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TAX LETTER

August 2024

HOW DO THE NEW CAPITAL GAINS RULES AFFECT YOU?
CRA STEPPING UP COVID BENEFIT RECOVERY MEASURES

HOW DO THE NEW CAPITAL GAINS RULES AFFECT YOU?

In April, as part of the Federal Budget, the Finance Minister announced a change to the capital gains inclusion rate from 50% to 66.67%, effective from June 25, 2024.

No matter your level of wealth, this change likely WILL affect you at some point. So, what has changed?

What is the capital gains inclusion rate?

The capital gains inclusion rate represents the portion of capital gains that are included in your income and thus subject to tax. Since 2000, this rate has been 50%, meaning that if you bought a capital asset for $100 and sold it for $400, you would have a $300 capital gain, 50% of which ($150) would be subject to income tax in the year of sale. The actual rate of tax depends how much other income you have in that year, and is normally somewhere from 20% to about 53%, depending on your level and province of residence.

The same applies to capital losses. If you sell an asset for a loss of $300, only $150 of this loss could be used to offset capital gains and reduce your tax bill.

Capital gains only started to be subject to tax in 1972. Before 2024, the inclusion rate had only been changed 4 times in over 50 years. A capital gains inclusion-rate change is therefore a major and fundamental change to the Canadian tax system.

Given the magnitude of the change, it is unfortunate that it was announced in April 2024 and became effective on June 25, 2024, with no relief given for gains accrued before then. This provided only a small window of time for taxpayers to digest the change and perhaps make significant decisions about whether to realize gains before the change took effect in order to pay less tax.

For the purposes of the discussion that follows, it is important to highlight that these changes, although effective from June 25, 2024, **have not yet become law**. The amendments to the Income Tax Act to change the inclusion rate and make related changes are still only in draft form and have not yet been enacted by Parliament.

Therefore, the new rules discussed below may change further before becoming law or could theoretically not even come into law at all.

What has changed?

The inclusion rate has changed from 50% to 66.67%, or two-thirds. This means that for capital gains that are realized (triggered on a sale) since June 25, 2024, more of that same $300 gain in the example above will be included in your taxable income and subject to tax. Specifically, $200 of the gain is subject to tax, rather than $150 under the old 50% inclusion rate.

To soften the blow of this overnight increase in tax, a new 50% inclusion rate band was introduced for *personal* capital gains. The **first $250,000 of capital gains each year** realized in an individual's personal hands, rather than through a corporation or a trust, continue to be brought into the income at the 50% rate. However, gains above this $250,000 threshold are subject to the new 66.67% inclusion rate.

This band is available in full every year, although it isn't possible to accumulate bands over the years. It is a "use it or lose it" band every year – although you *can* use the "capital gains reserve" rule, explained further below, to split a gain over up to 5 years if you don't receive the proceeds of the sale right away, and to get the 50% rate to apply to $250,000 gain for each of those years.

Importantly, the 50% inclusion rate is not available to corporations or to most trusts. Therefore, for these entities, the new inclusion rate will now apply from the first $1 of capital gains realized.

In the April 2024 tax letter, we discussed the fundamental tax concept of integration that tax rules are designed in such a way that the same amount of tax should be paid irrespective of whether income or gains are realized by an individual, by a corporation or through another type of entity). The new $250,000 band, as it applies only to individuals, appears to be completely at odds with this important concept as it now appears to be more beneficial in certain circumstances to hold capital assets personally, as the tax on personal capital gains may be lower!

A further softening of additional tax blow came in the form of an increase to the lifetime capital gains exemption (for certain small business shares and farm/fishing property) – increased to $1.25 million from just over $1 million. This increase only applies to qualifying capital gains realized on or after June 25, 2024.

The changes took effect in June.
What are the rules for 2024?

2024 represents a transitional year, as the new capital gain inclusion rate rules take effect for capital gains realized beginning June 25, 2024. To prevent uncertainty come tax time next year, the new rules divide 2024 into two periods: period 1 (January 1 through June 24) and period 2 (June 25 through December 31).

Any capital gains triggered in period 1 are subject to the old 50% inclusion rate. Capital gains triggered in period 2 are subject to the new 66.67% inclusion rate but also benefit from a full $250,000 50% inclusion rate band if the taxpayer is an individual (human being).

It was this dividing of 2024 into two periods that caused many people to rush out and realize capital gains in period 1.

As we are now into period 2, any capital gains realized from now through the end of 2024 will be subject to the 66.67% inclusion rate (subject to the availability of the personal $250,000 50% band).

There are various other transitional rules determining the inclusion rate that applies in specific circumstances. These rules particularly affect corporations (see the discussion of capital dividends below).

These new rules as a whole are very complex and **business owners should consult their tax advisor** if any significant gains or losses are expected before the end of 2024, as this could affect the inclusion rate applying to gains and losses occurring earlier in the year.

Are there any potential traps to watch out for this year?

Yes! In fact, there are some significant potential side-effects which may come as a nasty surprise next year if not appropriately planned for.

Firstly, for taxpayers who sold assets or investments to take advantage of the old inclusion rate, these sales will have generated a **2024 tax liability**. This is the case whether the money received on the sale has been retained or whether it has been re-invested or used for another purpose.

For example, where a taxpayer held shares, particularly stock exchange shares, it was possible to quickly sell these in order to realize a gain and then to immediately repurchase the same shares so that the initial investment was retained.

In that situation, the taxpayer would no longer have the cash from the sale, as this was re-invested, but now the taxpayer has an upcoming tax liability, payable in April 2025, with tax calculated based on 50% of the capital gain realized.

Therefore, it is important to plan now for a cash outlay next spring if assets were sold this year. Your tax advisor should be able to give you an estimate of the expected tax liability.

On a similar note, an aspect of Canadian taxation often overlooked is **Alternative Minimum Tax** (AMT). This concept will be particularly relevant for 2024 due to a combination of the rush to sell assets before June 25 and recent changes to the AMT system itself.

The concept behind AMT is that all taxpayers should pay a “fair” amount of tax, irrespective of the various tax exemptions and credits that they may be able to claim.

Behind the scenes of every personal tax return filed are two simultaneous tax calculations: the “normal” tax calculation and the AMT calculation.

The AMT calculation treats various types of income and credits slightly differently compared to the normal calculation. Taxpayers pay tax based on which of these two calculations produces the highest tax figure.

In most cases the “normal” calculation will produce the higher amount of tax. Most taxpayers are not even aware that this separate AMT calculation is taking place in the background.

The AMT calculation is very complex, but one of the differences between both calculations is that the AMT calculation has a 100% inclusion rate for capital gains. The recent amendments to the AMT calculation increased this inclusion rate from 80%, which applied before 2024.

Therefore, in a year such as 2024, where taxpayers may have realized large capital gains as a one-off event, there is an increased possibility of the AMT calculation for 2024 resulting in a higher tax figure compared to the normal tax calculation.

This may come as a surprise in April next year when tax-filing software determines that your tax liability is based on the AMT calculation rather than the calculation that you may be expecting!

This may not necessarily result in more tax payable over time. The excess of AMT over the normal tax calculation can be recovered if you have sufficient tax payable over the following 7 years (the AMT excess can be used to pay those tax liabilities). However, if you don't have a large enough tax liability over the following 7 years to recover the AMT excess, it becomes a permanent tax.

If you have large capital gains in 2024 and you don't usually have a significant tax liability, it is recommended that you discuss this with your tax advisor sooner rather than later to determine whether you are potentially going to pay extra upfront tax due to AMT. If so, there may plans you can put in place to try to ensure that you claw the excess back in future years.

Finally, the draft legislation as it currently stands may impact on the tax treatment of any **capital dividends** that have been paid out by a corporation in its 2024 tax year.

Each corporation has a capital dividend account, whose job is to keep track of the non-taxable portion of capital gains. To mirror the non-taxable portion of gains for individuals, the non-taxable portion of corporate gains (and non-allowable losses) is added to this account. Any positive balance in this account can be paid out tax-free to shareholders.

It is important to ensure that you don't pay out more capital dividends than there is balance available in the capital dividend account. Any excess withdrawn is subject to a penalty tax.

Businesses and their advisors keep a running total of all gains and losses realized by a corporation throughout its lifetime to ensure that the balance at the time of the capital dividend is sufficient to cover the full dividend amount paid out tax-free.

The transitional capital gains rules, as they are drafted, result in a peculiar situation in certain circumstances with respect to the percentage of gains and losses added to this capital dividend account for the entire corporate tax year that includes June 25, 2024.

As a result of these transitional rules, the exact amount added to the corporation's capital dividend account may not be able to be calculated until after the 2024 tax year. This is because the addition percentage may be calculated based on the split of gains and losses in both period 1 and period 2, which won't become clear until the year has ended.

The immediate consequence of this is that a corporation may have paid out a capital dividend before June 25, 2024 which was **greater than the actual capital dividend account balance** as calculated at the end of the year.

If you are a business owner who has paid out a capital dividend in your 2024 tax year, or if you plan to do so, you should contact your tax advisor for advice and to determine whether the balance of your capital dividend account is sufficient to pay the dividend, given the calculations contained in the new transitional rules.

I didn't realize any gains prior to the change. Did I miss out?

That depends! If your plan was to hold your capital properties for a long time, and you wouldn't otherwise have sold, you probably haven't missed out.

If a person sold an asset just because they wanted to benefit from the old inclusion rate, that sale is final and any future growth in value of the asset will belong to the buyer. If that person had instead kept the asset, they would have benefited from future growth in value.

Much depends on the rate of return that can be achieved on a particular asset but, very generally, by holding on to the asset for at least 7-12 years, it is likely that the growth in value of the asset will exceed the additional tax the person has saved by selling the asset before June 25, 2024.

Therefore, if you didn't otherwise have plans to sell an asset within 1-7 years, you quite likely have not missed out!

How might the change affect plans I've already made?

Any financial plans you have already made should be reviewed with your financial advisor in light of these capital gains rule changes, particularly if investments are involved.

There are a number of ways in which the rule changes could affect actions and plans which have already taken place. One of these is the 2024 **capital dividend** issue above.

Another is the impact of the new rules on **capital gains reserves**.

Often, when large capital assets are sold, payment is received in instalments over a number of years. When this happens, taxpayers have the ability to spread out the tax liability over up to five years.

So if, for example, you sold an asset in 2022, you may be able to report just one-fifth of the gain on your tax return for each of the five years beginning in 2022, and spread the tax out over those years.

The new rules confirm that the inclusion rate of the reserve gains brought in each tax year will be based on the inclusion rate which applies in that year. Therefore, these gains may be subject to the new 66.67% inclusion rate even if the original gain occurred before 2024!

If you are currently claiming a capital gains reserve, it may be worth considering bringing the remaining reserve gains into your tax return in 2024, as the new rules confirm that any reserve gains brought into the 2024 tax return will come in at the old 50% inclusion rate. As with everything else, you should discuss this with your tax advisor before taking any action.

Note however that the reserve rule can allow you to **multiply the new $250,000 threshold** for capital gains to be taxed at only 50 %. If you sell a property now but arrange to have payment only over time (e.g. you take back a mortgage, or sell property to a family member or friend), you can spread the gains over up to 5 years. Each can spread the gains over up to 5 years. Each year the portion of the gain that come into your income is eligible for the $250,000 threshold, to the extent you do not have other capital gains that year that are using up the threshold. So the $250,000 threshold can be up to $1,250,000, if you plan the sale correctly.

Finally, on a non-tax matter, any plans made in respect of administering your estate when you pass on should also be reviewed.

When we die, we are deemed to have sold all of our assets for tax purposes at fair market value just before death. Tax is payable at the time of our death on any gains that have accumulated on our assets while alive.

Many people plan for this, including taking out insurance to cover the estimated tax due on death. Given the increased capital gains inclusion rate, it is likely that the tax payable on death will now be higher than before for many people, meaning that insurance already taken out to cover tax on death may no longer be sufficient to cover the full tax bill.

Any existing policies should be reviewed in conjunction with a review of your expected tax liability on death with your tax advisor.

How might the change affect planning I might want to do in the future?

Over the last 20+ years, most corporate and estate planning has been undertaken on the assumption that the capital gains inclusion rate will remain at 50%. Therefore, some plans put in place years or decades ago may no longer be as tax-efficient as they could be.

For example, contrary to a common understanding held for years, and contrary to the fundamental principle of tax integration, it may now be more beneficial (from a tax perspective at least) to hold capital assets personally rather than in a corporation.

As individuals benefit from the $250,000 50% inclusion rate band, but corporations don't, significant tax could potentially be saved on capital assets when held personally. Obviously there are many non-tax reasons for preferring to hold assets in a corporation, but the tax implications of doing so will now play a larger role in such decisions.

Planning for death also now takes on an even greater importance. Overnight, the likely tax bill on death has increased significantly for many people. Therefore, steps should be taken as early as possible to put plans in place to minimize the deemed disposition of capital assets on death. This could involve actions such as lifetime gifting and structuring businesses to ensure that future growth passes to the next generation while you are alive.

On a related matter, lifetime estate planning, while already very tax-efficient, may have become even more attractive. Estate freezing allows you to retain the current value of your assets, while passing future growth to family members, commonly through a family trust. This already has a number of tax and other benefits when it comes to your legacy.

One of the big selling points of an estate freeze, particularly where a person owns farmland or shares of a corporation that qualify for the capital gains exemption, is that the capital gains exemption can be multiplied on a sale of the farmland or business by allocating portions of the gain to trust beneficiaries. Each beneficiary can use their capital gains exemption to shelter their allocated gain from tax.

Now in addition to this, each individual beneficiary will also have a $250,000 50% inclusion rate band that they can use against gains that are not covered by the capital gains exemption.

Therefore, gains arising in a trust through a structure such as an estate freeze can be allocated to beneficiaries, maximizing the availability of the now lower 50% inclusion rate!

Irrespective of the type of plans you already have in place, or you want to put in place, these should be reviewed now with your tax and financial advisors to make sure that they achieve your goals, given the new rules.

CRA STEPPING UP COVID BENEFIT RECOVERY MEASURES

The CRA recently announced that it is moving to the next phase of measures to recover COVID benefits that may have been incorrectly claimed.

Benefits include the Canada Emergency Response Benefit (CERB), the Canada Recovery Benefit (CRB) and the Canada Worker Lockdown Benefit (CWLB), among others.

A common theme with these benefits is that it was up to the taxpayer to determine whether they were eligible at the time of claiming. The CRA did not review eligibility before paying the amount claimed, and made it clear that eligibility may be reviewed at a later date.

If you have claimed any of these benefits in the past few years, you may have been contacted by CRA either requesting proof that you were eligible or informing you that CRA has decided that you weren't eligible and that you need to repay the benefit received.

CRA has now announced that, from July 2024, they will start to issue legal warnings to taxpayers who have not responded to such letters, or have not been co-operative. CRA do advise that "legal measures are only taken when there is no cooperation from an individual with an ability to repay the debt".

If you have received such letters, and you haven't done so already, now would appear to be the time to work with the CRA to either establish your eligibility or agree to a repayment of any over-claimed amounts. More details can be found here.

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