Capital gains planning: Pre-June 25 action items

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Background

Capital gains inclusion rate increased to 2/3

- Currently, only 1/2 of a taxpayer's capital gains are included in computing income. The 1/2 inclusion rate currently applies to all taxpayers (be it a corporation, trust or an individual).
- Budget 2024 proposed the following, effective for capital gains (other than on a principal residence) realized on or after June 25, 2024:
    - For corporations and trusts, increase capital gains inclusion rate from 1/2 to 2/3 for all capital gains; and
    - For individuals, increase capital gains inclusion rate from 1/2 to 2/3 on capital gains realized in the year that exceed $250,000.

Capital gains exemption increased to $1,250,000

- Under existing rules, an individual may claim a Lifetime Capital Gains Exemption (LCGE) of up to $1,016,836 in 2024 for capital gains realized on the disposition of qualified small business corporation (QSBC) shares.
- Currently, the cash tax savings from an individual claiming their full LCGE is ~$250,000.
- Budget 2024 proposes to increase the LCGE to $1.25 million for dispositions that occur on or after June 25, 2024. The tax savings of an individual claiming $1.25 million of LCGE when 2/3 of capital gains are included in income (ignoring the $250,000 lower rate portion) is ~$416,000 ($1.25 million x 2/3 x ~50% top marginal tax rate).

Change of law risk

As the decision to increase the inclusion rate is highly political, public response to the change may cause the government to significantly narrow the scope of its proposals. Currently, there is no draft legislation making it difficult to understand the full impact of

the proposals. The federal government has announced its intention to release draft legislation before the summer break.

Tax attributes

A vendor may have significant tax attributes available that may be sufficient to shelter capital gains. Some examples of planning mechanisms already available to shelter capital gains include:

- Losses may be available to shelter capital gains, which could result in the complete elimination of taxes payable. Further, where accrued gains exist within a corporate group, intra-group loss planning should be considered.
- For corporate vendors, safe income dividends may be declared to reduce an unrealized capital gain on shares.
- Where all the shares of a Canadian target corporation are acquired, through a series of corporate steps, it may be possible for a purchaser to eliminate capital gains on the target's underlying non-depreciable property by "bumping" up the cost base of such property.
- If a target company has tax losses that will become restricted or expire on an acquisition of control, there may be a tax election available to the target which allows the target to have any underlying capital property that has appreciated in value deemed to be disposed of for an amount between the adjusted cost base and the fair market value, so that it can shelter any gains with such losses.

As such, a vendor of capital property requires a thorough understanding of their tax attributes before implementing any capital gains planning.

Accelerating closing date

There is no grandfathering of unrealized capital gains accrued before June 25, 2024 – if such historical capital gains are realized on or after June 25, 2024, the entire amount will be subject to the new inclusion rate regime. Therefore, it could be beneficial to close planned dispositions before June 25, 2024, so as to avoid the new 2/3 inclusion rate on capital gains. This may not apply to the following types of taxpayers:

- An individual with a gain of $250,000 or less, as they would still have a ½ inclusion rate; or
- Individual who can benefit from the proposed expansion of LCGE to 1.25M on most of their gain.

There is less than one month to implement an accelerated closing and such quick decisions will likely be made based off imperfect information. Taking any steps now to trigger or crystalize capital gains may end up being disadvantageous.

The following are some numerical examples that help explain the tax savings (or cost) of closing before June 25, 2024, for an individual (not corporate) vendor:

Example 1

Capital Gain:	$1,000,000
Marginal Tax Rate:	53.53%
LCGE:	Not included in example, since LCGE on $1M gain would result in no tax under both scenarios.

Sale June 1, 2024

Capital Gain	$1,000,000
Taxable Capital Gain (50%)	$500,000
Tax Paid (53.53%)	$267,650
After Tax Proceeds	$732,350

Sale June 1, 2025

Capital Gain	$1,000,000
Taxable Capital Gain - First $250,000 (50%)	$125,000
Taxable Capital Gain - Balance (66.7%)	$500,250
Taxable Capital Gain	$625,250
Tax Paid (53.53%)	$334,696.33

After Tax Proceeds	$665,303.68
Tax Savings of accelerating closing:	$67,046.33

Example 2

Capital Gain:	$2,000,000
Marginal Tax Rate:	53.53%
LCGE:	Considered below

Sale June 1, 2024	**Assuming no LCGE**	**Assuming LCGE**
Capital Gain	$2,000,000	$2,000,000
Taxable Capital Gain (50%)	$1,000,000	$491,582 (after LCGE)
Tax Paid (53.53%)	$535,300	$263,143.84
After Tax Proceeds	$1,464,700	$1,736,856.16

Sale June 1, 2025		
Capital Gain	$2,000,000	$2,000,000

Taxable Capital Gain - First $250,000 (50%)	$125,000	$125,000
Taxable Capital Gain - Balance (66.7%)	$1,167,250	$333,500 (after LCGE)
Taxable Capital Gain	$1,292,250	$458,500
Tax Paid (53.53%)	$691,741.43	$245,435.05
After Tax Proceeds	$1,308,258.58	$1,754,564.95
Additional Tax Payable (Tax Reduction)	$156,441.43	$(17,708.79)

If the LCGE is being claimed on a $2,000,000 capital gain, it is more tax efficient to wait until after June 25, 2024 to dispose of the asset, due to the higher LCGE. The total tax cost associated with triggering the $2,000,000 capital gain before June 25, 2024 is roughly $17,000.

However, once a capital gain is over $2,200,000 the benefits of the higher LCGE are outweighed by the higher capital gains inclusion rate, so there will be a tax cost (more tax payable) with waiting until after June 25, 2024.

Delaying closing date

For individual taxpayers planning to sell shares in a QSBC during 2024 and can delay closing until after June 25, 2024, it may be worthwhile to model and compare the tax impact of these two alternatives:

1. *Sale closing before June 25, 2024:* Entitlement to the current LCGE amount of $1,016,836 only, and all capital gains beyond the LCGE amount subject to the 1/2 inclusion rate.
2. *Sale closing after June 25, 2024:* Entitlement to proposed LCGE amount of $1.25 million, but capital gain that exceeds the expanded LCGE amount plus the $250,000 threshold is subject to 2/3 inclusion rate.

Hybrid transaction structure

A hybrid transaction structure may work best for individuals with gains in excess of $1.25 million. For instance, recognizing all but $1.25 million of a capital gain prior to June 25 to take advantage of the ½ inclusion rate and recognizing the remaining $1.25 million of capital gains after June 25, 2024 to take advantage of the higher LCGE.

This could be accomplished through (1) a pre-closing reorganization by the Vendor to trigger gains on its property in excess of $1.25 million prior to closing at a ½ inclusion rate; and (2) subsequently selling the property to a third-party purchaser with an inherent gain now limited to $1.25 million that can be sheltered with the LCGE.

Reorganizations and pre-closing reorganizations to crystallize gain

Where there is no immediate sale contemplated, the vendor is a corporation or closing will be after June 24, 2024, and there is time for a pre-closing reorganization, it might be worthwhile for those with unrealized capital gains to realize such gains before June 25, 2024, with an internal crystallization transaction.

While this accelerates the tax payment, it will preserve the 1/2 inclusion rate for historical accrued gains and step-up tax cost base to the fair market value. On an eventual sale, the higher cost basis will reduce the gain on a sale to a third party by the amount of the crystallized gain. An example of a crystallization transaction includes the transfer of assets to a holding company and electing to recognize a gain under the *Income Tax Act*.

It is important to note that taxpayers wishing to explore this type of planning will have to consider a number of other issues, including (but not limited to) land transfer tax, recapture of depreciation, third party consents (*i.e*. lenders, etc.) and the costs of implementation.

Including shares in buyer as part of sale price to defer capital gains

A vendor that is open to accepting shares of a Canadian corporation as all or part of the sale price may be able to defer capital gains through a tax deferred share-for-share exchange. Where the purchaser is not a Canadian corporation, an exchangeable share structure may also allow for a complete deferral of capital gains.

Depending on how long the vendor wishes to hold the exchanged shares, it may be worthwhile to defer the tax using a share exchange instead of pre-paying tax at a lower capital gains inclusion rate.

Transactions that contain an earnout provision

The Canadian Revenue Agency accepts the use of the cost recovery method of reporting a gain or loss on the sale of shares under an earnout agreement. Under the cost recovery method, the vendor reduces their adjusted cost base of the shares as amounts on account of the sale price become determinable. Once the amounts exceed

the adjusted cost base of the shares, the excess is a capital gain realized when the amount became determinable. All amounts that subsequently become determinable are treated as capital gains at the subsequent time.

For any amounts that become determinable on or after June 25, 2024, it is arguable that any capital gains eligible for the LCGE can benefit from the higher exemption amount of $1.25 million. However, if the LCGE is not available, it may make sense for vendors to accelerate earnout payments to occur prior to June 25, 2024.

Vendors may also want to consider a reverse earnout instead of an earnout, wherein a capital gain is realized on closing. If closing is pre-June 25, 2024, the ½ inclusion rate would apply to the capital gain, instead of the 2/3 rate which would apply to capital gains after June 24, 2024.

Accelerate departure from Canada

Individuals departing Canada are subject to Canadian income tax on a notional capital gain based on the fair market value of their assets on their departure date. If severing residential ties from Canada on or after June 25, 2024, the notional capital gain will be subject to the new inclusion rate regime. Therefore, individuals may wish to accelerate their exit (emigration) from Canada.

Possible income splitting opportunities

The new $250,000 capital gain lower inclusion bracket for individuals may cause individuals to seek income splitting opportunities with their family members to multiply the quantum of capital gains subject to the ½ inclusion rate. For example, selling capital property to a spouse in exchange for a prescribed rate loan.

Application to partnerships and trusts

For entities such as partnerships and trusts that allocate gains out to their partners and beneficiaries, respectively, there may be timing and technical issues surrounding capital gains realized before June 25, 2024 that are allocated out to partners/beneficiaries after June 24, 2024.

Get in touch

To determine if any action needs to be taken prior to June 25 to minimize the impact of the increased capital gains inclusion rate, please reach out to a member of BLG's Tax Group.

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