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REDUCING THE IMPACT OF THE CAPITAL GAINS INCLUSION RATE INCREASE

By Michael Ding, Associate, Weir Foulds LLP

For capital gains realized on or after June 25, 2024, the capital gains inclusion rate is generally $66^2/_3$% (an increase from 50%). However, the first $250,000 of capital gains realized annually by individuals, graduated rate estates, and qualified disability trusts remain subject to the 50% inclusion rate. The $250,000 threshold is not available to corporations and other types of trusts. In certain circumstances, similar rules provide effective capital gain treatment with the same rates and threshold for employee stock options benefits, with the threshold applying to the aggregate of an individual's employee stock option benefit (that receives effective capital gain treatment) and capital gains. In the weeks leading up to June 25, many taxpayers crystallized unrealized capital gains in an attempt to take advantage of the lower inclusion rates. Since that ship has sailed, taxpayers may wish to consider some alternative tax planning to reduce the impact of the higher capital gains inclusion rate for the years ahead.

1) Limiting the realization of capital gains to $250k or less per year

It is tax advantageous for taxpayers that are subject to the annual $250,000 threshold to limit their capital gains to the threshold. As this threshold is available on a year-by-year basis and does not carryover, eligible taxpayers should consider realizing capital gains in excess of the threshold over several years. For instance, as shown in the table below, spreading $1 million in capital gains over four years would result in $125,000 less of taxable income as compared to the $1 million being reported in a single taxation year.

All Capital Gains realized in one year	Capital Gains equally realized over four years
= $250,000 x ½ inclusion rate + $750,000 x 2/3 inclusion rate = $625,000 included to be taxed	= $250,000 x ½ inclusion rate = $125,000 included in each year or $500,000 over 4 years
$125,000 more is included to be taxed	***$125,000 less is included to be taxed***

Capital gains may be able to be spread across two or more years, for example, through (a) timing dispositions of different properties (including the exercise or disposition of employee stock options and/or the result shares) to occur in different tax years, (b) receiving earn-out payments on a sale of shares where the CRA's cost recovery method is available (see Archived Interpretation Bulletin IT-426R), or (c) utilizing the capital gains reserve.

The capital gains reserve will often be available on a disposition of a capital property (e.g., real estate and corporate shares) where proceeds are to be paid across multiple years. Generally, a capital gains reserve can spread a capital gain across five years (including the year of disposition). In general, a minimum of 20% of the capital gain must be recognized in the year of sale and the four following years, depending on when payments are receivable from the purchaser. For transfers of shares in a family farm, fishing corporation or partnership, or small business corporation to a taxpayer's child (including grandchildren and a child's

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spouse or common-law partner), capital gains reserves can be claimed across a longer nine years following the year of disposition (i.e., ten years in total). There is an extended 10-year reserve period to certain corporate shares that are transferred as part of an intergenerational business transfer or sold to an employee ownership trust.

2) Forego Capital Gain Reserve for Pre-June 25, 2024 Dispositions

A taxpayer that disposed of capital property prior to June 25, 2024 that is entitled to claim a reserve in a tax year commencing after June 24, 2024 should consider whether to forego the reserve and pay tax on the remaining proceeds at the one-half inclusion rate.

3) Distribute Out Capital Gains to Beneficiaries

For trusts that do not have access to the $250,000 threshold (e.g., family trusts), trustees may wish to consider distributing out capital gains from the disposition of trust properties to individual beneficiaries. The individual beneficiaries are generally eligible for their own $250,000 threshold, which can result in the distributed capital gains being taxed at the lower one-half inclusion rate.

4) Lifetime Capital Gains Exemption (LCGE)

Budget 2024 increased the LCGE from approximately $1 million to $1.25 million. The LCGE is available to qualified small business corporation (QSBC) shares and qualified farm or fishing property (QFFP). While taxpayers have always had an incentive to utilize their LCGE and to take measures to secure it, such as satisfying the 24-month hold period and taking steps to purify the corporation of excess passive assets, the tax savings are now even greater (subject to alternative minimum tax). A capital gains reserve, if available, can be used in tandem with the LCGE if capital gains exceed the individual's LCGE.

5) Employee Ownership Trust (EOT)

An EOT is set up as a trust that holds qualifying business shares for the benefit of the business' employees in order to facilitate business succession from owners to employees. The qualifying business has to be a Canadian-controlled private corporation (CCPC) and a qualifying transfer generally requires the seller to be actively involved in the business for at least 24 months prior to the transfer of shares to the EOT, among other requirements. In addition to the extended capital gains reserve period noted earlier, a $10 million capital gains exemption is available on the sale of business shares to an EOT. As such, despite numerous criteria for qualification, the benefits (which will result in greater tax savings as a result of the capital gains inclusion rate increase) may warrant eligible taxpayers exploring the potential of selling CCPC shares to an EOT as an exit or succession option.

6) Canadian Entrepreneurs' Incentive (CEI)

Budget 2024 introduced the CEI which reduces the capital gains inclusion rate to one-third on a lifetime maximum of $2 million in eligible capital gains when a taxpayer sells shares or interests in their business. Qualifying taxpayers have to own at least 5% of the business' common shares for at least a 24-month period and be actively engaged in the business for three years prior to the sale. However, professional corporations and businesses in financial services, insurance, real estate, food and accommodation, arts, recreation and entertainment sectors, and consulting services are ineligible for the CEI. The CEI provides another option for business owners seeking to reduce capital gains on the sale of their business.

In conclusion, while the opportunity to benefit from the lower capital gains inclusion rate has passed, taxpayers still have various tax planning strategies available to mitigate the impact of the increased rate going forward. It is crucial for taxpayers and estate trustees to stay informed and plan accordingly to minimize tax liabilities in future transactions given the everchanging tax landscape in Canada.

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