TAXTALK

PENDING CHANGES TO THE CAPITAL GAINS TAX RATE

On April 18, 2024 we issued a TaxTalk which outlined the major proposals in the 2024 Federal Budget. The most critical component of the budget is the proposal to increase the capital gains inclusion rate from 50% to 66.67%.

Although the technical notes, which will give greater certainty to planning opportunities, have not yet been released, taxpayers have limited time in which to consider what steps they can, or should take, to mitigate the impact of the change. The proposed effective date of the changes is June 25, 2024.

In this document we highlight some of the major factors to consider in the planning process. However, due to the complexity and variety of individual positions, no one document can capture every possible scenario that might be applicable in your case. If you have not yet spoken with your advisor, please contact us as soon as you can so that we can review your situation.

Time Value of Money

An overriding factor to consider is that although the increase in the tax rate is known, future tax rates, and future incremental gains in assets currently held, are unknown.

Before making any decisions, you should consider, as an overall perspective, what your time horizon for holding any asset was prior to the recent rule changes.

If you were planning on a long-term hold then triggering a gain now to avoid the 66.67% inclusion rate will also trigger payment of tax many years in advance of when you originally planned for. In addition, any potential gain in the asset will be foregone.

If your planned sale was in the very near term, say 6 to 12 months, then triggering the gain prior to June 25th may generate significant savings.

For assets that are neither imminently for sale or long-term holds, the correct course of action is less clear.

In all cases, your analysis should consider the potential for changes in tax rates, future capital appreciation in the asset to be sold and the time value calculation comparing a lower inclusion rate now, to a higher inclusion rate at some future point.

Ownership of a Private Business

For owners of private businesses, structuring their ownership and planning for succession, either by way of family succession, sale of the business or on death, is a key component to their wealth strategy.

As noted above, consideration should be given to what your time horizon for a disposition, of any kind, was prior to the new rules and to do the appropriate analysis prior to making any decisions regarding your current structure.

Although the existing tax structure has generally always been more favourable to the vendor in the case of a share sale rather than an asset sale, the new rules tilt the field even more so.

The Lifetime Capital Gains Exemption (LCGE) has been increased to $1,250,000 and continues to be indexed for inflation, which will somewhat offset the higher inclusion rate. Additionally, each individual has an annual $250,000 exemption which will further shelter gains. Neither of these are available to corporations' selling assets.

The implementation of an estate freeze and putting a Family Trust into place has been a long-standing planning tool to facilitate succession to family members or a 3rd party via sale. It will now add greater benefit by allowing multiple family members to access the LCGE and the annual $250,000 exemption on future sales. The rules, and some restrictions, around this process are complex and must be considered carefully before implementation.

Capital Gains Reserves

Many clients have already realized sales of assets and have claimed capital gains reserves as the proceeds are being received over a period of up to 5 years.

In each year following the sale, at a minimum, 1/5th of the gain may be added to income.

The issue is that when the sale was made, all the taxpayer's planning was based on a 50% inclusion rate for capital gains, not a 66.67% inclusion rate. The question becomes, at what rate is the inclusion of the gain brought into income?

The technical notes have not yet been released but based on previous convention, it is expected that the addition to income will be considered as earned on the first day of that particular taxation year.

Therefore, when the first day of the taxation year is post June 24th, 2024 the add back to income will be at 66.67% not the planned rate of 50%.

Taxpayers will have to plan for these changes in managing their cash flow and tax payments. As technical commentary is released, we will update our clients.

Estate Planning

For those doing long range planning with regards to death and transfer of wealth to the next generation, the impact of the higher inclusion rate should be considered carefully.

Assets held at death are deemed to be disposed on the day of death and, with some exceptions such as a Principal Residence, a capital gain is calculated on the difference between the Fair Market Value (FMV) at day of death and the Adjusted Cost Base (ACB) of the asset.

Even if all other factors and assumptions about the future remain the same, the increase of the inclusion rate to 66.67% will result in a higher tax on death than previously anticipated. A review should be done of the amount of cash that is anticipated to be required to satisfy the taxes due on death.

Portfolio Investments

As noted above, the overriding view on the time value of money must especially be considered regarding portfolio investments as they are more liquid, and it is much easier to make a quick decision before reviewing all the factors.

While a sale before June 25th avoids the higher inclusion rate it also triggers a payment of tax earlier than anticipated, and also foregoes any future capital appreciation in the stock.

If the decision is made to sell some of the securities being held, it will be a good time to review the entire portfolio with your investment advisor. There may be other securities with accrued losses which, if sold, can mitigate the impact of the gain. Again, consideration must be given to the pre-existing planning and longer-term view of each particular security.

It is important to note that each individual has an annual $250,000 exemption of the increase from 50% to 66.67%, so the increased inclusion rate does not immediately impact all transactions.

Where appropriate, larger transactions can be conducted over several calendar years to take advantage of the $250,000 exemption.

Portfolio Investments held in Investment and Holding Companies

Consideration should be given to selling securities from Investment and Holding companies to individuals, where appropriate.

These transactions must be done at FMV and will trigger income tax. However, if done prior to June 25th the gain can be included at 50% and the individual can utilize the $250,000 exemption per year on future appreciation.

In prior planning, intercorporate dividends were often flowed to these companies on a tax-free basis from operating companies, giving the taxpayer a larger "pre-tax" amount to invest as principal. The absence of the annual $250,000 exemption threshold for corporations will require a review of this strategy on an ongoing basis.

Family Cottages

The transfer of a family cottage can generate significant gains within a family, especially considering the current real estate market and the time period over which many of them have been held.

The transfers must be at FMV and will generate a gain, which can sometimes be mitigated through the use of the Principal Residence Exemption (PRE).

Under the new rules, gains not covered by the PRE can be covered by the $250,000 threshold for the lower inclusion rate of 50%.

In some circumstances it may be appropriate to sell, or gift, the cottage to the next generation in fractional stages over a period of several years. Although this will accelerate the payment of income tax, it will keep the annual gain included in income at the 50% level. The time value of money and future tax rates will have to be considered.

Annual Minimum Tax (AMT)

The AMT rules continue to be expanded and strengthened.

Although they are, in effect, a temporary tax which can be imposed currently and then used to abate tax in future years, they can have a significant impact on current cash flows.

The rules are complex, and each situation and strategy must be reviewed to determine their impact.

Other Planning Opportunities

Some additional planning opportunities to consider are noted below:

Spousal Loan of Assets

Assets can be loaned from one spouse to another, with an election at FMV. There will be a deemed gain and an interest rate of 6% will be charged on the amount due.

However, in the right circumstances this could be advantageous. The spouse receiving the asset will, in future, be taxed on the income gains, and will have eligibility for the $250,000 threshold for 50% inclusion on future sales.

Gifting to Adult Children

Assets with accrued gains can be gifted to adult children prior to June 25th.

This will trigger 50% inclusion rate and income tax. However, it will reduce taxes on death and potentially, probate fees.

The transaction could also be set up to close over 5 years to take advantage of the capital gains reserve rules. The debt itself, owing from the children, can subsequently be forgiven within the will.

Insurance and Pension Plans

The increase of the inclusion rate to 66.67% will, for some taxpayers, make Individual Pension Plans (IPPs), Registered Retirement Savings Plans (RRSPs) and Life Insurance products much more attractive.

Consideration should be given to implementing, or topping up, IPPs and RRSPs.

Life insurance products can create an opportunity to generate capital growth in a corporation that can subsequently be realized on a tax-free basis. Although these products have always been favourable in the right circumstances, they may be more effective for many taxpayers under the current regime as an alternative to investing in securities. The gains can be realized on a tax-free basis rather than being included at 66.67%.

Next Steps

If you have not already discussed with your advisor at MG, you should contact us to review your planning and determine the best course of action to take.

There is no one solution that fits all cases, but consideration should be given to strategies such as passing portions of the estate on to the next generation in stages rather than waiting until death, or potentially increasing the amount of life insurance that will be available on death to fund the tax liability.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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