



TaxNewsFlash

Canada

Capital Gains Inclusion Increase — Finance Adjusts New Rules

September 27, 2024

No. 2024-37

Individuals, corporations and trusts may want to review additional changes to the legislative proposals to increase the inclusion rate for capital gains realized on or after June 25, 2024. Deputy Prime Minister and Minister of Finance Chrystia Freeland recently tabled revised proposed legislation in the House of Commons, which includes measures to implement these changes. Although these legislative proposals, which are included in a Notice of Ways and Means Motion, are largely the same as those released in a previous version of the draft legislation on August 12, 2024, taxpayers may be interested in some new relieving changes to adjust certain calculations, address a timing issue in changes to the loss reduction rules for graduated rate estates and introduce an additional transitional rule for certain taxpayers that are members of a partnership. These changes generally address issues raised during Finance's most recent public consultations on earlier drafts of these rules.

Note that the capital gains changes are not yet law and it remains unclear when this draft legislation may be included in a bill. Taxpayers affected by these proposals should continue to follow the legislative progress of the capital gains changes. Generally, once this draft legislation is included in a bill, it must pass three readings in both the House and the Senate before it can receive Royal Assent and be enacted into law.

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.

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.

Finance released draft legislation for the proposed capital gain changes alongside related backgrounders on June 10, 2024. Finance subsequently released updated draft legislation for the capital gains changes on August 12, 2024, that clarified certain aspects of the proposed rules, including new transitional rules affecting the capital dividend account and hybrid surplus. Following the resumption of Parliament in September, Deputy Prime Minister and Finance Minister Chrystia Freeland tabled a Notice of Ways and Means Motion for the proposed capital gain changes on September 23, 2024.

For more information, see *TaxNewsFlash-Canada* 2024-33, "[Finance Releases More Details on Capital Gains Changes](#)", *TaxNewsFlash-Canada* 2024-24, "[Capital Gains Rate Increase — Finance Provides More Details](#)" and *TaxNewsFlash-Canada* 2024-17, "[2024 Federal Budget Highlights](#)".

Calculation adjustments

Capital cost — Changes in use or non-arm's length transfers

The revised legislation adjusts certain formulas within the proposed capital gains rules related to depreciable property that has been subject to a change in use or certain non-arm's length transfers.

Generally, under the depreciable property rules, when a taxpayer changes its use of a depreciable property to gain or produce income, either in whole or in part, then the taxpayer's capital cost of that property will increase by the taxable capital gain resulting from this change in use. The latest amendments to the capital gains proposals adjust the capital cost formula when there is such a change in use to accurately determine this cost. This change addresses an unintended result that could have created an understated capital cost under the previous draft legislation.

In addition, the depreciable property rules provide that, where a Canadian-resident individual (or certain partnerships) directly or indirectly transfers certain depreciable

property to a non-arm's length person, the transferee's capital cost cannot exceed the capital cost to the transferor plus the taxable capital gain realized by the transferor. There is a similar rule where the transferor is neither an individual resident in Canada nor a partnership any member of which was a Canadian-resident individual or another partnership and there is a direct or indirect transfer of certain depreciable property to a non-arm's length person. The latest amendments to the capital gain proposals adjust the capital cost formula in these rules when there is such a non-arm's length transfer. This change addresses an unintended result that could have created an understated capital cost under the previous draft legislation.

Capital gains eligible for existing inclusion rate

The revised legislation also adjusts certain formulas within the proposed capital gains rules related to individual's capital gains that continue to be subject to the 1/2 inclusion rate. In particular, the proposals introduce new rules to allow an individual (other than a trust), a graduated rate estate or a qualified disability trust to deduct a certain amount against their net taxable capital gains so that these individuals and trusts have a 1/2 inclusion rate on the first \$250,000 of capital gains each year. The revised legislation amends the formula that determines the amount of a taxpayer's capital gains that are eligible for the 1/2 inclusion rate. Specifically, the formula now clarifies that only the transferor's capital gain in respect of certain depreciable property realized on certain changes of use or non-arm's length transfers is eligible for this deduction provided that the transferee and transferor file a joint election (under the previous draft legislation it appeared the transferee to the joint election could also claim the proposed deduction, even though they did not realize a gain on the transfer).

KPMG observations

These adjusted calculations appear to implement recommendations Finance received as part of the consultation process to address unintended and inappropriate tax consequences.

Graduated rate estates — Application of the stop-loss rule

The revised legislation amends the proposed changes to the rules that deny a certain amount of capital losses a trust (including an estate) can claim on the disposition of shares that are capital property to address a potential timing issue for graduated rate estates. Under the proposed changes to this stop-loss rule, the amount of the denied capital loss for a graduated rate estate in the first taxation year is reduced by 1/3 (currently 1/2) of the lesser of:

- The loss determined without reference to subsection 112(3.2), and
- The individual's capital gain from the disposition of the share immediately before death.

The revised legislation amends the capital gains proposals so that this change to the stop-loss rule applies to graduated rate estates of taxpayers that died on or after June 25, 2024 (instead of applying to share dispositions that occur on or after June 25, 2024).

KPMG observations

This change is intended to ensure that graduated rate estates of taxpayers who passed away before June 25, 2024, and realized a capital loss on or after June 25, 2024, would not be affected under these changes.

Transitional rule for partnerships

The revised legislation introduces a new transitional rule for certain partnerships. This transitional rule applies in respect of a taxpayer that has a taxation year that begins before June 25, 2024 and ends after June 24, 2024 (the transition year) during which the taxpayer is a member of a partnership with a fiscal period that either ends before June 25, 2024 or begins after June 24, 2024 (i.e., the partnership fiscal period does not straddle June 25, 2024).

Under the capital gains proposals, where a partnership has a fiscal period that straddles June 25, 2024, the partners are deemed to have realized capital gains, capital losses or business investment losses in the same period that the partnership itself realized those capital gains, capital losses or business investment losses (e.g., before June 25 or after June 24). This results in an effective inclusion rate of 1/2 for a capital gain, capital loss or business investment loss that was incurred before June 25, 2024 and a 2/3 rate on or after June 25, 2024.

The revised legislation now adds a new transitional rule that applies to partnerships with a fiscal period that does not straddle June 25, 2024. The new transitional rule provides that capital gains, capital losses or business investment losses that are realized by partnerships with fiscal periods ending before June 25, 2024 are included in the period before June 25, 2024 when allocated to partners, so that the 1/2 capital gains inclusion rate applies. Similarly, capital gains, capital losses or business investment losses that are realized by partnerships with fiscal periods that begin after June 24, 2024 are allocated to partners in the period after June 24, which are subject to the 2/3 capital gains inclusion rate.

KPMG observations

This change appears to address an issue raised during the consultation process in which a partner that is allocated a capital gain by a partnership with a fiscal period ending before June 25, 2024 and that realized no other gains or losses in the transition year could still be subject to a capital gains inclusion rate of 2/3 under the draft legislation released on August 12, 2024.

We can help

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