The increasing capital gains inclusion rate: Think first, (maybe) act later

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Much has been made (and continues to be made) of the government's decision in the 2024 federal budget to increase the portion of capital gains that are included in income from 50 per cent to $66^{2/3}$ per cent, effective June 25, 2024. Starting then, for natural persons two-thirds of capital gains realized each year above $250,000 will be included in income (any favourably taxed stock option benefits realized will reduce the $250,000 limit). For corporations and trusts, the two-thirds inclusion rate will apply to all capital gains realized on or after June 25, 2024. For an Ontario resident subject to tax at the highest marginal rate, the change in inclusion rate represents an increase in the effective tax rate on capital gains from roughly 26.8 per cent to 35.7 per cent. The result is to leave Canada with one of the highest marginal capital tax rates in the world.

The government has consciously chosen this effective date to give taxpayers the opportunity (if not actively encourage them) to realize capital gains before that date. This is quite unusual: most such amendments are made effective on the date they are announced, so as to prevent action being taken to sidestep the tax increase. The government is inviting taxpayers to realize gains in the next couple of months that might otherwise be realized later, and in so doing pay tax sooner but (potentially) at a lower rate.

Having choices is good, but taxpayers would be well-advised to think hard before deciding to trigger the realization of gains before June 25. The fact that only a fairly short period of time exists before then means that decisions will need to be made quickly and likely on the basis of imperfect information. Not all properties are capable of being sold within two months, although in some cases it may be possible to effect a controlled realization of gains via a sale to a non-arm's length party (e.g., a wholly controlled corporation), although even this involves transactions costs. Depending on the taxpayer's circumstances, some gains realized will trigger actual tax payable while others won't, and in some cases realizing gains after June 24 will produce a better result. Moreover, in some cases the desired commercial objective can be achieved without realizing gains at all. There are many things to think about before realizing a gain by June 24.

Change of law risk – Part I

The government has tried very hard to frame this move as an issue of "fairness", claiming that "only 0.13 per cent of Canadians with an average income of $1.4 million are expected to pay more personal income tax on their capital gains in any given year." Various constituencies from doctors to the tech sector to entrepreneurs to the business sector generally to owners of cottages or investment properties have all reacted to this change with varying degrees of anger. Concern has also been raised that this measure may affect many individuals who are deemed to realize all of their gains and losses upon death (this can also occur on emigrating from Canada, with some exceptions). Judging by the blowback reported in the media so far, the government is not winning the battle to frame the narrative on this issue as simply "asking the wealthiest Canadians to pay their fair share", and indeed trying to sell this measure on the basis it will only affect the wealthiest Canadians seems ill-considered if not disingenuous (there are few if any family doctors amongst that group).

Before accelerating the realization of capital gains before June 25, taxpayers should consider the possibility that the government may retreat from this proposal, either wholly or partially. For example, there are various changes the government could make that would eliminate some of the "collateral damage" (as the PBO puts it) and better align with its narrative that only the very wealthy will be impacted, such as:

- exempting "personal-use property" that is not "listed personal property," such as cottages (already subject to special treatment as capital losses on such property are not recognized), perhaps up to a specified dollar limit
- extending the $250,000 annual 50 per cent inclusion rate allowance to all taxpayers, not just natural persons, so as to take most small corporations out of scope; or
- expanding the scope of relieving provisions directed at entrepreneurs such as the seldom used eligible small business corporation rollover, to facilitate reinvestment of profits in high-risk start-up ventures.

Politics were clearly a significant element of this move, and the resulting political impact may be a cause for the government to resile from it. While rare, this type of retreat has occurred before, most recently a few years ago with respect to proposed changes to small business taxation. It is by no means beyond the realm of possibility that something similar may occur here (especially with a minority government riding low in the polls), and the recent debacle over the last minute cancellation of bare trust tax reporting (after most of those affected had incurred the compliance costs) is still fresh in everyone's minds.

Change of law risk – Part II

Even if these changes are enacted as proposed, the potential for a further change in law must be considered. A federal election is scheduled for less than 18 months away. Given the reaction to date, the potential exists for the Conservatives to view this issue (at least in its current form) as a political winner in terms of promising to repeal it or substantially narrow its scope. Anyone realizing a gain in 2024 and effectively pre-paying their tax may regret doing so if 2025 ends with the capital gains inclusion rate going back to 50 per cent within a short period of time.

Doing the math on unsheltered gains

Moving past change of law risk, fundamentally the choice being offered by the government (in some but not all cases, as discussed below) is to pay less tax based on a lower capital gains inclusion rate for dispositions before June 25, but to pay it sooner. “Sooner” may not be “sooner” at all for dispositions that would have occurred anyways during the 2024 taxation year, or “not much sooner” for dispositions that would have occurred anyways shortly thereafter. However, the further out in time one goes, the greater the time-value-of-money cost of accelerating into 2024 the payment of tax that would otherwise have been payable in a later year. Hence, unless the taxpayer has sufficient shelter available (see below) to absorb the gain such that tax is not actually payable, anyone considering triggering a disposition (even a non-arm’s-length one) just to crystallize the gain at the 50 per cent inclusion rate needs to form a view as to where interest rates and inflation are heading, so as to quantify the benefit of deferral.

Risks in acting: Rules unknown

The capital gains inclusion rate is part of a much larger and intricate tax system contained in the *Income Tax Act* (Canada) (ITA). Changing that single variable impacts the operation of many, many other rules within the statute, most notably the personal/corporate tax integration regime.

Apart from a couple of sentences dealing with stock option benefits, the Budget made only a very general reference to the fact that a number of other ITA provisions will need to be changed to reflect the higher inclusion rate:

> Other consequential amendments would also be made to reflect the new inclusion rate. Additional design details will be released in the coming months.

It is doubtful that those “coming months” will include May or June 2024, and somewhat discouraging that the government is clearly anticipating (based on its own revenue estimates) and indeed hoping that many taxpayers will accelerate the realization of gains based on incomplete information (don’t ask if such estimated revenue could really all be attributable to Canada’s wealthiest 40,000 people). Without a significantly higher degree of certainty as to what consequential changes will be made to provisions dealing with (for example) other provisions that are part of the personal/corporate tax integration regime and the various rules applicable to the realization of losses and their use to offset gains, choosing to accelerate the realization of gains without a complete understanding of the consequences is a risky exercise. Entities such as partnerships and trusts that allocate capital gains out to members or beneficiaries are in a particularly tricky position. The government would do everyone (including itself) a favour by deferring the effective date until after draft legislation with detailed rules for implementing this change have been released with adequate time to review them.

Is it taxable anyway?

Natural persons (and certain trusts) may be subject to alternative minimum tax (AMT), an alternative tax calculation designed to ensure that sufficient tax is paid by high-income earners who pay relatively low rates of regular income tax due to specific tax preference items (indeed, had the government pursued this initiative via an AMT amendment it would have been easier to defend as being limited to the very wealthy). One such item is capital gains, which as of 2024 are 100 per cent included in income for AMT purposes. Anyone contemplating the early realization of a capital gain to take advantage of a 50 per cent capital gains inclusion rate should determine the extent to which AMT might apply. AMT payable may be carried forward up to seven years and used to reduce normal income tax otherwise owing. Trustees of trusts that are subject to AMT will have some particularly difficult decisions to make, in terms of the impact on beneficiaries. Corporations are not subject to AMT.

The $250,000 annual limit for natural persons

After June 24, 2024, natural persons will be able to realize $250,000 of capital gains per year and still benefit from the existing 50 per cent inclusion rate. For some people, thoughtful use of this annual limit (which is not indexed to inflation) will be enough to largely or entirely avoid the higher $66^{2/3}$ per cent inclusion rate, depending on their circumstances. For example, while the ITA does have loss suspension rules that deny recognition of losses on property that is sold to trigger a loss and then immediately repurchased, no such rule applies to realizing gains. Hence for example, it may be possible to realize the gain on a portfolio of stocks over time and still remain fully invested. Moreover, in many cases properties may be jointly owned by two individuals (i.e., spouses owning a cottage), each of whom can – subject to the income attribution rules - use their own $250,000 limit against their own portion of the gain.

Some forms of property (e.g., real estate investment properties) cannot easily be disposed of in partial annual sales the way a stock portfolio can. For others, even a staggered realization over time may involve unacceptable costs such as land transfer tax or taxable income from the recapture of depreciation previously claimed. One simple fix the government could offer to address this issue would be to include a provision that allows a taxpayer to realize such amount of an accrued capital gain as exists on their property as they choose up to $250,000 per year, with a corresponding increase in their cost basis in that property. While still accelerating the payment of tax relative to what would otherwise be the case (unless accompanied by relief to allow deferred payment),such a deemed disposition solely for income tax purposes would allow natural persons to make full use of the annual $250,000 limit without incurring the costs of an actual disposition. This seems like low-hanging fruit for a government that claims to be targeting only the wealthiest Canadians.

How much net taxable capital gain really is there?

The fact that capital gains will be taxed at higher rates if these changes are enacted as proposed makes it that much more important to ensure that taxpayers make the best possible use of their available tax attributes in order to minimize the amount of capital gain left to be taxed. Depending on the circumstances, the amount of such taxable gain may be less than is immediately apparent. Numerous tools exist within the ITA specifically to reduce or eliminate capital gains taxation in appropriate circumstances, and these should be fully explored before acting precipitously to trigger gains before June 25 just to benefit from a lower inclusion rate.

As a general rule, losses from other sources may be used against capital gains, providing valuable shelter from taxation. A variety of rules[1] govern how losses are categorized, when they are considered realized, when they are recognized for tax purposes and when they may be applied against income or gains. The availability of existing loss carryforwards (or accrued but unrealized losses that can be permissibly crystallized) may influence the decision to trigger gains before June 25 and incur the costs involved and the risks thereby assumed.

In a corporate group (e.g., Canadian corporations under common control), it is frequently possible for losses of one entity to be applied against income or gains within another. Where accrued gains exist within a corporate group, the importance of intra-group loss planning should be carefully considered as part of any strategy to address the potential increase in corporate capital gains taxation before prematurely triggering gains.

In some cases, actually waiting to realize capital gains may be the better strategy under the proposed changes in the 2024 budget. Canadian-resident individuals benefit from the lifetime capital gains exemption on dispositions of qualified small business corporation shares (or qualified farm or fishing property), the amount of which is being increased to $1.25 million in the 2024 federal budget for dispositions occurring *on or after* June 25, 2024. Shareholders of private Canadian corporations are well-advised to look into whether those corporations qualify (or can be made to qualify) for this valuable exemption and undertake planning steps to make optimal use of this tax planning tool (e.g., planning to utilize the exemption for multiple family members), whether as part of a possible sale transaction or otherwise. Similarly, the 2024 federal budget also introduced a new Canadian Entrepreneurs' Incentive, which provides for a *reduced* capital gains inclusion rate on the sale of shares of a small business corporation by founders that meet certain conditions, effective (on a phased-in basis) starting in 2025. Some taxpayers will need to determine what is best for them based on the changes to the capital gains inclusion rate, the increased lifetime capital gains exemption and the Canadian Entrepreneurs' Initiative.

Reducing capital gains in an M&A context

The impact of an increase in the capital gains inclusion rate requires careful consideration in a mergers & acquisitions context. Among other reasons, this is because various mechanisms exist within the ITA specifically to reduce corporate taxation of capital gains, corporations being the taxpayers most impacted by the proposed amendments (and the largest source of expected tax revenue from them, according to Department of Finance projections).

Some of these structural mechanisms are specific to M&A transactions, while others are available outside of corporate acquisitions but are nonetheless especially useful as part of planning for an M&A transaction to reduce capital gains otherwise realized. For example, one source of relief may be Canada's foreign affiliate regime for the taxation of Canadian corporations that own a significant equity interest in a foreign subsidiary. Where the Canadian corporate shareholder has an accrued gain on the shares of that foreign subsidiary, that gain can often be reduced or even eliminated by a dividend received (or deemed for Canadian tax purposes to have been received) in respect various "surplus" accounts that the Canadian shareholder computes and tracks for Canadian tax purposes. Such s. 93(1) ITA dividends are specifically intended to reduce

Canadian tax on capital gains otherwise realized by Canadian corporations (in particular for gains attributable to active business income earned by foreign subsidiaries in countries with which Canada has international tax agreements) as part of the capital import neutrality[2] explicitly designed into the corporate tax system.

“Safe income” dividends represent another frequently used mechanism within the Canadian corporate tax system that exists specifically to reduce capital gains permissibly. Like the s. 93(1) dividend for foreign subsidiaries, the “safe income” concept makes use of actual or deemed dividends, but in this case between Canadian corporations. The basic concept is that to the extent that the accrued gain on a corporation’s shares is attributable to amounts that have already borne corporate-level tax during the particular shareholder’s period of share ownership (i.e., retained earnings, as opposed to accrued but unrealized gains on the corporation’s property), a tax-free dividend from that Canadian corporation to its Canadian corporate shareholder to reduce the latter’s gain on the dividend payer’s shares is not abusive. Where a corporation has significant accrued gains on shares of a foreign or Canadian corporation, some or all of that gain could be eliminated via s. 93(1) ITA or “safe income” dividends, respectively, reducing the impetus to accelerate the realization of any such gains before June 25th, 2024.

Other tools for managing corporate capital gains are more specific to corporate acquisitions. For example, where a Canadian corporation acquires all of the shares of a Canadian target corporation and thereafter winds up or amalgamates the Canadian target up into itself, it is quite often possible to eliminate the accrued but unrealized gains on the Canadian target corporation’s non-depreciable capital property (e.g., land or shares). This s. 88(1)(d) cost basis step-up is an extremely valuable tool that an acquiror may use to avoid inheriting existing accrued gains on significant assets owned by a Canadian corporation.

Similarly, where control of a corporation has been acquired, its accrued but unrealized losses are deemed to have been realized, unlocking them to be used without an actual disposition of those properties. Because post-acquisition-of-control use of pre-acquisition-of-control losses is often restricted or prohibited[3], a corporation that undergoes an acquisition of control can make a one-time election under 111(4)(e) ITA[4] to use such losses (including any deemed-realized losses) to offset any gains (including accrued but unrealized gains) the target corporation has on its property. As such, careful pre-closing planning in M&A transactions to ensure that gains and losses are in the same entity can go a long way towards eliminating corporate capital gains that would otherwise eventually be realized.

Finally, even when gains are realized, they may not be subject to Canadian tax in all cases. Most notably, non-residents of Canada are generally subject to Canadian tax on capital gains they realize only on property that is “taxable Canadian property” (e.g., interests in land in Canada, or unlisted securities deriving their value primarily from such interests in Canadian land). Even in the case of “taxable Canadian property”, a non-resident may be exempt from Canadian tax on gains under a tax treaty[5] between Canada and its home country. For this reason, M&A transactions with a tax deferral component are frequently structured to restrict Canadian tax deferral to Canadian residents who will actually be taxable in Canada on capital gains realized.

Capital gain deferral

Finally, where gains cannot be eliminated, there is still potential to defer recognition of them (perhaps indefinitely) in an M&A context, depending on the circumstances. Amongst the many tools open to the parties for bridging valuation gaps on M&A transactions is a tax-deferred share-for-share exchange, whereby a seller willing to accept shares of a Canadian corporation as part or all of the sale price can defer capital gains[6] otherwise realized. Indeed, most assets can be transferred to a Canadian corporation on a tax-deferred basis under s. 85(1) ITA in exchange for shares of the buyer. Even where the buyer is not a Canadian corporation, use of an "exchangeable share" structure may allow a comparable deferral of Canadian tax for those taxpayers otherwise taxable on their gains. Depending on how long the anticipated hold period is and one's view on the time value of money in the interim, a lengthy enough deferral of tax provided by a tax-deferred exchange may be better than paying tax sooner at a lower capital gains inclusion rate.

Similarly, corporate reorganizations can often be effected on a tax-deferred basis in a perfectly permissible manner without gains being realized. A common example is divisive reorganizations[7] (sometimes called "de-mergers") whereby one Canadian corporation effectively splits into two. Within specific constraints set out in the ITA and Canada Revenue Agency administrative policy these can be done without gain or loss being realized rather than requiring corporate-level and/or shareholder-level gains to be realized (although even here if sufficient tax attributes exist and the transaction is properly structured, a "taxable" divisive reorganization may not involve any tax actually being paid).

Earnouts

Sellers in transactions with an earnout feature will need to consider both their particular circumstances and the specific terms of their earnout. In some cases, they will likely wish to pursue a reverse earn-out in order to crystallize the entire gain for tax purposes before June 25 and accept the pre-payment of tax as the cost of getting the lower inclusion rate. In other cases where the earnout is spread out over time and most or all of it can benefit from the annual $250,000 limit available to individuals, the choice will be less clear, and more analysis will be necessary. For completed transactions with an earnout that is still active, it may be open to the parties to come to a negotiated result that achieves a better result for the seller than the status quo, depending on the circumstances.

So, what should I do?

Where the taxpayer is fairly certain of disposing of an asset during 2024 in any event (or emigrating from Canada, which creates a deemed disposition), it will usually but not always be desirable to do so before June 25 if waiting would cause the resulting gain being taxed at a higher inclusion rate. However, this will not universally be the case. Individuals able to stagger the realization of gains over time to take advantage of the $250,000 annual limit will be in a different position than others, as are those who can claim the increased lifetime capital gains exemption and/or benefit significantly from the Canadian Entrepreneurs' Initiative. Where it would be beneficial to accelerate realization of a capital gain before June 25 and completing an arm's-length sale by then would be impractical, it may be possible to do so via a non-arm's-length transaction. The important point is that each case depends on the taxpayer's own circumstances, and one should not assume that realizing the gain before then will always be the right move.

The most useful thing a taxpayer can do at this stage to put themselves in a position to make an informed decision is to carefully review their own situation, in particular:

- forming a view on the likelihood of a further change of law, and the time value of money in the future (i.e., the benefit of deferring the payment of tax);
- reviewing what useful tax attributes the taxpayer has available to it; and
- obtaining advice (preferably on a confidential solicitor-client privileged basis) as to the best planning options based on those facts.

Because in some cases establishing what the facts are can take a significant amount of time (e.g., computing a corporate shareholder's share of a corporation's "safe income"), the time to start is now. There are many variables to consider and quite a bit of information to gather in order to be in a position to make an informed, considered decision.

Contact us

If you have any questions about the new capital gains inclusion rate, reach out to BLG's tax group or any of the key contacts below.

Footnotes

[1] See under 5., Losses.

[2] See para. 55.

[3] See page 457.

[4] See page 791.

[5] See under Tax Treaties & Capital Gains.

[6] See page 781.

[7] See under 10. Mergers & Divisive Reorganizations.

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