TAX FOR THE Owner-Manager

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Going, Going . . . Gone: Change in the Capital Gains Inclusion Rate

On April 16, 2024, the Department of Finance released the 2024 federal budget. The budget provided for, among other things, certain changes to the way capital gains are taxed. (Supporting draft legislation was released on June 10, 2024.) These changes included the following:

- For taxation years that end after June 24, 2024, the capital gains inclusion rate, pursuant to paragraph 38(a), will increase from one-half to two-thirds. This will generally apply to all capital gains earned by all taxpayers. Individuals, however, will be entitled to a special carve-out whereby their first $250,000 of capital gains earned in each year is still subject to the one-half inclusion rate. The specifics of the $250,000 carve-out are beyond the scope of this article.

The changes identified above are proposed to become effective on June 25, 2024. It is not known why such a specific date was chosen, other than for the possible reason that it is exactly 10 weeks after the release of the budget announcement. The delay in implementing these changes implies that Finance intended for taxpayers to "crystallize" any accrued capital gains.

The CRA indicated in document no. 2024-1016011E5 (April 29, 2024) that such crystallizations do not violate GAAR because the delay in the implementation of the increased inclusion rate was a deliberate policy choice. This is further evidence that Finance expected, and is tacitly allowing, these types of transactions.

The change to the capital gains inclusion rate may sound like a simple measure, but certain practical issues need to be considered.

Capital Gains Earned by a Trust

Trusts may earn capital gains throughout the year, but the CRA's established position is that a trust can designate its income and capital gains to its beneficiaries only on the last day of its year. The beneficiary is then taxed on the basis that it received the income or capital gains on that same day. This gives rise to a question: If a trust earns a capital gain on, for example, March 31, 2024 but allocates it to a beneficiary on December 31, 2024, will the beneficiary be considered to have received the gain on December 31, 2024 and thus be taxed on the gain at the new inclusion rate, despite the fact that the underlying disposition occurred before the implementation date?

The draft legislation, in proposed subsections 104(21.4) to (21.7), proposes special transitional rules for trusts. Pursuant to subsection 104(21.4), the transitional rules apply if a trust allocated a capital gain to a beneficiary under subsection 104 (21) and the trust's taxation year began before June 25, 2024 and ends after June 24, 2024.

- If the conditions of subsection 104(21.4) are met, and the beneficiary's taxation year begins before June 25, 2024, then paragraph 104(21.7)(a) deems that a capital gain earned by a trust before June 25, 2024 is deemed to be a capital gain of the beneficiary from the disposition of property before June 25, 2024. Therefore, the one-half inclusion rate would be available to the beneficiary.
- Furthermore, if the conditions of subsection 104(21.4) are met, and the beneficiary's taxation year begins after June 24, 2024, then paragraph 104(21.7)(b) deems that a capital gain earned by a trust before June 25, 2024 is deemed to be a capital gain of the beneficiary in the taxation year that begins after June 24, 2024. However, this specific rule allows an initial inclusion rate of three-quarters, which is then multiplied by the new two-thirds inclusion rate to determine the taxable capital gain. Therefore, on the basis of this mechanism, the one-half inclusion rate would still be available to the beneficiary under this scenario.
- Under paragraph 104(21.7)(c), all capital gains that do not meet the conditions of either paragraph 104(21.7)(a) or 104(21.7)(b) are deemed to occur after June 24, 2024 and thus to be subject to the inclusion rate of two-thirds.
- It should be noted that paragraph 104(21.4)(c) requires the trust to disclose to the beneficiaries, in the prescribed form, the portions of the deemed gains that are realized both before June 25, 2024 and after June 24, 2024. If the trust does not make this disclosure, this special transitional rule is not available, and all capital gains realized by the trust will be subject to the two-thirds inclusion rate. The draft legislation did not make any specific reference to how this disclosure will be made, but one hopes that it will be a box on the 2024 T3 slip.

Capital Gains Earned by a Partnership

Partnerships may earn gains throughout the year, but under subsection 96(1), any gains are allocated to the partners at the end of the partnership's year.

Subsection 96(1.7) provides a general rule on capital gains inclusion rates: if a partnership has a fiscal period that is different from that of the partner, the partner is taxed on any capital gains allocated by the partnership at the end of the

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partnership's fiscal year, but the inclusion rate is based on the partner's fiscal year (not the partnership's). Unfortunately, this rule does not address the matter of a mid-year inclusion rate change.

The draft legislation, in proposed subsection 96(1.72), proposes special transitional rules for partnerships. Pursuant to subsection 96(1.72), the transitional rules apply if a partnership's taxation year began before June 25, 2024 and ends after June 24, 2024.

- Paragraph 96(1.72)(a) states that the general rule in subsection 96(1.7), as discussed above, does not apply.
- Paragraph 96(1.72)(d) states that if a partnership disposes of property after June 24, 2024, the partner is deemed to have disposed of the property after June 24, 2024, meaning that the two-thirds inclusion rate will apply to the disposition.
- Paragraph 96(1.72)(e) states that if a partnership disposes of property prior to June 25, 2024, and the partner's taxation year begins prior to June 25, 2024, the partner is deemed to have disposed of the property before June 25, 2024, meaning that the one-half inclusion rate will apply to the disposition.
- Paragraph 96(1.72)(f) states that if a partnership disposes of property prior to June 25, 2024, and the partner's taxation year begins after June 25, 2024, the partner is deemed to have disposed of the property after June 25, 2024. However, as with paragraph 104(21.7)(b), the partner will have a special initial inclusion rate of three-quarters, which is then multiplied by the new two-thirds inclusion rate to determine the taxable capital gain. Therefore, on the basis of this mechanism, the one-half inclusion rate would still be available to the partner under this scenario.
- Paragraph 96(1.72)(g) states that the partnership must disclose to the partners in prescribed form the portions of the deemed gains that are realized both before June 25, 2024 and after June 24, 2024. With this rule, unlike the rules for trusts, there does not appear to be a punitive result if the partnership does not make this disclosure. As with trusts, the draft legislation did not make any specific reference to how this disclosure will be made for partnerships, but one hopes that it will be a box on the 2024 T5013 slip.

Capital Gains Reserve

If a taxpayer realizes a capital gain in the year before the rate change, and if certain conditions are met, a taxpayer may deduct a capital gains reserve under subparagraph 40(1)(a)(iii) in that year. The reserve is then included in the subsequent year's taxable income under subparagraph 40(1)(a)(ii).

Capital gains are determined on the basis of the rules in sections 39 to 55, and then, once they are determined, the capital gains inclusion rate is applied pursuant to section 38. Because the calculation of the capital gains reserve is based on section 40, the applicable inclusion rate applied to the income inclusion under subparagraph 40(1)(a)(ii) would be based on the year in which the reserve is included in income, not on when the original disposition occurred. Thus, claiming a reserve while deferring the tax on a capital gain could trigger an increased tax liability.

Another consideration is that subparagraph 40(1)(a)(ii) does not specify the point in time in a taxation year at which the income inclusion occurs.

However, the draft legislation indicates that, in a taxation year that includes June 25, 2024, the income inclusion under subparagraph 40(1)(a)(ii) is deemed to occur on the first day of that taxation year. Therefore, the one-half inclusion rate would be preserved for the year that includes June 25, 2024, but the two-thirds inclusion rate would apply to all years thereafter.

Therefore, if a taxpayer is in a position whereby a capital gain is earned in a year that ends before June 25, 2024, and the reserve is available, the taxpayer should consider whether it would be beneficial to forgo the reserve and accelerate the tax. This would allow the taxpayer to pay tax at a lower rate.

The change to the capital gains rate is one of the most significant tax changes in recent years. The fact that this change provides for a 10-week window to crystallize capital gains but that no corresponding draft legislation was released until 2 weeks before the implementation date suggests that this change was poorly thought out. To date, the government has refused to grant an extension of the 10-week window, and it has not considered making the crystallization mechanism available by election. It is unfortunate that the government has taken something so conceptually simple and turned it into a huge undertaking.

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