



# TaxNewsFlash

Canada

## Finance Releases More Details on Capital Gains Changes

August 20, 2024

No. 2024-33

Individuals, corporations, and trusts may want to review new details released on measures proposed in the 2024 federal budget relating to the tax treatment of capital gains. Finance recently released draft legislation to implement the Canadian Entrepreneurs' Incentive, which will allow individuals to apply a reduced 1/3 inclusion rate on certain capital gains from qualifying dispositions, beginning in 2025. The draft legislation reflects several changes to the original budget proposal, including expanded eligibility for the new incentive and an accelerated five-year phase-in period. In addition, Finance released updated draft legislation that clarifies certain aspects of the proposed change to increase the capital gains inclusion rate for capital gains realized on or after June 25, 2024. Although this draft legislation is largely the same as the previous draft released on June 10, 2024, taxpayers may be interested in several welcome changes included in the latest release, including new transitional rules affecting the capital dividend account (CDA) and hybrid surplus.

Finance is accepting comments on the draft legislation for capital gains until September 3, 2024, and on the Canadian Entrepreneurs' Incentive until September 11, 2024.

### Background

The 2024 federal budget announced an increase to the capital gains inclusion rate for corporations and trusts to 2/3 (from 1/2) and for individuals to 2/3 (from 1/2) on the portion of capital gains realized in the year that exceed \$250,000. The increase in the inclusion rate would apply to dispositions on or after June 25, 2024. However, the \$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.

The budget also included details of several consequential amendments to reflect the change in the inclusion rate, including a reduction in the employee stock option deduction to 1/3 (from 1/2), as well as the adoption of various transitional rules for tax years that straddle June 25, 2024, where two different inclusion rates would apply.

To provide some relief from the increase in the capital gains inclusion rate, the budget introduced the new Canadian Entrepreneurs' Incentive that would allow an individual taxpayer to apply a 1/3 inclusion rate to certain capital gains realized from the disposition of qualifying shares. The budget noted that the incentive would be subject to an individual lifetime limit of \$2 million of capital gains, in addition to any available Lifetime Capital Gains Exemption (LCGE) that the individual may be able to claim, and would be phased in by increments of \$200,000 per year until 2034. The Canadian Entrepreneurs' Incentive would apply to dispositions on or after January 1, 2025. Note that some of these proposed details have been updated in the recently released draft legislation.

The budget also included an increase to the LCGE to \$1.25 million (from \$1,016,836) with respect to dispositions that occur on or after June 25, 2024.

Finance released draft legislation for the proposed capital gain changes (except for the Canadian Entrepreneurs' Incentive) alongside related backgrounders on June 10, 2024. At that time, Finance acknowledged that additional consequential amendments were required, and that it intended to release updated draft legislation as well as implementation details for the Canadian Entrepreneurs' Incentive at the end of July 2024. For more information, see *TaxNewsFlash-Canada* 2024-24, "[Capital Gains Rate Increase — Finance Provides More Details](#)" and *TaxNewsFlash-Canada* 2024-17, "[2024 Federal Budget Highlights](#)".

### Canadian Entrepreneurs' Incentive

The draft legislation provides additional details of the Canadian Entrepreneurs' Incentive, including several changes to the eligibility requirements that were originally announced in the 2024 federal budget. These changes are generally intended to expand access to the incentive, which effectively allows an eligible individual to apply a 1/3 inclusion rate to capital gains realized from the disposition of qualifying shares, subject to a phased-in lifetime limit of \$2 million of capital gains.

Specifically, the draft legislation relaxes some of the conditions that must be met in order to qualify for the incentive, including to:

- Expand the incentive to business owners other than founders
- Reduce the taxpayer's minimum ownership requirement to 5% (from 10%)

- Reduce the minimum ownership time to any continuous 24-month period prior to the sale of the business (generally from a minimum five-year period ending immediately before the sale)
- Reduce the minimum period the taxpayer is required to be actively engaged in the business on a regular, continuous and substantial basis to any combined three-year period since the founding of the business (from a five-year period ending immediately before the sale)
- Expand eligibility for the incentive to dispositions of qualified farming and fishing property.

In addition, the draft legislation accelerates the annual phase-in of the \$2 million lifetime maximum incentive to \$400,000 per year (from \$200,000) beginning in 2025, resulting in the maximum being reached by 2029 (instead of 2034).

The draft legislation also includes further details on certain businesses which are excluded for purposes of this incentive, including professional practices, certain businesses operating in the financial, insurance, real estate, food and accommodation, arts, recreation and entertainment sector and businesses providing consulting services, among others.

### **Additional changes related to capital gains inclusion rate increase**

Although the revised draft legislation is largely consistent with the draft legislation previously released on June 10, 2024, it clarifies the calculation of CDA and hybrid surplus, among other consequential changes.

#### ***Capital dividend account***

The draft legislation introduces additional adjustments to address an unintended result in computing a corporation's CDA balance for a taxation year that begins before June 25, 2024 and ends on or after June 25, 2024 (the transition year). Under the revised draft legislation, the capital dividend account is increased by 1/2 of the capital gain (or decreased by 1/2 of the capital loss) where the disposition occurred before June 25, 2024, and is increased by 1/3 of the capital gain (or decreased by 1/3 of the capital loss) where the disposition occurred on or after June 25, 2024. The revised rules then provide for a "true-up" of the CDA balance at the end of the transition year where there is a difference between these adjustments and the actual non-taxable portion of the capital gain or loss calculated based on the blended inclusion rate at the end of the transition year. This revised approach should reduce uncertainty as to whether a corporation has sufficient CDA balance at a particular point in time in the year for purposes of paying a capital dividend in the transition year.

The revised rules also clarify how net capital losses are applied against taxable capital gains of a prior or future year that has a different inclusion rate from that of the loss year. These adjustments to the CDA balance allow a capital loss to fully offset the same amount

of capital gain regardless of any difference in the inclusion rates applicable to the capital gain and capital loss in the year they are realized.

### *Foreign affiliates and hybrid surplus*

The draft legislation includes several amendments to the foreign affiliate hybrid surplus regime to reflect the increase to the capital gains inclusion rate for capital gains realized on or after June 25, 2024. The amendments ensure that dividends received by Canadian corporations from the hybrid surplus of its foreign affiliates are also subject to the increased inclusion rate where the hybrid surplus distributed arose from capital gains realized by the foreign affiliate on or after June 25, 2024.

The draft legislation introduces two new hybrid surplus pools to the surplus regime — legacy hybrid surplus, which includes capital gains realized by the foreign affiliate before June 25, 2024, and successor hybrid surplus, which includes capital gains realized by the foreign affiliate on or after June 25, 2024. Under the default ordering rule, dividends received by a corporation resident in Canada from a foreign affiliate on or after June 25, 2024 are deemed to be paid first out of any legacy hybrid surplus of the foreign affiliate before being paid from its successor hybrid surplus. Dividends received from a foreign affiliate's legacy hybrid surplus would remain eligible for the 1/2 income inclusion rate and dividends received from its successor hybrid surplus would be subject to the 2/3 inclusion rate.

#### **KPMG observations**

Although this effective grandfathering of the 1/2 inclusion rate for the repatriation of hybrid surplus that arose prior to June 25, 2024 is generally favourable for taxpayers, it adds to the already high degree of complexity of the foreign affiliate surplus rules.

### *Other changes*

As expected, the draft legislation also includes consequential changes to the alternative minimum tax (AMT) for individuals and trusts to reflect the increase in the capital gains inclusion rate. These amendments apply to taxation years that end after 2023.

To prevent multiple deductions of the same amount under various capital gain exemptions and incentives, the revised legislation also includes an ordering rule that allows the LCGE to be claimed only after a taxpayer deducts any available capital gains exemption under the Employee Ownership Trust (EOT) rules against net capital gains for the year, and before any available amount under the Canadian Entrepreneurs' Incentive is deducted for the year.

#### **KPMG observations**

Although AMT should generally not apply to capital gains realized on or after June 25, 2024 that are subject to the higher 2/3 inclusion rate, federal and provincial AMT may still arise on certain capital gains realized by individuals. For example, gains subject to

the 1/2 inclusion rate and capital gains sheltered by the Canadian Entrepreneurs' Incentive or LCGE may be subject to AMT. For AMT purposes, 100% of capital gains (subject to certain exceptions such as a 30% inclusion rate for capital gains sheltered by LCGE) are included in the AMT base. Note that capital gains sheltered by the capital gains exemption available under the EOT rules are not included in the AMT base.

### We can help

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