The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada
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Robert Demeter
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Dear Mr. Demeter:

Subject: Federal Budget 2024 – Capital Gains Inclusion Rate

We are enclosing a submission which considers the changes to the *Income Tax Act* (the "Act") which will be required to implement the proposals made in the Federal Budget 2024 relating to the increase in the capital gains inclusion rate. Our objective in this submission is to raise specific issues and concerns along with suggestions and recommendations provided by the Joint Committee regarding the changes. Given the significance of the proposals to ordinary taxpayers, and the short period before the proposals are intended to become effective, we would appreciate your consideration of the issues as soon as possible.

In addition, this submission sets out the most time sensitive and fundamental issues regarding the proposal. The Joint Committee may make further submissions.

Members of the Joint Committee and others in the tax community participated in the discussion concerning this submission and contributed to its preparation, including:

- Anu Nijhawan – Bennett Jones
- John Oakey – CPA Canada
- Carmela Pallotto – KPMG

- Jeffrey Shafer – Blakes
- Carrie Smit – Goodmans LLP

We would like to thank you for your consideration of this submission. We trust that you will find our comments helpful but would welcome the opportunity to discuss the submission and our concerns with you at your convenience.

Yours truly,

Carmela Pallotto, CPA, CA
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Carrie Smit
Chair, Taxation Section
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Cc: Trevor McGowan, Associate Assistant Deputy Minister

CBA - CPA Canada Joint Committee on Taxation Submission
Federal Budget 2024 - Capital Gains Inclusion Rate

General comment

The 2024 Federal Budget proposed to increase the capital gains inclusion rate from one-half to two-thirds, for dispositions occurring on or after June 25, 2024. As proposed, corporations and trusts will be subject to the higher inclusion rate on all capital gains while individuals will only be subject to this higher inclusion rate on capital gains realized in a year in excess of $250,000. The delayed effective date, which we understand was designed to provide taxpayers sufficient time to plan their affairs, is insufficient and causes a high degree of uncertainty for taxpayers and their advisors.

Specific comments, addressed below, relate to the following categories:

1. Election to Realize a Capital Gain;
2. Effective Date;
3. Grandfathering;
4. Legislative Amendments Required to Avoid Retroactive Effects;
5. Private Corporations and Integration;
6. Trusts; and
7. Carry Forward of Threshold.

Election to Realize a Capital Gain

We recommend that taxpayers be provided with the ability to realize a capital gain through filing an election, which would deem designated assets to be disposed of for (up to) fair market value proceeds prior to June 25. This elective process would allow taxpayers to realize capital gains without an actual disposition of assets. This election could be filed separately or with the taxpayer's income tax return for the 2024 tax year. We have set out the following reasons to consider an elective process:

- **No draft legislation has been released.** Taxpayers require a level of certainty when planning their affairs, and there are many considerations that should be taken into account before realizing gains through the sale of assets. There is no draft legislation to guide taxpayers, and the draft legislation when released may differ from what is anticipated. The inclusion of an elective process would mean that taxpayers do not need to rush to sell assets and can wait until legislation is available providing a necessary level of certainty. Requiring taxpayers to plan their affairs and potentially enter into irrevocable transactions without draft legislation is unfair and inappropriate.

- **Gain crystallization transactions are difficult for middle-class taxpayers.** Providing taxpayers with the ability to file an election ensures that all taxpayers have an equal opportunity to crystalize capital gains prior to June 25. Furthermore, absent an election, crystallization transactions are not always possible. Some assets cannot be easily liquidated, such as shares in a private company, real estate, or unvested stock options. For assets that can be sold, such as cottages or publicly-traded securities, the pressure to close a disposition transaction before June

25 may distort pricing and put downward pressure on values, causing unintended market impacts and potentially reducing anticipated tax revenues.

- **Simplicity and efficiency** would be attained by permitting taxpayers to file an election. This would avoid significant costs such as professional fees and selling costs, particularly in situations where the sale is only being undertaken to crystallize the gain and the taxpayer wishes to continue to own the asset. The money spent on these costs could be better utilized in other areas that could contribute to the growth and development of the economy.

- **Revenue target** for the fiscal 2024/25 period would not be negatively impacted by an election and could possibly be increased as more taxpayers would have access to tax planning through the more simplified election process. We also recommend that the election process allow taxpayers to elect a deemed disposition price between tax cost and fair market value to provide maximum flexibility. This flexibility could be subject to guardrails such as minimum or maximum deemed realized gains.

We would also recommend that taxpayers filing an election be allowed to pay the resulting tax liability over a period of time. This is consistent with other transitional rules implemented for previously unanticipated taxes.

If the government decides to implement an elective process, we strongly urge that an announcement be made as soon as possible to prevent a mass sell-off and frantic scramble to obtain professional advice and execute transactions before June 25.

Effective Date

It is our understanding that the June 25 effective date was provided allowing taxpayers 10 weeks from the announcement date to plan for the increase in the capital gains inclusion rate and to facilitate in-progress transactions. However, the 10-week period is insufficient to properly plan for many taxpayers. With no draft legislation to follow, transactions during this 10-week period would be executed with an unfair level of uncertainty. As discussed above, we recommend that an elective process be introduced to deal with this uncertainty. Alternatively, or in addition to this process, we recommend the effective date be moved to January 1, 2025 as this would:

- Provide more time for the Department of Finance to draft legislation and have a public consultation, and for the legislation to be enacted;
- Allow taxpayers, at a minimum, to have draft legislation available when planning their affairs. The draft legislation might even be enacted by January 1 giving a much higher level of certainty;
- Be consistent with the legislative changes announced in the 1987 tax reform when the capital gains rate changed to 2/3 on January 1, 1988 and then changed to 3/4 on January 1, 1990. This would provide both the Department of Finance and taxpayers a higher level of certainty given the precedent set for the previous increase;
- Align with existing reporting systems that provide detailed reporting of purchases and sales of assets, costs and fair market values, such as reports provided by financial institutions;
- Provide taxpayers with sufficient time to properly plan their affairs, particularly for assets that are illiquid or do not have a readily available market; and

- Align with the structure of the Act, which is often based on a taxation year (such as partnership and trust income allocations).

Grandfathering

Many taxpayers entered into binding agreements to sell capital property prior to Budget Day. Such agreements may have conditions to closing which are outside the control of the taxpayer (*e.g.,* regulatory approval) and which preclude the disposition occurring prior to June 25, 2024. Such taxpayers entered into their agreements based on the law existing at the time of the agreement and without any notice of a potential change, and the applicable tax rate is often a key driver of the economics agreed to in the binding agreement.

Consistent with grandfathering provisions that Finance has implemented in the case of other legislative amendments, we recommend that the increased capital gains inclusion rate not apply to "*dispositions of property occurring pursuant to legally binding obligations entered into by the taxpayer in writing before April 16, 2024*".

To the extent there are policy concerns with extending grandfathering relief inappropriately, the grandfathering could be limited, including, for example as follows:

- The grandfathering could apply only to legally binding obligations with a person or partnership with whom the taxpayer was dealing at arm's length;
- There could be a loss of grandfathering status if the binding agreement is significantly modified; and
- The grandfathering could apply only to the extent that the disposition cannot occur prior to June 25 due to conditions outside of the taxpayer's control.

Legislative Amendments Required to Avoid Retroactive Effects

The Budget proposals indicate that the increase in the capital gains inclusion rate is to apply to capital gains realized on or after June 25, 2024. We understand that the policy is that capital gains in respect of dispositions of capital property prior to June 25 (**Pre-June 25 Dispositions**) remain subject to the one-half inclusion rate. Members of the Joint Committee have identified several provisions of the Act which will require amendment/clarification to ensure that capital gains realized in respect of Pre-June 25 Dispositions are not inadvertently included in income at the higher inclusion rate. While this is not a comprehensive list, the identified areas include:

- **Capital Gains Reserve** – Various taxpayers have claimed capital gains reserves under subparagraph 40(1)(a)(iii) for Pre-June 25 Dispositions. Subparagraph 40(1)(a)(ii) requires such prior year reserves to be included in computing the taxpayer's gain for its 2024 taxation year. Any such inclusion which relates to a Pre-June 25 Disposition should be subject to the pre-June 25 one-half inclusion rate. As an alternative, an elective mechanism could be included to permit a taxpayer to bring any prior year reserve into income in 2024 as a Pre-June 25 Disposition.

- **Hybrid Surplus** – Where a taxpayer receives a dividend from a foreign affiliate, paragraph 113(1)(a.1) currently permits the taxpayer a deduction for one-half of a dividend prescribed to have been paid out of hybrid surplus. We assume that the reference to one-half will be altered

to one-third for hybrid surplus resulting from capital gains realized by foreign affiliates in respect of dispositions after June 24, 2024. The amendments to paragraph 113(1)(a.1) should include, however, a continuance of the one-half deduction rate for hybrid surplus resulting from capital gains realized by foreign affiliates in respect of Pre-June 25 Dispositions, irrespective of the year such hybrid surplus is repatriated in the form of a dividend. As an alternative to amending paragraph 113(1)(a.1), consideration could be given to creating a new category of hybrid surplus for capital gains realized after June 24, 2024 with a new paragraph 113(1)(a.2) added to provide a deduction for one-third of a dividend prescribed to have been paid from this new category of "post-June 24, 2024" hybrid surplus.

- **Stock Options** – Taxpayers may have exercised stock options granted by Canadian controlled private corporations (**CCPCs**) prior to June 25, 2024. Paragraph 110(1)(d.1) currently provides for a 50% deduction of the section 7 option benefit where certain conditions are satisfied, including that the acquired shares are held for two years. The Budget proposals include an amendment to the 50% rate to be one-third (subject to the $250,000 threshold). The amendments to paragraph 110(1)(d.1) should include, however, a continuation of the 50% deduction rate for CCPC options exercised prior to June 25, 2024, irrespective of the year in which the acquired shares are disposed of.

- **Allocations of Capital Gains of Trusts and Partnerships** – A capital gain recognized by a trust or a partnership prior to June 25, 2024 should retain its status as a capital gain from a Pre-June 25 Disposition when allocated to beneficiaries or members, notwithstanding that this allocation will occur at the end of the fiscal period of the trust or partnership.

- **Mutual Fund Trusts** – Consequential changes will be required to the capital gains refund mechanism for 2024.

Private Corporations and Integration

Incorporation is the normal form of business organization in Canada, allowing for limited liability and facilitating raising capital. As discussed in detail in the Joint Committee's October 2, 2017 submission regarding the taxation of private companies, due to under-integration there is actually no material tax saving to earning active business income or aggregate investment income in a private corporation. Many middle-class Canadian individuals and small business owners indirectly own and operate their businesses through private corporations, including restaurants owners, tech entrepreneurs, doctors, and farmers. Assets accumulated within these corporations are typically used to expand business operations or support the individuals through retirement. In particular, many of these individuals do not have employment pensions to rely on during retirement but rather accumulate investments in their corporations in order to fund what may be 20+ years of retirement.

The $250,000 annual safe harbour granted to individuals allows Canadians to pay tax at a lower rate on a base amount of annual capital gains, reflecting that the purpose of the proposal is increased taxation on only the wealthiest Canadians (the 0.13%). However, with no proposed threshold provided to corporations, many ordinary Canadians who operate their businesses indirectly through private corporations will unfairly lose access to the $250,000 safe harbour. This result does not align with the government's policy intent. There is currently under-integration on capital gains realized by private

corporations in every province and territory. Not extending the threshold to private corporations will result in a further increase of under-integration on capital gains between 9.24% and 15.13%.

In order to properly align the government's policy, we believe it is imperative that the rules be drafted to allow Canadian individuals the ability to share their annual $250,000 safe harbour with a private corporation of which they are a (direct or indirect) shareholder. The sharing or transfer of the threshold could be based on the proportionate common share ownership of the private corporation or otherwise. Restrictions could be put in place to ensure double counting would be avoided (similar to the current sharing of the small business deduction limit). Alternatively, the rules could be drafted to allocate a capital gain from a private corporation to individual shareholders, allowing the individuals to utilize their own $250,000 threshold. The Joint Committee would be happy to work with Finance to structure and draft a rule that allows individuals who indirectly hold their assets in a private corporation to fairly benefit from the $250,000 threshold.

Trusts

The $250,000 safe harbour granted to individuals was not proposed to be extended to trusts. This inability for trusts to access the safe harbour threshold will have a negative impact on routine estate planning situations. Examples of the trusts that would be negatively impacted are as follows:

- **Graduated Rate Estate (GRE)** – The administration of an estate typically results in the retention of capital gains in the GRE. This could be a result of planning or due to necessity. Without access to the safe harbour threshold, the increase in the capital gains inclusion rate would result in higher taxes for the estate, which will ultimately affect the beneficiaries, including those in the middle class. We recommend that a GRE should be afforded its own $250,000 threshold to minimize the impact on individual taxpayers.

- **Qualified Disability Trust (QDT) and Henson Trust** – QDTs and Henson trusts are set-up to provide indefinite help for individuals with disabilities. The exclusion of the safe harbour threshold will subject any undistributed capital gains to the increased inclusion rate. We recommend that a QDT and Henson trust should each be afforded their own $250,000 threshold. To avoid duplication of the threshold, the trust and the disabled beneficiary could share the $250,000 threshold.

- **Alter Ego (AE) or Joint Spousal/Partner Trusts (JSP)** - Upon death of the beneficiary or the last surviving spouse beneficiary, the capital gains realized are taxed in the trust. Without the benefit of the safe harbour threshold, the trust would be subject to the increased capital gains inclusion rate. We recommend that AE and JSP trusts should be afforded their own $250,000 threshold. To avoid duplication of the threshold, the trust and the settlor could share the $250,000 threshold.

Given that these trusts are routinely used by many taxpayers to administer or protect their estates or even help manage assets for disabled beneficiaries, we believe that these exceptions align with the government's overall policy.

Carry Forward of Threshold

The $250,000 annual threshold is a meaningful measure to ensure that middle class Canadians are not impacted as heavily by the increase to the capital gains inclusion rate. However, an annual "use-it-or-lose-it" threshold is not well matched to the reality of how this segment of the population often realizes capital gains. For many people, investment portfolios can be stable for long periods of time, without generating material annual capital gains (until, perhaps, larger dispositions are undertaken as individuals enter retirement). Many Canadians also have significant portions of their wealth tied up in large long-term assets, such as small businesses, family farms, real estate, or inherited property. These assets are much more likely to generate very large one-time gains, rather than annual smaller amounts. This is particularly the case where there is a disposition of assets to fund retirement or the deemed disposition of assets realized on an individual's death.

To address the above, we recommend that Canadians be permitted to carry forward unused safe habour amounts. Such a carryforward could be indefinite, but consideration can also be given to time limitations and limitations on the portion of the annual safe harbour available for carryforward.

Finally, to ensure that the $250,000 threshold remains relevant to Canadians, we recommend that the amount be indexed going forward.