-half inclusion rate, resulting in $5 million in taxable capital gains.

Otherwise, if Mio takes full advantage of the five-year reserve and includes only 20% of the capital gain in income each year, only $2 million of capital gains would be realized in 2024 and would be included in income at a one-half inclusion rate, resulting in a taxable capital gain of $1 million.

For each of the 2025 through 2028 tax years, assuming Mio had no other capital gains or stock options, the first $250,000 of capital gains would be included in income at a one-half inclusion rate, and the remaining $1.75 million would be included at a two-thirds inclusion rate, resulting in annual taxable capital gains of $1,291,667, for total taxable capital gains of $6,166,667 over the five years.

Trusts – Designations of Taxable Capital Gains

Typically, a trust resident in Canada can designate any part of its net taxable capital gains for a year to one or more Canadian-resident beneficiaries of the trust at the end of the trust's taxation year. This allows the character of taxable capital gains to be preserved when flowed through the trust to its beneficiaries.

For the taxation year of a trust that begins before June 25, 2024 and ends after June 24, 2024 (such as a calendar taxation year that applies to most trusts), the amount designated in respect of its net taxable capital gains would instead be grossed up (doubled for gains in the pre-June 25 period or increased by 3/2 for gains in the post-June 24 period) and deemed to be capital gains realized by the beneficiary in the period that the trust disposed of the relevant capital property (either pre-June 25 or post-June 24). Trusts would be required to

disclose to their beneficiaries in prescribed form the portion of the deemed capital gains that relate to dispositions of property that occurred in each period. If a trust does not disclose this information, the deemed capital gains would be deemed to have been realized after June 24, 2024.

Commercial trusts (such as mutual fund trusts) would have the option of electing the deemed capital gains allocated to investors to have been realized by them proportionally within the two periods based on the number of days in each period divided by the number of days in the trust's taxation year.

Each individual's $250,000 capital gains threshold would apply for the purpose of determining the effective inclusion rate of capital gains or taxable capital gains allocated to the individual as a beneficiary of a trust.

Similar rules would also apply where a taxpayer is a member of a partnership that has a fiscal period that begins before June 25, 2024 and ends after June 24, 2024.

Non-Resident Dispositions of Taxable Canadian Property

Non-residents of Canada are generally subject to Canadian tax on capital gains from dispositions of taxable Canadian property (such as Canadian real estate). To ensure collection, certain procedures apply. Specifically, a non-resident person may obtain a certificate of compliance in respect of a disposition, or proposed disposition, of taxable Canadian property if the required tax on the capital gain is paid. Absent this certificate, the purchaser is required to withhold a portion of the proceeds as tax on behalf of the non-resident person.

The rate applicable to this withholding is intended to approximate the combined federal and provincial tax payable on capital gains at the highest marginal tax rates. Consequential on the proposed change to the capital gains inclusion rate, and to reflect current federal, provincial, and territorial tax rates, the withholding rate applicable to non-resident dispositions of taxable Canadian property would be raised from 25 per cent to 35 per cent, applicable to dispositions that occur on or after January 1, 2025.

Other Forthcoming Amendments

The government release also noted that additional consequential amendments would be made to reflect the new inclusion rate, for other rules in the tax legislation which are premised on a one-half inclusion rate for capital gains. This would include the Alternative Minimum Tax (AMT) rules, which are currently subject to amendments originating from the last two Federal Budgets.

Planning Considerations before June 25 – Capital Gain Crystallization

The impact of the proposed increase in the capital gains inclusion rate can be significant, resulting in a higher tax rate of 8 – 9% for corporations, trusts, and individuals at the top marginal tax rate. Accordingly, there may be a benefit to implementing a possible sale (or disposition – such as a gift/transfer) of investments or real estate properties with significant accrued gains before June 25, 2024, to capture the current 50% inclusion rate, particularly where these gains would otherwise be realized in the next couple of years. However, some considerations include:

- Acceleration of taxes owing, and other possible impacts to a higher taxable income – such as potential OAS clawback, and cash flow issues related to higher tax liabilities/installments.
- Potential AMT considerations for individuals and trusts.
- The 'time value of money', which will create a 'break-even' point after which it would 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. In general, the lower the expected return, the longer the timeframe before this 'break-even' point occurs.
- The timing of transactions will be important to ensure settlement on or before June 24, 2024, at the latest. For example, for publicly traded securities, since the Canadian and U.S. exchanges have recently moved to next-day trade settlement, the last trading day for settlement on Monday, June 24, will be Friday, June 21.

Given the availability of the annual $250,000 threshold for individuals, many individuals will be able to avoid the proposed higher inclusion rate by timing their dispositions to stay below this threshold each year. However, the following scenarios may warrant action to accelerate a sale, transfer, or a crystallization transaction to create a disposition for tax purposes before June 25, 2024:

- Proposed near-term exercise of stock options or sales of capital assets (such as securities, real estate, shares of private businesses) with large accrued capital gains.
- Individuals with a shortened life expectancy holding assets with significant accrued capital gains that would otherwise be realized at death (particularly where no spousal/common-law partner rollover is available).
- Investment holding companies with significant accrued capital gains, since the $250,000 threshold is not available to corporations and since the addition to the Capital Dividend Account (CDA) will decrease (with the corresponding increase to the capital gains inclusion rate).

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Conclusion

The proposed increase in the capital gains inclusion rate announced in the recent 2024 Federal Budget has significant implications for many taxpayers and introduces possible tax planning opportunities prior to the June 25, 2024 effective date. However, caution is warranted before proceeding with any tax-motivated transactions since these measures remain only proposals at this stage and may not ultimately be enacted into law as described, or at all. As such, readers are advised to consult with their external tax and legal advisors for tailored advice on how they may be affected by these proposals and for specific direction in their particular circumstances.

For more information, please ask your BMO Private Wealth Professional for a copy of our full report, *2024 Federal Budget – A Deeper Dive into the Proposed Increase to the Capital Gains Inclusion Rate*.

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