



# TaxNewsFlash

Canada

## Capital Gains Rate Increase — Finance Provides More Details

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Corporations, trusts and individuals may want to review additional details now available on the upcoming increase to the inclusion rate for capital gains realized on or after June 25, 2024. Finance has released proposed legislation and related information that clarifies several design aspects of this upcoming tax change, including how trusts (including mutual fund trusts), mutual fund corporations, partnerships and stock options may be affected by this increase. These measures, which were first announced in the 2024 federal budget, were included in a Notice of Ways and Means Motion (NWMM) that was issued alongside related backgrounders on June 10, 2024.

Now that Finance has confirmed that it still intends for the increase to take effect for capital gains realized on or after June 25, 2024, affected taxpayers that hold assets with significant accrued gains only have a short time to take action. Taxpayers should contact their KPMG tax advisor to determine what options are available and whether it may be beneficial to realize capital gains before the June 25, 2024 effective date.

### Background

Finance announced in the 2024 federal budget that it would increase the inclusion rate for corporations and trusts to  $\frac{2}{3}$  (from  $\frac{1}{2}$ ) and for individuals to  $\frac{2}{3}$  (from  $\frac{1}{2}$ ) on the portion of capital gains realized in the year that exceed \$250,000.

Under the proposed capital gains rules, the \$250,000 threshold would effectively apply to capital gains realized by an individual, either directly or indirectly via a partnership or trust, net of any:

- Current-year capital losses
- Capital losses of other years applied to reduce current-year capital gains
- Capital gains in respect of which the Lifetime Capital Gains Exemption, the proposed Employee Ownership Trust exemption or the proposed Canadian Entrepreneurs' Incentive is claimed.

Where an individual claims the employee stock option deduction, a 1/3 (instead of 1/2) deduction of the taxable benefit would be available to reflect the new capital gains inclusion rate, but that individual would continue to be entitled to a deduction of 1/2 of the taxable benefit up to a combined limit of \$250,000 for both employee stock options and capital gains.

Under these changes, net capital losses of prior years would continue to be deductible against taxable capital gains in the current year by adjusting their value to reflect the inclusion rate of the capital gains being offset. As a result, a capital loss realized prior to the rate change would fully offset an equivalent capital gain realized after the rate change.

Transitional rules are available for tax years that begin before and end on or after June 25, 2024 where two different inclusion rates would apply. Effectively, the annual \$250,000 threshold for individuals would not be prorated in 2024 and would apply only in respect of net capital gains realized on or after June 25, 2024.

For details, see *TaxNewsFlash-Canada* 2024-17, "[2024 Federal Budget Highlights](#)".

## Capital gains inclusion rate — Finance outlines latest changes

In the NWMM and accompanying backgrounders, Finance provides additional details on new changes to increase the inclusion rate for capital gains realized on or after June 25, 2024.

### *Capital gains threshold*

Finance clarifies that, where there is a property that is jointly owned by multiple individuals, and there is a capital gain on a disposition of that property, each individual would have access to their own \$250,000 threshold.

In addition, Finance confirms that Graduated Rate Estates and Qualified Disability Trusts would also be eligible for the \$250,000 threshold available to individuals for capital gains that are not allocated to a beneficiary in the year.

### *Capital gains reserves*

Finance notes that the amount of a prior year's capital gain reserve that is brought into income in a subsequent year would be deemed to be a capital gain of the taxpayer from a disposition of property on the first day of the taxpayer's taxation year for the purpose of determining the inclusion rate, for taxation years that include June 25, 2024. As a result, the 1/2 inclusion rate would continue to apply to amounts that are brought into income from a prior year's reserve in a taxation year that begins before June 25, 2024 and ends after June 24, 2024.

### *Employee stock option deduction*

Finance clarifies the rules to provide that, when total employee stock option benefits and capital gains exceed \$250,000, the allocation of the \$250,000 threshold between capital gains and the stock option benefit deduction, for purposes of accessing the 1/2 capital gain inclusion rate or 1/2 stock option deduction rate, respectively, would be at the taxpayer's discretion.

### *Allowable business investment losses*

Finance confirms that, as a consequence of the increase in the capital gains inclusion rate, the deductible proportion of an allowable business investment loss (ABIL) will also increase to 2/3 (from 1/2) for losses realized on or after June 25, 2024. Finance notes that, because these losses are not adjusted to account for the inclusion rate that applies in the year the loss is claimed, ABILs realized on or after June 25, 2024 would always be determined in reference to the new basic 2/3 inclusion rate, even if these losses are carried back and applied in any of the three previous years. Finance further advises that, the amount of an ABIL may be reduced by the proposed Employee Ownership Trust exemption or the partial exemption under the proposed Canadian Entrepreneurs' Incentive that was claimed in prior years, similar to the current reduction to an ABIL for the lifetime capital gains exemption.

#### **KPMG observations**

Individual taxpayers should wait until June 25, 2024 to realize ABILs where possible if they plan to carry back these losses to any of the three previous years because the amount of these losses will be determined using the 2/3 inclusion rate (instead of the 1/2 inclusion rate).

### *Final return and net capital losses*

Unapplied net capital losses that remain after being applied to any taxable capital gains in the year of an individual's death may otherwise be applied to offset other income in the individual's final taxation year (i.e., their year of death) and the immediately preceding year. Finance advises that these losses will be reduced by amounts deducted in the individual's

lifetime for the proposed Employee Ownership Trust exemption and the partial exemption under the proposed Canadian Entrepreneurs' Incentive.

#### *Capital cost of depreciable property on non-arm's length transfer or change in use*

Finance confirms that it will generally align the rules on the capital cost of depreciable property acquired from a non-arm's length transferor or deemed to be acquired on a change-in-use of the property from a non-income earning to an income earning purpose with the increase in the capital gains inclusion rate. In particular, Finance advises that it intends to adjust the rules so that the transferee will generally be deemed to have acquired the depreciable property at a capital cost equal to the transferor's capital cost, plus  $\frac{2}{3}$  (from  $\frac{1}{2}$ ) of any capital gain the transferor realized on the non-arm's length transfer or change in use of the property.

However, where the transferor is an individual, and an election is made to include a portion of the capital gain in the transferor's net capital gains for the purpose of applying the \$250,000 threshold, only  $\frac{1}{2}$  (instead of  $\frac{2}{3}$ ) of the elected amount would be added to the transferee's capital cost of the depreciable property. Where the election applies to the capital cost of a depreciable property acquired from a non-arm's length transferor, the election must be made jointly by the transferor and the transferee. Where the election applies to the deemed acquisition on a change in use by an individual, the individual makes the election.

#### *Designations by trusts, including mutual fund trusts, in respect of taxable capital gains*

Finance also clarifies that, where a trust has a taxation year that begins before June 25, 2024 and ends after June 24, 2024, the amount designated in respect of its net taxable capital gains would instead be grossed up (doubled for gains in the pre-June 25 period or increased by  $\frac{3}{2}$  for gains in the post-June 24 period) and deemed to be capital gains realized by the beneficiary in the period that the trust disposed of the relevant capital property (either pre-June 25 or post-June 24). Finance advises that trusts would be required to disclose to their beneficiaries in prescribed form the portion of the deemed capital gains that relate to dispositions of property that occurred in each period. If a trust does not disclose this information, Finance notes that the deemed capital gains would be deemed to have been realized after June 24, 2024.

Finance further clarifies that commercial trusts (i.e., trusts that are not personal trusts, such as mutual fund trusts) would have the option of electing the deemed capital gains allocated to investors to have been realized by them proportionally within the two periods based on the number of days in each period divided by the number of days in the trust's taxation year. Commercial trusts can also make this election where capital gains and capital losses are retained in the trust.

#### **KPMG observations**

The transitional rules that apply to a trust with a taxation year that includes June 25, 2024 are very complex. The retail mutual fund industry will welcome this relief that

allows a commercial trust to elect to allocate the aggregate net capital gains of the fund for the full taxation year to each of the pre-June 25 and post-June 24 periods based on the number of days in each period pro-rata. This election may significantly simplify the fund's compliance burden which would otherwise require detailed tracking of each capital gain or loss.

Finance advises that it intends to make further adjustments to certain values used in the computation of the capital gain refund mechanism for taxation years that end after June 24, 2024.

### *Mutual fund corporations and mortgage investment corporations*

Finance also advises that, for taxation years of shareholders of mutual fund corporations that end on or after June 25, 2024, any capital gains dividend received by the shareholder would be taxed based on when the corporation realized the underlying capital gain (either pre-June 25 or post-June 24). Finance states that the corporation will be required to disclose to their shareholders in prescribed form the portion of the capital gains dividend that relates to dispositions of property that occurred after June 24, 2024 and, if the corporation does not do so, the capital gains of the shareholder receiving the dividend would be deemed to have been realized after June 24, 2024.

Finance notes that, for the purposes of the capital gains dividend distributed to shareholders, mutual fund corporations with taxation years that begin before June 25, 2024 and end after June 24, 2024 would be able to elect that the underlying capital gain realized by the corporation be deemed to be realized proportionally within the two periods based on the number of days in each period divided by the number of days in that taxation year. Mutual fund corporations can also make this election where capital gains and capital losses are retained in the corporation.

Finance further notes that mortgage investment corporations, and shareholders that receive capital gains dividends from mortgage investment corporations, would be subject to a similar tax treatment as mutual fund corporations.

### **KPMG observations**

Like the election available for commercial trusts, the fund industry will welcome this election for mutual fund corporations.

Finance advises that it intends to make further adjustments to certain values used in the computation of the capital gain refund mechanism for taxation years that end after June 24, 2024.

### *Related segregated fund trusts*

Finance states that capital gains or capital losses that are deemed to be realized by a policyholder on a disposition of a property by a related segregated fund trust would be subject to similar rules that apply to commercial trusts. Specifically, the related segregated fund trust would be required to disclose the deemed capital gains that relate to dispositions of property that occurred pre-June 25 or post-June 24, but could make the proportional election that is also available to commercial trusts.

### *Partnerships*

Finance provides transitional rules for a taxpayer that is a member of a partnership that has a fiscal period that begins before June 25, 2024 and ends after June 24, 2024. In this case, Finance advises that the amount of each partnership's taxable capital gain, allowable capital loss or allowable business investment loss that is shared with the taxpayer would be grossed up (doubled for gains in the pre-June 25 period or increased by 3/2 for gains in the post-June 24 period) and deemed to be a capital gain, capital loss or business investment loss of the taxpayer for the period (either pre-June 25, 2024 or post-June 24, 2024) in which the partnership's disposition of the relevant capital property occurred.

A partnership would be required to disclose to its partners in prescribed form which deemed capital gains, deemed capital losses, or deemed business investment losses allocated to the partners are attributable to dispositions of property in each period.

#### **KPMG observations**

Unlike commercial trusts and mutual fund corporations, partnerships do not have the ability to allocate capital gains between periods based on days and therefore would be required to segregate capital gains realized in each of the pre-June 25 and post June 24 periods for purposes of allocation to its investors. Affected partnerships should pay special attention when applying certain other tax provisions, such as suspended losses and stop losses, on the amount of the net capital gains in each of the pre and post periods.

### *Foreign affiliates and hybrid surplus*

Finance says it also intends to make consequential changes to rules related to foreign affiliates and hybrid surplus as necessary, including to the deduction available to corporations resident in Canada in respect of dividends received out of a foreign affiliate's hybrid surplus.

Finance clarifies that dividends received by a corporation resident in Canada out of a foreign affiliate's hybrid surplus, relating to capital gains and losses in respect of dispositions occurring before June 25, 2024, would continue to be eligible for the 1/2 deduction when received on or after June 25, 2024. In the case of dividends received out of hybrid surplus relating to capital gains and losses in respect of dispositions occurring on or after June 25, 2024, Finance states that the corporation would instead be entitled to a

deduction equal to 1/3 of the amount of the dividend (as well as a deduction in respect of applicable foreign taxes).

Finance advises that taxpayers would be required to track hybrid surplus relating to capital gains and losses in respect of dispositions by their foreign affiliates occurring before June 25, 2024 separately from hybrid surplus relating to capital gains and losses in respect of dispositions occurring on or after June 25, 2024.

#### *Non-resident dispositions of taxable Canadian property*

As a consequence of the increase to the capital gains inclusion rate, Finance states that it will also increase the withholding rate applicable to non-resident dispositions of taxable Canadian property to 35% (from 25%) applicable to dispositions that occur on or after January 1, 2025.

#### *Consequential amendments*

Finance acknowledges that it will have to make additional consequential amendments to other tax rules to reflect the new inclusion rate for capital gains, including to the proposed changes to the alternative minimum tax rules.

#### **KPMG observations**

Finance has indicated that it intends to release additional technical changes related to this increase in the near future, which it will include in draft legislation to be made available at the end of July 2024. Finance indicated that it would also release implementation details on the Canadian Entrepreneurs' Incentive, another capital gains-related measure announced in the 2024 federal budget, in conjunction with the release of the updated draft legislation.

In a related background, Finance addressed certain public comments and recommendations that it received following its federal budget announcement on these changes. Specifically, Finance confirmed that it does not intend to incorporate certain relieving changes that were recommended in those submissions, including to:

- Introduce a tax election to allow the recognition of a gain without an actual disposition
- Allow capital gains to be averaged over multiple years to stay under the \$250,000 annual threshold
- Allow individuals to share their \$250,000 annual threshold with corporations they own
- Exempt specific assets or corporations from the 2/3 inclusion rate

- Introduce special rules based on how long an asset is held, or other such criteria.

### We can help

Your KPMG adviser can help you assess the effect of these new developments. For more details, contact your KPMG adviser.

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