2024 Federal Budget Review

A Deeper Dive into the Proposed Increase to the Capital Gains Inclusion Rate

The recent 2024 Federal Budget proposed several important new measures impacting individuals and business owners, most notably a change in the capital gains inclusion rate (from 1/2 to 2/3 effective June 25, 2024) for all capital gains realized by corporations and trusts, and for individuals on annual capital gains exceeding $250,000.

This article highlights some key implications of an increased capital gains inclusion rate to various taxpayers and considers some potential planning considerations for those impacted. For full details of the most significant income tax measures affecting individuals and Canadian private companies, please refer to our *2024 Federal Budget Review* publication.

Note that the measures introduced in the recent Federal Budget, including the changes to the capital gains inclusion rate, are only proposals at this stage and may not ultimately be enacted into law as described, or at all. Moreover, at the time of writing, no draft legislation has yet been released on the proposed increase to the capital gains inclusion rate, so many details regarding the specific application of these proposals are unknown. In light of this uncertainty, readers are cautioned to consult with their independent tax advisors for specific advice and direction on how they may be affected by these proposals, as we await further announcements from the Department of Finance on these important developments.

General Commentary

Capital Gains Inclusion Rate

Under current tax legislation, one-half of a capital gain is included in computing a taxpayer's income – referred to as the capital gains inclusion rate. Effective for capital gains realized on or after June 25, 2024, the 2024 Federal Budget proposes to increase 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 announced recently that Quebec intends to amend its legislation to harmonize with the Federal changes to the capital gains inclusion rate and consequential measures (with the exception of the stock option deduction, which will require the Quebec nuances to be legislated separately).

Capital Losses

Net capital losses of prior years will continue to be deductible against taxable capital gains in the current year by adjusting their value to reflect the inclusion rate of the capital gains being offset. Essentially, a gross capital loss realized prior to the rate change would still fully offset an equivalent gross capital gain realized after the inclusion rate change. For taxation years that straddle June 25, 2024, two different inclusion rates would apply. As a result, transitional rules would be required to separately identify capital gains and losses realized before and after the June 25 effective date.

Capital Gains Reserve

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). However, even if the property is sold prior to June 25, 2024 (including prior year transactions), 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 - but this treatment is uncertain until the draft legislation is released.

Planning Opportunities

Many initial discussions following the Federal Budget contemplate a possible sale (or disposition – such as a gift) 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 other potential impacts to a higher taxable income – such as potential OAS clawback, alternative minimum tax (discussed below), and cash flow issues related to higher tax liabilities / instalments.

However, in situations where significant accrued capital gains would otherwise be realized in a short timeframe following the proposed increase in the capital gains inclusion rate, the benefit of accessing the current 50% capital gains inclusion rate by liquidating (before June 25, 2024) and re-investing the proceeds immediately could exceed the 'time value of money' advantage lost, by foregoing the deferral on these gains that would otherwise be realized in the future (albeit at the proposed higher tax rate, assuming that rate is still in effect at the time of a future disposition).[1] For example, our modelling suggests a 'break-even' point at which a taxpayer would be indifferent between holding an existing asset with an accrued capital gain, versus liquidating (before June 25, 2024 to access the current 50% inclusion rate) and reinvesting the after-tax proceeds immediately in the same investment.

For example, as outlined in the chart below, for an individual with an existing security with an accrued gain of $1,000,000 (FMV $2M and cost base of $1M), assuming further capital appreciation of 5%, the break-even point would be approximately 8 years. Accordingly, if the individual expects to only hold this asset for the short-term and does not anticipate holding the asset beyond this break-even point, it may be advantageous to sell prior to June 25, 2024 to realize the current, lower capital gains inclusion rate. To the extent that the expected return is lower, the break-even point will be longer (and vice-versa).

However, these basic calculations are only estimates and would need to be extrapolated to the actual situations of specific taxpayers, who should consult with their tax advisors for advice and direction in their particular situation, and to confirm the tax attributes relevant to a potential sale transaction (including determination of the proper tax cost base, possibility of "superficial" losses, etc.).

In addition, it will be important to consult with your BMO Financial professional to discuss your asset allocation, cash flow needs, investment time horizon and broader investment goals, before undertaking any tax-motivated investment transactions.

		Immediate Sale: Sell prior to June 25 and reinvest proceeds				**Tax Deferral:** Hold and sell in future year at 2/3 inclusion rate				
Calendar Year	End of Year Sale	Future Value of Asset	Realized Gain	Capital Gains Taxes	Value of Asset (after-tax)	Future Value of Asset	Realized Gain	Capital Gains Taxes	Value of Asset (after-tax)	Difference (after-tax)
2025	1	$1,837,500	$87,500	**$21,875**	$1,815,625	$2,100,00	$1,100,000	**$345,833**	$1,754,167	**$61,458**
2029	5	$2,233,493	$483,493	**$140,331**	$2,093,162	$2,552,563	$1,552,563	**$496,688**	$2,055,875	**$37,286**
2032	8	$2,585,547	$835,547	**$257,682**	$2,327,865	$2,954,911	$1,954,911	**$630,804**	$2,324,107	**$3,757**
2033	9	$2,714,824	$964,824	**$300,775**	$2,414,050	$3,102,656	$2,102,656	**$680,052**	$2,422,604	**-$8,555**
2036	12	$3,142,749	$1,392,749	**$443,416**	$2,699,332	$3,591,713	$2,591,713	**$843,071**	$2,748,642	**-$49,309**

Assumptions:

- Taxpayer is an individual that is subject to a top marginal tax rate of 50%
- Owns an investment with a current market value of $2M and tax cost of $1M, i.e., $1M accrued capital gain
- Expected rate of return is 5% accrued capital growth only (i.e., no income yield)
- In each year of sale, the capital gains taxes provide that the first $250,000 realized gain is subject to a 50% inclusion rate and any excess gain is subject to a 66.67% inclusion rate
- Alternative Minimum Tax (AMT) does not apply

Individuals - Possible Implications and Planning Opportunities

$250,000 Threshold

As noted previously, unlike other taxpayers (such as corporations and trusts), individuals will be allowed a $250,000 threshold below which the capital gains inclusion rate will remain at its current rate (50%). Notably, the $250,000 threshold for individuals will not be prorated for 2024 and would only apply in respect of net capital gains realized on or after the effective date of June 25, 2024 - i.e., the extent of net capital gains realized in the current year from January 1 to June 24, 2024 (Period 1), will not impact this threshold in the June 25 to December 31, 2024 timeframe (Period 2). However, net capital losses realized in Period 1 (or net capital losses applied from another taxation year) will reduce the capital gains subject to the higher inclusion rate in Period 2, such that only the portion of net capital gains arising in Period 2 that exceed the $250,000 threshold, will be subject to the higher capital gains inclusion rate (2/3).

Given the availability of this annual $250,000 threshold, many individuals will be able to avoid the proposed higher inclusion rate by timing their dispositions to stay below this threshold each year. Since it is expected that all individuals will be eligible for their own $250,000 threshold, income splitting (of capital gains) amongst with family members could assist in managing this threshold, although there are many provisions in the tax legislation that seek to prohibit income splitting (e.g., income attribution rules, Tax on Split Income (TOSI), etc.).

Stock Options

As a related measure to the proposed increase in the capital gains inclusion rate, an individual claiming the employee stock option deduction will only be eligible for a one-third deduction of the taxable benefit as of June 25, 2024. However, they would still be entitled to a deduction of one-half of the benefit up to a combined limit of $250,000 for both employee stock options and capital gains.

Tax Rates on Investment Income

The proposed increase in the capital gains inclusion rate has considerably reduced the discrepancy in the top marginal tax rates for individuals on investment income. Specifically, the top marginal tax rate on capital gains will now increase from approximately 25%, to 35% in most provinces and territories, which is similar to the top marginal tax rate on eligible dividends (which varies widely, but averages 35% to 40%), which could have implications to many investment and asset allocation decisions for top rate taxpayers. In addition, this reduced gap in rates will affect many tax planning strategies previously undertaken, such as “surplus stripping” which seeks to extract corporate retained earnings at capital gains rates, and post-mortem planning involving holding corporations (discussed below).

Tax-Loss Selling

The amount of capital gains that are subject to tax each year is based on the calculation of net capital gains, which is the sum of all capital gains less all capital losses realized in the year. Accordingly, many taxpayers engage in a tax-loss selling strategy, typically towards the end of their taxation year, where a sale makes sense from an investment perspective. With this strategy, investments that have declined in value are sold to generate a capital loss for tax purposes, which can be used to offset capital gains that are generated during the year.

Given the higher capital gains inclusion rate proposed, tax loss selling at year-end will become more important, since the amount of net capital gains realized in Period 1 would not impact the $250,000 threshold in Period 2. Moreover, it will be worthwhile to strategically consider the application of capital loss carrybacks from future years, in light of the amount of tax paid on net capital gains reported in the 2024 or prior taxation year(s), since a loss applied to a capital gain with a 2/3 inclusion rate will be more beneficial. For more information on Tax Loss selling, including the “superficial loss rules” and other considerations, please ask your BMO Financial Professional for a copy of our *Understanding Capital Losses* publication.

Alternative Minimum Tax

Introduced in 1986, the AMT is a parallel tax calculation for individuals (and many trusts) that calculates an alternate taxable income that allows fewer deductions, exemptions, and tax credits than under the ordinary income tax rules, and applies a flat tax rate on this adjusted taxable income (exceeding a standard exemption amount) instead of the usual progressive rate structure. A taxpayer ultimately pays the AMT or regular tax, whichever is highest. The 2023 Federal Budget proposed several changes to the AMT calculation, with the stated goal of better targeting high–income individuals by broadening the AMT base, further limiting tax preference items (i.e., exemptions, deductions and credits) and increasing the AMT tax rate.

Notably, although currently only 50% of a capital gain realized is included in income for regular tax purposes, for AMT purposes, 100% of the capital gain is proposed to be included effective in 2024 and thereafter (which is up from the 80% inclusion for AMT purposes in prior years). Since the proposed AMT rate for 2024 of 20.5% would exceed the current top Federal regular tax rate on capital gains of 16.5% (i.e., 33% x ½ inclusion rate), many individuals with large capital gains who claim offsetting deductions, exemptions or credits to substantially reduce their regular tax liability may be subject to the AMT in 2024. However, the proposed higher capital gains rate of 2/3 will lessen the likelihood of AMT applying in these scenarios after June 24, 2024, since the top Federal regular tax rate on capital gains will increase to 22% (i.e., 33% x proposed 2/3 inclusion rate), which will exceed the flat AMT rate of 20.5%. Notwithstanding these proposed changes, the AMT may be relevant for many higher-income individuals (and many family trusts) who seek to crystallize large, accrued capital gains prior to June 25, 2024.

The 2024 Federal Budget proposed some changes to the original amendments noted above, including an increase in the charitable donation tax credit for AMT purposes to 80% (instead of the previously proposed 50%). However, an awareness of AMT will be critical for charitable high-income earners who donate securities, because of this reduced donation tax credit and the proposed increase to the inclusion rate to 30% (vs. 0% currently) of capital gains incurred when donating publicly-listed securities, for the purposes of the AMT calculation in 2024, and thereafter.

Please see our *Alternative Minimum Tax* publication for a detailed overview of the broader amendments initially proposed to the AMT, which have not yet been formally enacted at the time of writing.

Cottage / Real Estate

Although the increase in the capital gains inclusion rate will primarily impact the wealthiest Canadians, many families with significant accrued gains on real estate may also be impacted. In light of the long sales process and the short timeframe it will be difficult for property owners contemplating a sale to access the current 50% capital gains inclusion rate by June 25, 2024. However, for any real estate sales currently in negotiation, the closing date will be relevant in the determination of the capital gains inclusion rate and ultimate tax liability, pending the details of the forthcoming draft legislation.

Families who have been contemplating the transition of cottage property to the next generation may consider the acceleration of the transfer / gift prior to the June 25, 2024 effective date of the proposed change, to access the current 50% inclusion rate, subject to consideration of all implications, such as funding the tax liability, managing future usage of the cottage and potential land transfer tax.

Notably, the Federal Budget documents clearly indicate that the Principal Residence Exemption is not affected by these proposals such that any gain realized on the sale of your home (or other property qualifying as a principal residence) will remain tax-free. However, it should be noted that recent amendments to the tax legislation will tax the sale of Canadian residential properties held for less than 12 months, including a rental property, as business income (and ineligible for the Principal Residence Exemption). However, exemptions apply for Canadians who sell their home due to certain life circumstances, such as a death, disability, the birth of a child, a new job, or a divorce.

To the extent it is desirable to maintain the cottage ownership in the family, the proposed increase in the capital gains inclusion rate could impose a higher tax liability at death (as noted below). In this regard, life insurance can be an effective and tax-efficient source of funding to cover a potentially higher tax liability on death.

Death

For Canadian income tax purposes, when an individual dies they are deemed to dispose of their capital properties and to have received proceeds equal to fair market value ("FMV") immediately prior to death, which may result in a capital gain and an income tax liability on the deceased's terminal (final) return. However, where assets are transferred or bequeathed to a surviving spouse (or common-law partner) the assets are deemed to have transferred at their cost amount, thereby providing for a tax-deferred "rollover" of the assets to the surviving spouse.

Accordingly, the date of death of an individual will be relevant in the determination of the capital gains inclusion rate and ultimate tax liability, pending the details of the forthcoming draft legislation. As above, the one-time realization of a large capital gain at death could cause the higher capital gains inclusion rate to impact many average Canadians. Individuals with a shortened life expectancy – particularly those without a spouse or common-law partner – may therefore wish to

consider planning to realize accrued capital gains prior to the June 25 effective date, or plan to spread these gains over multiple years, as previously noted.

Non-residents
There are many considerations if a change in tax residency has occurred, most notably for Canadian tax purposes a "deemed disposition" of worldwide assets (with certain exceptions) at the time of departure would occur, triggering any accrued capital gains/losses as at the date of the cessation of Canadian residency. Accordingly, the specific date of the cessation of Canadian residency for tax purposes will be relevant in the determination of the capital gains inclusion rate, pending the details of draft legislation. However, it is uncertain whether this $250,000 threshold will apply to non-residents of Canada on capital gains subject to Canadian tax, such as gains on "Taxable Canadian Property".

Finally, individuals leaving Canada permanently should consider the potential impact of AMT, since it could represent an additional (unrecoverable) tax liability in the year they cease Canadian residency.

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. This is perhaps more significant for corporations (or trusts), particularly investment holding companies, since there is no annual $250,000 threshold to manage future capital gains such that all net capital gains realized after June 24, 2024 will be subject to the higher capital gain inclusion rate. Unfortunately, the simple calculations to determine a 'break-even' point when selling a portfolio of securities with (only) accrued gains before June 25, 2024 (to crystallize capital gains at the current inclusion rate and re-purchasing the same portfolio immediately with the after-tax funds), versus maintaining the existing portfolio, are complicated by the refundable tax system that applies to corporate investment income.

Integration
The concept of integration within the Canadian tax legislation for Canadian-Controlled Private Corporations (CCPCs) seeks to make an individual indifferent between earning investment income personally, or indirectly through a corporation. This is a concern since an individual earning investment income directly pays only one level of taxation, whereas someone earning investment income through a corporation will pay tax at two levels (i.e., corporate tax on the investment income earned in the corporation and personal tax on the distribution of the after-tax income to the individual shareholder; which is typically received as a dividend). Integration attempts to equalize the ultimate tax paid in either scenario. Through the use of various corporate tax accounts, such as the Capital Dividend Account ("CDA") and the Refundable Dividend Tax on Hand accounts, as well as other tax mechanisms (e.g. dividend tax credit, and dividend refund), distributions from a corporation may result in a refund of corporate tax previously paid and/or will be subject to a reduced personal rate of taxation as partial compensation for this high initial corporate tax paid.

This integration methodology seeks to equalize the aggregate amount of corporate and personal tax paid in a corporate structure, with the amount of tax paid for investment income earned personally that is subject to only one level of taxation. However, the integration system is imperfect and often results in a pre-payment of tax or a tax cost from double taxation when a corporate structure is used to earn investment income, particularly for US/foreign investment income subject to withholding tax at source. Unfortunately, the proposed higher inclusion rate will exacerbate the integration breakdown for capital gains, resulting in 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).

The government announced in the 2024 Federal Budget that it intends to make other consequential amendments as a result of the inclusion rate increase and to release additional design details in the coming months, but it is uncertain whether the negative impacts to integration will be addressed.

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 be considering a possible wind-up of their corporation to distribute the after-tax proceeds to invest

personally, either before the June 25, 2024 effective date of the proposed changes, or subsequently. However, these shareholders should be aware that there may be significant corporate and personal tax costs to wind-up the company and distribute the corporate assets, particularly where there are large, accrued gains on the (investment) assets within the company. Specifically, any accrued investment gains would be realized by the corporation on wind-up and there would be a personal tax cost to distribute the assets (in-kind or in cash following liquidation) to its shareholder(s). Ultimately, taxpayers should work with their tax advisors to determine the possible tax costs of winding up the corporation now vs. the annual (and ultimate – e.g. death) tax costs of maintaining the corporation, in light of the proposed tax changes.

For more information on the taxation of investment income within a corporate structure and tax-efficient ways of distributing funds from the corporation, please ask your BMO professional for our publication *Understanding Personal Holding Companies*.

Donation of Publicly-Traded Securities

A popular charitable giving strategy is to donate shares of publicly-traded securities with accrued gains. Although a donation of securities is considered a disposition for tax purposes, tax incentives provided to encourage charitable donations will eliminate the taxable capital gain that would otherwise be realized on a disposition and allow a tax receipt for the full value of the donation. Because of recent proposed changes to the Alternative Minimum Tax (AMT) noted previously, some charitable higher-income Canadians may experience a reduced benefit from this strategy when donating personally. However, 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 (without the $250,000 threshold available to individuals), charitably-minded shareholders may wish to consider using this donation strategy through their corporation.

Corporate charitable giving can also provide the same tax benefits as individual giving, namely the potential elimination of any capital gains tax on a qualifying gift of publicly-traded securities, however, a tax deduction (instead of a tax credit for individuals) equal to the fair market value of the gift is available (up to a maximum of 75% of current year net income). This will result in a reduction of the tax that would otherwise be payable on income earned by the corporation.

For a CCPC which donates a qualifying publicly-traded security, the 100% non-taxable capital gain portion will be added to its Capital Dividend Account ("CDA"). This notional account, when positive, may be paid to shareholders on a tax-free basis, which could facilitate the withdrawal of funds from the company to its shareholders.

Additional Considerations for Investment Holding Companies (Holdcos)

Post-Mortem Planning

As outlined previously, the use of a corporation to hold investments creates the potential for double taxation, by introducing a second level of (corporate) taxation. At death, double-taxation could arise 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). This is of particular concern when an individual dies while owning shares of an investment holding company, and their heirs are more likely to sell the underlying assets owned within the company and wind it up, instead of selling the shares of the company directly to a third party after death (such as an active business).

Various post-mortem tax strategies exist to reduce or eliminate this double taxation, however, the proposed increase to the capital gains inclusion rate will further complicate this planning as a result of the changes to the integration system described previously. Accordingly, shareholders should work with their tax and estate advisors to carefully track the potential consequential amendments to the tax legislation resulting from the proposed increase in the capital gains inclusion rate and update their Wills and estate plan accordingly to ensure tax minimization for the estate and its beneficiaries.

Capital Dividend Account ("CDA")

The CDA represents the cumulative non-taxable portion of net capital gains/losses and certain other amounts (such as life insurance proceeds) received by a corporation. It is an important component of the tax integration system described previously. Distribution of the CDA allows for the tax-free flow-through of certain amounts that would be non-taxable if the shareholder had received them directly. Since CDA represents the cumulative balance at a point in time, it is generally beneficial to distribute whenever a significant

positive balance exists (and prior to the realization of any accrued capital losses).

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
CCPCs accessing the small business deduction (SBD) and earning investment income – such as professional corporations - should be aware of the 'claw back' of the small business deduction by $5 for every $1 of passive investment income above a $50,000 threshold. Accordingly, a (professional) corporation earning over $150,000 of passive investment income itself or through an associated corporation, will lose access to the small business deduction and would therefore be subject to the higher general corporate tax rate.

Since the taxable portion of capital gains will increase due to the higher inclusion rate, it is likely that the current asset allocation will result in many (professional) corporations reaching this $50,000 taxable income threshold earlier, potentially resulting in a reduction in the SBD. As a result, shareholders should consult with their tax advisors to determine how they may be affected by these proposed changes, pending the details of the forthcoming draft legislation.

Additional Considerations for Business Owners, Farmers and Fishers

Estate Freeze
A potential strategy used to transfer wealth or implement a succession plan, and to manage the tax liabilities on a transfer, is to freeze the value of your shares during your lifetime. An "estate freeze" allows you to fix the value of all or part of the capital gains accrued to date on the shares of your business. The future growth in the business is transferred to the eventual owners, typically your children, either directly or through a family trust.

By limiting the tax liability on an appreciating asset in this way, your estate may avoid facing a potentially higher tax liability in the future, upon your death. Your estate's tax liability can be limited by the fixed present value of your "freeze" shares, and any future capital gains can be taxed in the hands of the new owner(s) and sufficient life insurance can then be obtained to cover your fixed death tax liability. With the possibility of a higher inclusion rate on capital gains realized on a future sale of your business (above the $250,000 threshold for individuals), the benefits of an estate freeze will be even more pronounced. Assuming your business continues to grow in value, the earlier the estate freeze is undertaken, the amount of (future) capital gains that can be deferred to the next generation will increase.

For more information on this strategy, please contact your BMO Financial professional for a copy of our publication, *Transferring Your Business 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). However, in light of the long sales process and the short timeframe it will be difficult for business owners, or farmers/fishers, 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 closing date will be relevant in the determination of the capital gains inclusion rate and ultimate tax liability, pending the details of the forthcoming draft legislation.

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). In that regard, notably the 2024 Federal Budget seeks to counter the impact of the higher capital gains inclusion rate to small business owners, by increasing the LCGE (from approximately $1M to $1.25M for capital gains realized after June 24, 2024), introducing a temporary $10M Employee Ownership Trust Tax Capital Gain Exemption, and providing a lower capital gain inclusion rate on dispositions of shares of certain qualifying businesses, through the new Canadian Entrepreneurs' Incentive.

For our full report on all significant measures affecting Canadian individuals, private businesses and charities, please contact your BMO Private Wealth professional for a copy of our publication entitled *2024 Federal Budget Review*.

Family Trusts - Possible Implications and Planning Opportunities

Capital Gain Crystallization

As noted above for individuals and corporations, 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 such that all net capital gains realized after June 24, 2024 will be subject to the higher capital gain inclusion rate to the extent of taxable income that is retained in the trust and not distributed to the beneficiaries. Unfortunately, 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, although it is expected that capital gains distributed to Canadian resident beneficiaries will retain their character and be included in the $250,000 threshold available to individuals.

Graduated Rate Estates and Qualified Disability Trusts

Although a trust is treated as an "individual" for tax purposes, it is notable that the Federal Budget proposals did not provide a $250,000 threshold to trusts, likely to prevent taxpayers from creating separate trusts to 'multiply' this benefit. However, it remains unclear how certain trusts will be subject to the proposed changes to the capital gains inclusion rate, such as a Graduated Rate Estate (GRE) - which arises upon an individual's death for a period of up to 36 months while the estate is being administered – and a Qualified Disability Trust (QDT) – which can be established for a beneficiary who is eligible for the Federal Disability Tax Credit. It is possible – though uncertain – that a different treatment could arise for these specific trusts given their nature, as has been provided for other tax measures, including the recent AMT proposals.

Alternative Minimum Tax (AMT)

The AMT rules apply to trusts that are not "exempt trusts" (such as a GRE) in much the same manner as they do for individuals, with a key difference being that most trusts (excluding QDTs) are not eligible for the AMT exemption threshold. However, trustees of other (non-exempt) trusts, such as family trusts, will need to consider if the proposed AMT changes could result in an AMT liability, even though the trust has allocated all of its (regular) income to beneficiaries to be taxed in their hands. This determination will be further complicated by the proposed increase to the capital gains inclusion rate, resulting in potentially higher taxable income to trusts after June 24, 2024.

Spousal, alter-ego and joint-partner trusts (Life Interest Trusts)

Certain trusts provide specified beneficiaries with the right to receive income from the trust, during their lifetime. The most common of these "Life Interest" trusts include alter-ego trusts, joint-spousal or common-law partner trusts, and spousal or common-law partner trusts. These trusts offer many benefits in estate planning, such as confidentiality, probate tax planning, creditor protection and incapacity planning.

Similar to an individual, the death of beneficiary individual of a life-interest trust will cause a deemed disposition for tax purposes of all the assets of the trust at fair market value and any resulting capital gains would be taxed within the trust. The proposed changes to the capital gains inclusion rate, which results in potentially different treatment between individuals and trusts, will have important implications for these life-interest trusts, during both the lifetime of the beneficiary(ies) and upon their death. Accordingly, the estate planning community will be tracking these developments closely, to determine if any consequential amendments to life interest trusts will be introduced in the forthcoming draft legislation.

Other Considerations

Life Insurance

Permanent insurance, such as whole life and universal life, provides coverage for long-term needs that are ongoing, evolving and of a permanent nature, such as estate preservation, business succession planning, supplementing retirement income, income tax reduction, and paying one's final taxes and estate settlement costs. 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. In addition, considering insurance as an alternative investment in light of the higher taxes on investments or

properties realizing capital gains, can uncover many benefits such as:

- no taxation during the accumulation period;
- earnings gained on a policy's cash value are not taxable;
- no taxation on the death benefit received; and
- the receipt of the life insurance policy death benefit in a corporation will create a credit in your company's Capital Dividend Account, which can be paid out tax-free to shareholders.

The General Anti–Avoidance Rule (GAAR)

The General Anti–Avoidance Rule ("GAAR") in the tax legislation seeks to prevent abusive tax avoidance by denying a tax benefit that was unfairly created. In recent Federal Budgets, the government has proposed changes to modernize and strengthen the GAAR and ensure its continued effectiveness.

In a recent CRA Interpretation (2024-1016011E5), in respect of potential planning undertaken in advance of the proposed increase in the capital gains inclusion rate, the CRA stated that "it is our view that where a taxpayer crystallizes an accrued capital gain prior to the increase in the capital gains inclusion rate, the GAAR would generally not apply to redetermine the inclusion rate in respect of the crystallized capital gain." However, the CRA further added that "the crystallization of an accrued capital gain as part of a series of transactions, one of the main purposes of which is to obtain a tax benefit (other than, or in addition to, the taxation of an accrued gain at the current inclusion rate) would not be immune from scrutiny under the GAAR." Accordingly, taxpayers should consult with their external advisors for confirmation of the specific tax implications in their particular scenario in respect of any potential planning undertaken.

Conclusion

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.

1 Although the current 50% capital gains inclusion rate has been in place since October 18, 2000, the capital gains inclusion rates have historically ranged from one-half to three-quarters since the taxation of capital gains was first introduced in Canada in 1972.

This document is a summary of the Federal Budget and does not represent BMO Financial Group's view on the tax policies expressed in the Federal Budget.

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