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Canadian Federal Budget 2024: Increasing the Capital Gains Inclusion Rate

Introduction

On 16 April, Canada's Deputy Prime Minister and Finance Minister Chrystia Freeland released Canada's 2024 budget ("**Budget 2024**"). Titled "Budget 2024: Fairness for Every Generation", the changes seek to address an ongoing shortage of affordable housing by levying increased taxes on Canada's citizens.

Although Budget 2024 does not change the federal personal or corporate tax rates, the government intends to generate C$21.9 billion in new revenue over the next five years with a sharp focus on wealthy Canadians paying their "fair share".

This note focuses predominantly on the changes to the capital gains ("**CG**") inclusion rate. However, please note that other notable changes include various amendments to personal income taxes (such as an increase to the lifetime capital gains ("**LCGE**") exemption and a Canadian Entrepreneurs' Incentive), proposed improvements to rules relating to charities and certain qualified donees, corporate income tax measures and international tax measures.

Current capital gains inclusion rate

Capital gains inclusion rate refers to the portion of capital gains that is subject to taxation. Under the current tax regime, where an individual sells a capital asset for more than its original purchase price and realises a capital gain, only 1/2 of the capital gain on the sale is subject to tax at the individual's marginal rate.

As a result, those who are non-residents of Canada for tax purposes ("**Non-residents**") would be subject to a tax rate of 24.42% to the extent that they dispose of "taxable Canadian property" such as Canadian real estate (further discussed below) and realise a capital gain.

Capital gains inclusion rate to increase

Budget 2024 proposes that **after 24 June 2024**, the capital gains inclusion rate will increase to:

- **2/3** for corporations and trusts; and
- **2/3** for the portion of capital gains realised for individuals in excess of an annual C$250,000 threshold.

The annual threshold for individuals will apply to capital gains realised by individuals (either directly or indirectly), net of:

- Current year capital losses;
- Capital losses of other years applied to the relevant year to reduce the rate; and
- Capital gains in respect of which the LCGE, proposed Employee Ownership Trust Exemption or proposed Canadian Entrepreneurs' Incentive is claims.

Individuals will continue to benefit from the 1/2 deduction of the taxable benefit up to a combined C$250,000 for both employee stock options and capital gains.

Transitional rules are due to be implemented for tax years beginning before and ending on or after 25 June 2024. These rules will distinguish between two periods: Period 1 and Period 2, each subject to a different inclusion rate based on the timing of the transaction, such that the net capital gains realised before June 25, 2024 would be subject to the 1/2 inclusion rate and the net capital gains realised after June 24, 2024 will be subject to the 2/3 inclusion rate.

As a result, the following tax rates will apply to capital gains earned by Non-residents to the extent that they dispose of any taxable Canadian property:

	CG Inclusion Rate	**Tax rate**
Before June 25, 2024	1/2	24.42%
After June 25, 2024, up to C$250,000 in CG	1/2	24.42%
After June 24, 2024, in excess of C$250,000 in CG	2/3	32.56%

For Canadian tax residents, the increase in capital gains inclusion rate will not only increase their effective tax rates, but also make it less attractive for them to earn capital gains in excess of C$250,000 through their holding companies. This is mainly because the C$250,000 exemption is not available for dispositions made by holding companies.

Canadian capital gains taxes and Non-residents

Budget 2024 does not distinguish between capital gains realised by Canadian tax residents and Non-residents. Non-residents may be subject to Canadian taxes on the disposition of taxable Canadian property ("**TCP**") which is defined in full in Canada's Income Tax Act and generally includes Canadian real estate and shares of a private company where at any time during the last 60 months more than 50% of the fair market value of the shares of the company or the interest was derived directly or indirectly from Canadian real estate, natural resources or timber resources.

One consequence of the increase in the capital gains inclusion rate for Non-residents relates to dispositions, or deemed dispositions on death, of TCP. Where a non-resident makes a disposition or deemed disposition of TCP they will now be subject to the increase in the capital gains inclusion rate.

A typical deeming event is death. For example, a Non-resident individual owns Canadian real property directly or through his Hong Kong holding company which was incorporated for the sole purpose of investing in Canadian real estate a few years ago. The Non-resident would be subject to Canadian capital gains tax (and thus the increase in the capital gains inclusion rate too) if he transfers the real estate or shares of his Hong Kong holding company to his family members either during his lifetime or upon his death through his estate.

It is worth noting that if a Non-resident sells Canadian real estate, the purchaser must withhold and remit 25% of the proceeds to the Canada Revenue Agency unless a tax clearance certificate could be obtained in advance. It is anticipated that the withholding tax rate on dispositions of TCP by Non-residents may be amended to reflect the increase in the capital gains inclusion rate, which in turn may create further exposure for Non-residents.

Conclusion

High net-worth clients in Asia who own substantial Canadian real estate should carefully consider potential opportunities to mitigate the tax liability prior to the changes coming into effect on 25 June 2024, such as accelerating disposal timelines.

There may also be estate planning opportunities in relation to private wealth structures which include non-Canadian companies, shares in which may constitute TCP.

Despite Budget 2024 citing that only 0.13% of individual Canadians will be liable to the increased rate, the increase to the capital gains inclusion rate is expected to have a notable impact on investment behaviour. We understand further details of the mechanics of the capital gains inclusion rate increase will be announced in the coming months. Please contact us for further advice on how these tax changes may affect your private wealth structures.re

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