PAUL RIOUX CPA inc.

Planification financière et fiscale

Capital Gain Inclusion Rate

2024

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In the Federal Budget of April 16, 2024, Finance Minister Chrystia Freeland announced an increase in the inclusion rate on capital gains realized after June 25, 2024 from 50% to 66.66% in certain circumstances. The Quebec government subsequently announced that it would harmonize with this new measure, which, rightly or wrongly, was the subject of much comments in the news.

For example, on April 23, the Canadian Medical Association (CMA) published on its website - somewhat awkwardly, it must be said - a warning that it would adversely affect the recruitment and retention of physicians.

https://www.cma.ca/about-us/what-we-do/press-room/proposed-tax-changes-will-hurt-physician-recruitment-retention-cma - :~:text=The%20Canadian%20Medical%20Association%20(CMA,and%20retention%20across%20the%20country.

Former Finance Minister Bill Morneau, for his part, mentioned that this would be detrimental to investment in Canada.

All this attention has prompted questions from many customers about the impact of this new measure on their tax and financial planning.

Please find below our comments on this subject.

Historical background

This is not the first time our governments have changed the capital gains inclusion rate.

Until 1972, capital gains were simply not taxable.

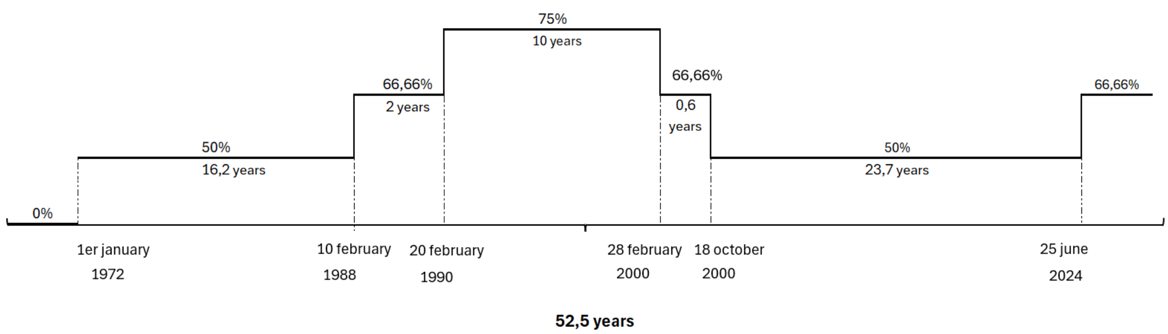
It wasn't until January 1, 1972 that 50% of capital gains became taxable as part of a major tax reform following a recommendation by the Royal Commission on Taxation, better known as the Carter Commission.

The inclusion rate then remained at 50% for 16 years, until February 10, 1988, when then Conservative Finance Minister Michael Wilson increased it to 66.66%, and two years later to 75% in his February 20, 1990 budget.

In 2000, the inclusion rate was reduced twice. First, from 75% to 66.66% in Liberal Finance Minister Paul Martin's February 28, 2000 budget, and then from 66.66% to 50% in the October 18, 2000 economic statement.

In 2000, financial institutions struggled to adjust tax slips and capital gains and losses reports to reflect capital gains for each tax period or rate. Older accountants still remember that tax season...

The following table illustrates the evolution of the capital gains inclusion rate since 1972.



From 1972 to 2024, the inclusion rate was 50% for around 40 of the 52 years.

The new measure

Effective June 25, 2024, the capital gains inclusion rate will be increased from 50% to 66.66%.

For example, on a realized profit of $1,000, the taxable capital gain to be reported on the tax return will increase from $500 to $666.

For individuals, this increase from 50% to 66.66% will only apply to annual gains in excess of $250,000.

Companies will not benefit from this $250,000 annual exemption, and all capital gains realized after June 25, 2024 will be subject to the new 66.66% inclusion rate from the first dollar.

The following table illustrates the maximum tax rates on capital gains before and after the new measure.

Maximum capital gains tax rate				
	Personnal	**Companies**		
	%	During accumulation %	After payment to shareholders %	Overlay %
Up to June 24 2024	26.66	25.08	29.36	2.70
From June 25, 2024				
▪ **Up to $250,000**	26.66	33.34	39.14	12.50
▪ **More than $250,000**	35.54	33.34	39.14	3.60

Individuals

As illustrated in the previous table, individuals realizing capital gains in excess of $250,000 will now be taxed at a maximum rate of 35.54% on excess gains, up 8.88% from the previous rate of 26.66%.

The following table shows the additional tax payable on capital gains realized on or after June 25, 2024.

Capital gain (100%)	**Additional personal tax at maximum rate according to the new inclusion rate of 66.66%.**			
	Inclusion rate		Additional personal tax	
	50%	66.66% (more than $250,000)		
$	$	$	$	% of the gain
Up to 250,000	66,638	66,638	-	-
300,000	79,965	84,408	4,443	1.48
400,000	106,620	119,948	13,328	3.33
500,000	133,275	155,488	22,213	4.44
1,000,000	266,550	333,188	66,638	6.66

The alternative minimum tax (AMT) must be taken into account for gains in excess of $1 million.

Companies

During the accumulation period

In the case of investments held by a company, capital gains will be taxed at a rate of 33.34% during the accumulation period, i.e. 6.66% more (33.34% - 26.66%) than at the personal level for personal gains under $250,000, or 2% less (33.34% - 35.54%) for personal gains over $ 250,000.

After distribution to shareholders

Once distributed to the shareholder, taking into account the combined corporate and personal tax, the overtaxation could reach 12.49% for gains under $250,000 and 3.60% for gains over $250,000.

The overtaxation of capital gains paid to the shareholder could be lower or even eliminated to the extent that the payments are made at retirement, when the personal tax rate is lower.

It should also be noted that the company's main advantage remains the fact that it can invest a larger share of future business or professional income, given the company's lower tax rate (26.5%, 20.5% or 12.5% depending on the situation) rather than 53.31% at the personal level.

To sell or not to sell before June 25, 2024, that is the question...

Individuals

Annual personal capital gains under $250,000

Given that only capital gains in excess of the $250,000 threshold will be subject to the new 66.66% inclusion rate, the vast majority of individuals will have no reason to anticipate selling and reinvesting before June 25, 2024.

To put things in perspective, let's just mention that less than 1% of clients declared capital gains in excess of $250,000 on their 2023 personal tax return, often from the sale of real estate or shares in private companies.

A sound portfolio tax management strategy aimed at not exceeding the $250,000 threshold and thus benefiting from the 50% inclusion rate seems to us to be the appropriate strategy.

In this respect, many clients were already in the habit of selling securities at year-end at a loss in order to reduce the amount of capital gains realized in the year.

This strategy could also be used in light of the new $250,000 annual capital gains threshold.

Annual personal capital gains in excess of $250,000

On the other hand, in certain situations where accumulated capital gains are very high, it is possible that future capital gains will exceed $250,000 and thus be subject to the new 66.66% inclusion rate. In this case, is it preferable to sell and reinvest before June 25, 2024?

The following table illustrates the difference between the 2 scenarios, assuming a 5% rate of return in the form of capital gains (without interest or dividends).

Years	No sale before June 25, 2024		Sell before June 25, 2024 and reinvest	
	Accumulated value		Accumulated value	
	Before tax	After tax	Before tax	After tax
	$	$	$	$
1	1,050	700	788	775
5	1,276	851	957	888
6	1,340	893	1,005	920
9	1,551	1,034	1,163	1,026
10	1,629	1,086	1,222	1,064
14	1,980	1,320	1,485	1,240
15	2,079	1,386	1,559	1,289
20	2,653	1,769	1,990	1,577
25	3,386	2,258	2,540	1,943

As can be seen from the previous table, it would take 9 years to make the strategy of holding on to the investments profitable, assuming a 5% rate of return. The following table illustrates the number of holding years required to make it profitable not to sell before June 25, 2024, and to hold the investments depending on the expected rate of return.

Expected yield of return	**Number of years of ownership required to make it profitable not to sell before June 25, 2024**
9%	5
7%	6
5%	9
3%	14

The higher the expected return, the shorter the holding period required to justify the decision to hold the investments. This is because, since you're not paying taxes, you have a higher sum invested, and the higher return more quickly offsets the higher future taxes at the 66.66% inclusion rate.

Decisions on whether or not to sell investments and reinvest them should naturally be taken in collaboration with your portfolio manager.

Don't wait until the last minute

In the case of stock market transactions, the CRA generally considers that a sale takes place on the settlement date, not on the date on which instructions to sell are given. Recently, U.S. and Canada reduced the settlement period for stock market transactions to 1 day (T-1). So, since June 24 is a statutory holiday in Quebec, the deadline for giving selling instructions is technically Thursday, June 20.

If you decide to sell your stock investments, we strongly recommend that you do so before June 20, as your investment advisor may need additional time to settle internal administrative and compliance procedures before proceeding with the sale.

Companies

Many clients hold their investments through their company. This situation merits closer examination, since companies do not benefit from the $250,000 exemption threshold at the 50% inclusion rate, and all capital gains will be taxed at 66.66% as of June 25, 2024.

Realize the gains accumulated in the company?

We ran three simulations to determine whether, given the increase in the inclusion rate for realized capital gains in the company, it would be preferable to :

1) Not to realize the gains before June 25, 2024 and distribute the gains to shareholders at a later date

2) Realize capital gains before June 25, 2024 and reinvest in the company and distribute to shareholders at a later date

3) Realize capital gains and distribute them immediately to shareholders for personal reinvestment, benefiting from the future 50% inclusion rate.

The rate of return used is 5% in the form of capital gains (without interest or dividends).

	Scenario 1		**Scenario 2**		**Scenario 3**
Years	**Not to be sold before June 25, 2024 and distributed at the end of the period**		**Sell before June 25, 2024 and reinvest in the company**		**Sell before June 25, 2024 and distribute immediately to the shareholder for personal reinvestment**
	In the company before distribution to the shareholder	To the shareholder after future distribution by the company	In the company before distribution to the shareholder	To the shareholder after future distribution by the company	Inclusion rate 50%
	$	$	$	$	$
1	1,050	639	787	729	732
5	1,276	777	956	832	845
10	1,629	991	1,220	993	1,012
11	1,710	1,041	1,281	1,030	1,049
12	1,796	1,093	1,345	1,069	1,088
15	2,079	1,265	1,558	1,198	1,212
20	2,653	1,615	1,988	1,460	1,451

As we can see, at a 5% rate of return, it would take 10 to 12 years to make profitable keeping the investments compared to selling them before June 25, 2024, whether to reinvest in the company (scenario 2) or personally (scenario 3).

<table>
<tr><th></th><th colspan="3">Number of years of ownership required to make it profitable to hold investments compred to selling before June 25, 2024 in relation to the following 3 scenarios
(based on expected rate of return)</th></tr>
<tr><th rowspan="3">Yield</th><th rowspan="3">Sell before June 25, 2024 and keep in the company and distribute later</th><th colspan="2">Sell before June 25, 2024 and immediately distribute the gain for personal reinvestment</th></tr>
<tr><td colspan="2">Inclusion rate</td></tr>
<tr><td>50%</td><td>66.66%</td></tr>
<tr><td>9%</td><td>6 years</td><td>7 years</td><td>5 years</td></tr>
<tr><td>7%</td><td>8 year</td><td>9 years</td><td>7 years</td></tr>
<tr><td>5%</td><td>11 years</td><td>12 years</td><td>9 years</td></tr>
<tr><td>3%</td><td>17 years</td><td>20 years</td><td>15 years</td></tr>
</table>

Caution is required

Although the most advantageous scenario in terms of financial profitability will often be the one where the company sells the investments and distributes the realized gains to shareholders who reinvest them personally, it would be prudent to consider the following human factor:

The company is often regarded as a pension fund by the professional or entrepreneur, and the investments thus held until retirement. Funds distributed are more likely to be used for other purposes. So, unless you have a specific use for the funds (e.g. mortgage repayment, RRSP or TFSA contributions), it may be wiser to reinvest them in the company rather than distribute them.

These scenarios are intended to illustrate general trends. As each situation is unique, we invite you to consult your advisor to assess the best strategy, particularly in the case of larger capital gains (in the order of $200,000 or more, for example).

The case of the Capital Dividend Account (CDA)

It is generally good practice to “crystallize” capital gains annually by selling certain investments in order to benefit from the privilege of paying shareholders tax-free dividends corresponding to the non-taxable portion of capital gains, currently 50%.

Indeed, the non-taxable portion of realized capital gains, currently 50% of capital gains, can be paid to shareholders tax-free from the Capital Dividend Account (CDA).

Although the budget does not elaborate on this issue, it is foreseeable that following the planned increase of the inclusion rate from 50% to 66.66%, **the non-taxable portion that can be paid out to shareholders would be reduced to 33.33% of the capital gains amount.**

Normally, we carry out this exercise when preparing the financial statements. In view of the new measure, it will generally be advantageous to crystallize capital gains before June 25, 2024, so as to benefit from the privilege of paying tax-free dividends corresponding to 50% of the gain rather than 33.33%.

It should be noted that the important step to take before June 25 is for the company to sell investments in order to benefit from the 50% CDA. The tax-free dividend may be paid at a later date.

Real estate

Principal residence

The gain realized on the sale of a principal residence continues to qualify for the principal residence exemption. Thus, the increase in the inclusion rate should generally have no impact in this regard.

Note that the principal residence exemption can be shared between the home in town and the cottage based on the number of years of ownership.

Cottage

Clients considering transferring the cottage to a child in the short or medium term may wish to consider doing so before June 25, 2024.

The transfer, whether by sale or donation, will be considered a disposition of the cottage at market value by the tax authorities, resulting in a capital gain. You should therefore plan to be in a position to pay the taxes arising from the transfer.

As previously mentioned, the principal residence exemption may be claimed, in whole or in part, on the disposition of the cottage rather than the home in town. This could be advantageous when the annual gain on the cottage per year of ownership is greater than that on the townhouse.

It should be noted, however, that giving or selling the cottage to several children rather than just one may lead to certain conflicts in the future. For example, how much time the children or grandchildren will spend occupying the property, whether or not renovations should be carried out according to their individual tastes and financial means, etc.

Income properties

As we saw earlier, the sale of a building is likely to generate a capital gain in excess of $250,000, which is a nice problem in itself.

Those already in the process of selling a property might consider ensuring that the transaction is completed by June 25, 2024, to the extent that the anticipated gain exceeds $250,000.

A balance of sale could also be granted to the buyer, allowing the capital gain to be taxed over a maximum of 5 years, so as not to exceed the annual threshold of $250,000.

> A real estate transaction already involves many points of negotiation and stress. Given the sums involved, is it worth complicating it further for tax purposes and risking an aborted transaction?

Selling a building to your company

Some customers who are already incorporated ask us whether they should consider selling their income property to their own company, declaring all or part of the capital gain.

There are many elements to consider in such a transaction:

- Eligibility or non-eligibility for the transfer tax exemption (welcome tax);
- Potential mortgage prepayment penalties;
- Potential recovery of amortization claimed in the past;
- Report from a chartered appraiser to establish the market value of the property;
- Etc.

In addition, the strategy of spreading capital gains over several years cannot be used in the case of a sale to a company you control.

In view of all these factors and the short timeframe involved, it's probably best not to rush into such a transaction, and to plan it carefully, even if it means carrying it out after June 25.

In this respect, don't hesitate to contact your advisor to assess the relevance of such a transaction.

Note that the profit realized on the rapid resale of a property (including a principal residence, cottage or income property) that has been held for a period of less than one year is deemed to be business income and not a capital gain.

What does the future hold?

Seperate bill of law

Finance Minister Chrystia Freeland has asked Parliament to introduce the proposed changes in a separate Budget Act. Her intention appears to be to force the opposition parties to take a specific position on the proposed measures relating to the capital gains inclusion rate.

This could allow the opposition parties to request modifications without risking bringing down the government by voting against the budget as a whole.

Mr. Poilièvre, whose Conservative party is leading in recent polls ahead of the fall 2025 federal election, has remained tight-lipped on this issue. In a recent interview, he was asked whether a Conservative government would repeal or retain the capital gains changes. He didn't answer the question specifically, saying only that he thought it was ineffective and that the Liberals do not even agree between themselves on this new measure.

The Minister indicated that the bill would be tabled before the end of parliamentary business on June 21, three days before the June 24 deadline...

Joint Committee of the Canadian Bar Association and CPA Canada

On May 1, the committee made a number of recommendations to the government regarding the proposed measure, including the following:

- It should be possible to crystallize capital gains on assets held on June 25, 2024, i.e. to be able to declare potential capital gains at that date without having to sell the investments. This would enable more informed choices to be made when preparing tax returns and avoid hasty sales before June 25. Older ones will recall that this approach was adopted in 1994, when the $100,000 capital gains exemption was abolished.

- Alternatively, the sale deadline to benefit from the 50% inclusion rate should be extended to January 1, 2025.

- Individuals should be able to share the $ 250,000 annual threshold at the 50% inclusion rate with companies in which they are shareholders.

You can consult the committee's full report by clicking on the following link:
https://www.cpacanada.ca/fr/nouvelles/analyse/plaidoyer-gain-capital