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Tax Alert – Canada

Proposed change in capital gains inclusion rate

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 16 April 2024, as part of the 2024 federal budget (Budget 2024), the federal government proposed an increase to the capital gains inclusion rate. In this Tax Alert, we provide an outline of those changes and opportunities that may be available to crystallize inherent capital gains to take advantage of the current inclusion rate.

The proposals summarized below are outlined in the *Tax Measures: Supplementary Information* document, which accompanies the Budget 2024 package. It is important to note that the draft legislative details required to implement these proposed changes were not provided by the Department of Finance (Finance) in the Notice of Ways and Means Motion in Budget 2024 or in Bill C-69, *Budget Implementation Act, 2024, No. 1*, which received first reading in the House of Commons on 2 May 2024.¹ Finance notes in the Budget 2024 package that the design details and other consequential amendments will be released in the coming months.

Background

Currently, one half of capital gains realized by Canadian taxpayers are included in their income. Budget 2024 proposes to increase the capital gains inclusion rate, for capital gains realized on or after 25 June 2024, from one half to two thirds for corporations and trusts, and from one half to two thirds on the portion of capital gains realized in the year that exceed \$250,000 for individuals.

¹ For more information on the income tax measures included in Bill C-69, refer to [EY Tax Alert 2024 Issue No. 27](#).

Individuals claiming the employee stock option deduction will be provided a one-third deduction of the taxable benefit to reflect the new capital gains inclusion rate, but will be entitled to a deduction of one half the taxable benefit up to a combined limit of \$250,000 for both employee stock options and capital gains.

Transitional rules will be required to separately identify capital gains and losses realized before the effective date (being 25 June 2024) and those realized on or after the effective date. For example, taxpayers will be subject to the higher inclusion rate in respect of the portion of their net gains arising on or after the effective date (in excess of the \$250,000 threshold in the case of individuals), to the extent that these net gains are not offset by a net loss incurred before the effective date or any other taxation years. The annual \$250,000 threshold for individuals will be fully available in 2024 (i.e., it will not be prorated) and will apply only in respect of net capital gains realized on or after the effective date.

Quebec has announced that it will harmonize with the proposed increase to the capital gains inclusion rate but is still reviewing the proposed changes to the stock option deduction.

Additional Budget 2024 related measures include, but are not limited to, an increase in the lifetime capital gains exemption (LCGE) on up to \$1.25 million (from \$1,016,836 in 2024) of capital gains realized on the disposition of qualified small business corporation shares and qualified farm or fishing property. The increased limit will apply to dispositions that occur on or after 25 June 2024, and indexation of the LCGE will resume in 2026.

There is also a new Canadian entrepreneurs' incentive proposed in Budget 2024 whereby the tax rate on capital gains will be reduced on the disposition of qualifying shares by an eligible individual, by one half of the prevailing inclusion rate, on up to \$2 million in capital gains per individual over their lifetime. This measure will apply to dispositions that occur on or after 1 January 2025 and will apply in addition to any available capital gains exemption. The lifetime limit will be phased in by increments of \$200,000 per year, beginning on 1 January 2025, before ultimately reaching a value of \$2 million by 1 January 2034.

Impact to effective rates and integration

The tables in Appendix A summarize some of the income tax implications of the proposed changes to the capital gains inclusion rate in certain provinces. The analysis also compares the impact of a Canadian-controlled private corporation (CCPC) realizing capital gains (and distributing the after-tax amount as a dividend) in comparison to an individual realizing capital gains directly. Most notably, the tax cost to an individual of earning capital gains in excess of \$250,000 through a CCPC post-24 June 2024 will increase by approximately 8.5% to almost 10%, depending on the province of residence, and any small tax deferral advantage will be eliminated and replaced with a prepayment of tax.

Planning opportunities in anticipation of increased capital gain inclusion rate

Transfer of assets

Prior to 25 June 2024, there is the opportunity for a taxpayer to crystallize existing accrued capital gains so that the taxpayer can benefit from the lower inclusion rate. There is also an opportunity to undertake transactions prior to 25 June 2024 and then decide after 25 June 2024 whether the capital gain should be realized in full, partially or not at all.

For example, a transfer of property to a taxable Canadian corporation for shares of the taxable corporation would be a fully taxable transaction, but if the property transferred is eligible property as defined in subsection 85(1.1) of the *Income Tax Act* (the Act), a joint election may be filed in accordance with subsection 85(1) of the Act. This joint election would give the transferor taxpayer the ability to elect only a partial capital gain or no capital gain at all if the taxpayer later decided not to realize a capital gain prior to 25 June 2024.

It is important to note that certain types of properties are excluded from qualifying as eligible properties (and as such the subsection 85(1) election would not be available), such as real property held as inventory and certain real properties held by nonresidents of Canada.

A transfer made pursuant to subsection 85(1) of the Act generally provides the taxpayer with the option to elect an amount to be deemed as proceeds of disposition to the taxpayer for each transferred property. Where the property transferred has an accrued capital gain, the taxpayer should be able to elect any amount at or above the adjusted cost base (or undepreciated capital cost, as applicable) but not exceeding the fair market value of the property. Therefore, the elected amount selected will impact the amount of the capital gain (and/or recapture, as applicable) realized by the transferor on the disposition of each property. In this scenario, as noted above, the taxpayer would have the option to elect to trigger a full or partial capital gain on the transfer (and therefore incur a tax liability at the lower inclusion rate) or elect at the adjusted cost base so as to not trigger any capital gain, such that the transfer would occur on a fully tax-deferred basis.

The above planning mechanics are expected to allow taxpayers to realize inherent capital gains on eligible properties prior to 25 June 2024 to benefit from the current lower capital gain inclusion rate. If a joint election under section 85 is filed, the election form would be due on or before the earliest date on which any party to the election has to file an income tax return for the tax year in which the transaction occurred, with the possibility to file the election within the three following years if payment for the late filing penalty² is included with the filing. Where the transferor is a corporation, the taxes owing on any income generated

² The penalty is the lesser of the following two amounts: (1) one-quarter of 1% of the amount by which the fair market value of the transferred property exceeds the elected transfer price, for each month or part of a month from the time the election was due to the time it is actually filed; and (2) \$100 for each month or part of a month from the time the election was due to the time it is actually filed, up to a maximum of \$8,000.

(including capital gains realized) would generally be due two months following the taxpayer's year-end. Interest may start accruing on any unpaid balances after this date, and the current prevailing interest rate charged by the Canada Revenue Agency (CRA) on overdue taxes is currently 10% per annum.

There may be circumstances where it is preferential to transfer the property to a Canadian partnership instead of a taxable Canadian corporation. Similar to a transfer to a corporation, a transfer to a Canadian partnership would be a fully taxable transaction, but a joint election could be made pursuant to subsection 97(2) of the Act if there was a desire for the transfer to result only in a partial capital gain or no capital gain.

Share exchange

Another viable planning opportunity for taxpayers is to consider exchanging shares the taxpayer holds in a corporation in consideration for a different class of shares of the same corporation. On proper implementation, this type of share exchange generally should automatically occur on a tax-deferred basis under the Act (i.e., section 51 or section 86 of the Act). As such, neither provision should result in a capital gain being realized.

In cases where subsection 85(1) applies, neither of sections 51 nor 86 of the Act are to apply. Therefore, the share exchange agreement could provide for the taxpayer and corporation to jointly elect for section 85 to apply to the share exchange at the request of the taxpayer. This could be helpful in a scenario where a taxpayer holds shares of a corporation and prefers to have the flexibility to delay the determination of whether to realize inherent gains prior to the effective date of the capital gains inclusion rate increase.

Net capital loss carryforward balances

If a taxpayer is expecting to realize material capital gains on or after 25 June 2024, it may be beneficial to carry forward any currently available net capital loss carryforward balances to be used after this date. In doing so, the net capital losses carried forward may be applied to offset capital gains at a two-thirds inclusion rate, rather than carrying them back where they would only be applied to offset capital gains at a one-half inclusion rate.

Possible elective provision

While nothing has been confirmed by Finance as of yet, the tax community has inquired whether Finance would consider introducing an elective provision to permit taxpayers to elect to realize a capital gain on a property prior to 25 June 2024 without having to undertake legal transactions. This would help taxpayers avoid complex commercial transactions and a legal disposition of property, as well as reduce the compliance burden, given the short lead time to 25 June 2024. This option may only be available for taxpayers who have the current cash flow to prepay the tax liability (or significant losses carried forward to offset the capital gain generated).

Considerations in respect of planning opportunities

Present value of tax savings: prepay now versus pay later

Prior to implementing a transaction before 25 June 2024 to realize a capital gain at the lower inclusion rate, one should consider the cost-benefit analysis of paying the income tax today at the lower inclusion rate compared to the net present value of paying the income tax in the future at a higher inclusion rate.

Based on high-level net present value calculations (using a 5% after-tax rate of return and currently proposed tax rates), it may be more beneficial for a taxpayer to pay the income tax today at the lower inclusion rate if the taxpayer was otherwise intending to realize the capital gain within the next five years.

Sale transactions

Capital gains reserve: Where a portion of the proceeds of disposition is receivable in years following the year of disposition, a reserve may be available to taxpayers to defer the immediate realization of the entire capital gain so that it better aligns with the receipt of such proceeds. As such, in claiming a capital gains reserve, future recognition of the original capital gain may be subject to the higher inclusion rate.

It may therefore be beneficial to forgo claiming a reserve for the current year and instead realize the full capital gain at the lower inclusion rate. Similarly, for existing reserves, it may be beneficial to include the full amount in income before the increase in inclusion rate. These options may only be feasible to the extent the taxpayer has sufficient funds available to pay the income tax owing prior to receiving the proceeds on this portion of the capital gain.

Earnout agreements: The consideration paid by the purchaser to vendors in many sale transactions often includes an earnout component that is based on whether the company sold achieves certain future performance targets. Some earnouts are structured to meet the cost recovery method for Canadian income tax purposes, such that if/when the amount is received or receivable, it may be treated as being on account of capital and is included in taxable income at that time. There are also “reverse earnouts”, where the entire maximum purchase price is agreed on closing, with the earnout component being reduced if the agreed-upon targets are subsequently not achieved.

To take advantage of the lower inclusion rate for sale transactions closing in the days prior to 25 June 2024, a reverse earnout should be considered as the entire maximum capital gain is included in the taxpayer’s taxable income in the year the transaction closes. The taxpayer would need to have the funds available to pay the income tax liability arising from the earnout component prior to that portion of the proceeds being received.

Conclusion

Undertaking some of the proposed transactions to crystallize a capital gain at the current inclusion rate may have other unintended income tax consequences (i.e., triggering a safe income determination time or triggering other taxes, such as land transfer taxes), and therefore care should be taken when implementing such a transaction. In addition, since draft legislative proposals have not yet been tabled, limited information is currently available to fully assess the implications of the design details and consequential amendments that will be proposed throughout various sections of the Act.

The CRA recently indicated in a technical interpretation³ that crystallizing an accrued capital gain, solely as a means of ensuring access to the current inclusion rate, should not, in and of itself, be subject to the general anti-avoidance rules (GAAR) (as amended in Bill C-59, *Fall Economic Statement Implementation Act, 2023*).⁴ However, the CRA cautioned 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 the gain at the current capital gains inclusion rate), would not be immune to the application of GAAR.

In addition, the proposed alternative minimum tax changes expected to be effective from 1 January 2024 (which have yet to be enacted) also need to be considered on any capital gain crystallizations by individuals. Refer to [EY Tax Alert 2023 Issue No. 45](#) and [EY Tax Alert 2024 Issue No. 25](#) for a more comprehensive discussion of the proposed revisions to the alternative minimum tax.

As the capital gain inclusion rate is expected to increase in respect of dispositions occurring on or after 25 June 2024, it is crucial for taxpayers to start planning as soon as possible for any reorganizations, as other non-tax constraints and restrictions may apply (e.g., regulatory approvals required, customer/landlord consents to be obtained, land transfer taxes).

Consult your EY advisor to assess the benefits and opportunities of undertaking transactions prior to 25 June 2024.

³ See CRA document 2024-1016011E5.

⁴ For information on Bill C-59, see [EY Tax Alert 2023 Issue No. 44](#).

Learn more

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Appendix A: Impact to effective rates and integration

Alberta

	Pre-25 June 2024		Post-24 June 2024		Post-24 June 2024	
	Individual	Earned in CCPC (fully distributed)	Individual		Earned in CCPC (fully distributed)	
			Capital gain ≤\$250,000	Capital gain >\$250,000	Capital gain ≤\$250,000	Capital gain >\$250,000
Incremental capital gain amount	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
Corporate federal income tax		\$ 14.00			\$ 18.67	\$ 18.67
Corporate refundable tax		\$ 5.33			\$ 7.11	\$ 7.11
Provincial income tax		\$ 4.00			\$ 5.33	\$ 5.33
Total corporate income tax		\$ 23.33			\$ 31.11	\$ 31.11
Net cash	\$ 100.00	\$ 76.67	\$ 100.00	\$ 100.00	\$ 68.89	\$ 68.89
Non-eligible refundable dividend tax on hand		\$ 15.33			\$ 20.44	\$ 20.44
Available for distribution		\$ 92.00			\$ 89.33	\$ 89.33
Personal income tax	\$ 24.00	\$ 17.77	\$ 24.00	\$ 32.00	\$ 23.69	\$ 23.69
Net cash remaining	\$ 76.00	\$ 74.23	\$ 76.00	\$ 68.00	\$ 65.65	\$ 65.65
Effective tax rate	24.00%	25.77%	24.00%	32.00%	34.35%	34.35%
Tax cost/(saving)		1.77%			10.35%	2.35%
Tax deferral/(prepayment)		0.67%			(7.11%)	0.89%

British Columbia

	Pre-25 June 2024		Post-24 June 2024		Post-24 June 2024	
	Individual	Earned in CCPC (fully distributed)	Individual		Earned in CCPC (fully distributed)	
			Capital gain ≤\$250,000	Capital gain >\$250,000	Capital gain ≤\$250,000	Capital gain >\$250,000
Incremental capital gain amount	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
Corporate federal income tax		\$ 14.00			\$ 18.67	\$ 18.67
Corporate refundable tax		\$ 5.33			\$ 7.11	\$ 7.11
Provincial income tax		\$ 6.00			\$ 8.00	\$ 8.00
Total corporate income tax		\$ 25.33			\$ 33.78	\$ 33.78
Net cash	\$ 100.00	\$ 74.67	\$ 100.00	\$ 100.00	\$ 66.22	\$ 66.22
Non-eligible refundable dividend tax on hand		\$ 15.33			\$ 20.44	\$ 20.44
Available for distribution		\$ 90.00			\$ 86.67	\$ 86.67
Personal income tax	\$ 26.75	\$ 19.56	\$ 26.75	\$ 35.67	\$ 26.07	\$ 26.07
Net cash remaining	\$ 73.25	\$ 70.44	\$ 73.25	\$ 64.33	\$ 60.59	\$ 60.59
Effective tax rate	26.75%	29.56%	26.75%	35.67%	39.41%	39.41%
Tax cost/(saving)		2.81%			12.66%	3.74%
Tax deferral/(prepayment)		1.42%			(7.03%)	1.89%

Ontario

	Pre-25 June 2024		Post-24 June 2024		Post-24 June 2024	
	Individual	Earned in CCPC (fully distributed)	Individual		Earned in CCPC (fully distributed)	
			Capital gain ≤\$250,000	Capital gain >\$250,000	Capital gain ≤\$250,000	Capital gain >\$250,000
Incremental capital gain amount	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
Corporate federal income tax		\$ 14.00			\$ 18.67	\$ 18.67
Corporate refundable tax		\$ 5.33			\$ 7.11	\$ 7.11
Provincial income tax		\$ 5.75			\$ 7.67	\$ 7.67
Total corporate income tax		\$ 25.08			\$ 33.44	\$ 33.44
Net cash	\$ 100.00	\$ 74.92	\$ 100.00	\$ 100.00	\$ 66.56	\$ 66.56
Non-eligible refundable dividend tax on hand		\$ 15.33			\$ 20.44	\$ 20.44
Available for distribution		\$ 90.25			\$ 87.00	\$ 87.00
Personal income tax	\$ 26.77	\$ 19.22	\$ 26.77	\$ 35.69	\$ 25.62	\$ 25.62
Net cash remaining	\$ 73.24	\$ 71.03	\$ 73.24	\$ 64.31	\$ 61.38	\$ 61.38
Effective tax rate	26.77%	28.97%	26.77%	35.69%	38.62%	38.62%
Tax cost/(saving)		2.20%			11.86%	2.93%
Tax deferral/(prepayment)		1.68%			(6.68%)	2.24%

Quebec

	Pre-25 June 2024		Post-24 June 2024		Post-24 June 2024	
	Individual	Earned in CCPC (fully distributed)	Individual		Earned in CCPC (fully distributed)	
			Capital gain ≤\$250,000	Capital gain >\$250,000	Capital gain ≤\$250,000	Capital gain >\$250,000
Incremental capital gain amount	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00	\$ 100.00
Corporate federal income tax		\$ 14.00			\$ 18.67	\$ 18.67
Corporate refundable tax		\$ 5.33			\$ 7.11	\$ 7.11
Provincial income tax		\$ 5.75			\$ 7.67	\$ 7.67
Total corporate income tax		\$ 25.08			\$ 33.44	\$ 33.44
Net cash	\$ 100.00	\$ 74.92	\$ 100.00	\$ 100.00	\$ 66.56	\$ 66.56
Non-eligible refundable dividend tax on hand		\$ 15.33			\$ 20.44	\$ 20.44
Available for distribution		\$ 90.25			\$ 87.00	\$ 87.00
Personal income tax	\$ 26.66	\$ 19.60	\$ 26.66	\$ 35.54	\$ 26.14	\$ 26.14
Net cash remaining	\$ 73.35	\$ 70.65	\$ 73.35	\$ 64.46	\$ 60.86	\$ 60.86
Effective tax rate	26.66%	29.35%	26.66%	35.54%	39.14%	39.14%
Tax cost/(saving)		2.70%			12.48%	3.60%
Tax deferral/(prepayment)		1.57%			(6.79%)	2.10%

Notes and assumptions

- 1) The computations are based on all rate proposals announced up to 16 April 2024.
- 2) The table illustrates the tax cost (or savings) on a fully distributed basis of earning capital gains through a CCPC rather than directly as an individual. The table also illustrates the tax deferral (or prepayment of tax) that results when the income is earned and retained in the corporation.
- 3) The calculations assume the individual is taxed at the top marginal federal-provincial personal tax rate.
- 4) It is assumed that capital gains are eligible for refundable dividend tax treatment and that the corporation can pay the total amount of dividends necessary to recover the full amount of non-eligible refundable dividend tax on hand (RDTOH).
- 5) It is assumed that the non-taxable portion of any capital gains is flowed out to the shareholder as a capital dividend; however, there may be situations where it is more tax-effective to pay more taxable dividends (rather than a capital dividend) to recover non-eligible RDTOH.

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