TAX Matters@EY

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TaxMatters@EY: Family Wealth Edition

TaxMatters@EY is an update on recent Canadian tax news, case developments, publications and more. The quarterly Family Wealth Edition focuses on tax strategies and related topics for preserving family wealth.

How could the capital gains inclusion rate increase affect you?

Gael Melville, Vancouver

This year's federal budget contained a surprising announcement that will affect many taxpayers. The capital gains inclusion rate is changing for the first time in more than 20 years.

The budget documents predicted that fewer than 1% of Canadians would be expected to pay more tax on their capital gains in any given year as a result of the changes. But it's important to understand that the changes affect not only high-income or high-net-worth individuals — they could apply to you if you realize a large, one-off capital gain after June 24, 2024. This situation can crop up unexpectedly, for example, when someone dies or when they emigrate from Canada.

Here we offer three examples of situations where individuals may need to pay increased tax on capital gains as a result of the new rules.

Background to the changes

The government tabled its 2024 federal budget on April 16, 2024, and although the first budget implementation act of 2024 followed soon after, the changes to the capital gains inclusion rate that had been announced on budget day were not included.[1]

Broadly, the government proposed increasing the capital gains inclusion rate for individuals from one half to two thirds on the portion realized in the year above $250,000 for capital gains realized on or after June 25,

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[1] Bill 69, *Budget Implementation Act, 2024, No. 1*, received Royal Assent on June 20, 2024. For more information, see EY Tax Alert 2024 Issue No. 36.

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2024. The annual $250,000 threshold will not be prorated for 2024 and will apply only to net capital gains realized on or after June 25, 2024.[2]

On June 10, 2024, Deputy Prime Minister and Minister of Finance Chrystia Freeland tabled a notice of ways and means motion (NWMM) to implement the capital gains inclusion rate increase. The House of Commons adopted the notice the following day.[3]

However, no implementing bill followed before the House's spring session ended in June. The government released draft legislation on August 12 along with explanatory notes, and the measures were open for public consultation until September 3, 2024. We expect the measures to be included in a bill some time in the fall. See EY Tax Alert 2024, No. 45 for more information. A new NWMM was tabled in the House of Commons on September 23. At the time of writing, it was expected that the updated NWMM would be adopted in early October, but it was unclear whether a bill would follow immediately.

Death and taxes

One situation that can lead to a large capital gain arising is an individual's death. When you die, the *Income Tax Act* treats you as if you disposed of certain types of property immediately before your death. The deceased individual is deemed to have realized all accrued gains and losses on capital property, resource property and any land that was part of the inventory of a business. Effectively, these assets are assumed to have been sold at their fair market value.

Examples of the types of property that may be included in this deemed disposition are a home or vacation property, investments (apart from ones held in registered plans such as TFSAs or RRSPs), vehicles and boats.[4]

In some cases, you may be able to claim an exemption on a property that's subject to the deemed disposition on death. One of the most common examples of this is your home, which may qualify for the principal residence exemption.

Similarly, property that is left to your spouse or common-law partner, or to a testamentary spousal or common-law partner trust, may benefit from a tax-deferred rollover, becoming taxable only when the second spouse or partner dies.[5] Several conditions must be met in order for the spousal rollover to apply, including that the property *vest indefeasibly* in the spouse or common-law partner within 36 months of the deceased individual's death. The CRA may allow a longer period if an application is made.[6]

The deceased's legal representative must prepare a terminal income tax return on behalf of the deceased individual, and any gains that cannot be sheltered by an exemption like the principal residence exemption or deferred on a spousal rollover must be included in the deceased's income at the applicable capital gains inclusion rate. When these gains are added to other income the deceased may have in the year of their death, the result can be a significant income tax bill.

Example

Beverley is 75 years old at the start of 2024 and is a widow with two adult children and no financially dependent children or grandchildren. When her spouse died two years ago, she became the sole owner of their Ontario home, a portfolio of non-registered investments and a small RRIF. The investment portfolio

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[2] Employees claiming the employee stock option deduction will be provided a one-third deduction of the taxable benefit to reflect the new capital gains inclusion rate. However, they will be entitled to a deduction of one half the taxable benefit up to a combined limit of $250,000 for both employee stock options and net capital gains.

[3] A NWMM is the first step in a budget measure becoming incorporated in legislation.

[4] Special rules that apply to registered plans govern the tax treatment of registered plan assets when the holder or annuitant dies. These rules are outside the scope of the capital gains rules. For more information on the tax treatment of registered retirement savings plans on death, see TaxMatters@EY: Family Wealth Edition – April 2023.

[5] If the property is sold before the death of the second spouse or partner, it becomes taxable at that time instead.

[6] The term "vest indefeasibly" is not defined in the *Income Tax Act*. In CRA IT Folio S6-F4-C1, *Testamentary Spouse or Common-law Partner Trusts*, the phrase is described as referring to the unassailable right to ownership of a particular property. It's a question of fact and law whether a property has vested indefeasibly in an individual or trust.

consists mostly of a single technology sector stock that Beverley's late spouse purchased for $10 per share and that now has a fair market value of $200 per share. The fair market value of Beverley's properties immediately before Beverley's death in 2024 is as follows:

	Fair market value	Adjusted cost base	Unrealized gain
Home	$1,100,000	$300,000	$800,000
RRIF	$80,000	N/A	N/A
Non-registered investment portfolio	$600,000	$30,000	$570,000

Assume that Beverley's legal representative claims the principal residence exemption on the home for all years of ownership and that the RRIF proceeds are taxable on Beverley's terminal tax return.

Other potential sources of income or types of property are ignored for purposes of this example.

Beverley's taxable income on her terminal tax return would be as follows:

	Scenario 1: Beverley dies before June 25, 2024	Scenario 2: Beverley dies after June 24, 2024
RRIF income from deemed disposition on death	$80,000	$80,000
Taxable capital gain on home (fully sheltered by principal residence exemption)	0	0
Taxable capital gain on non-registered investments	$285,000*	$338,333**
Total income	$365,000	$418,333
Federal and provincial income tax[7]	$152,039	$180,588
Effective tax rate	41.65%	43.17%

**($600,000-$30,000) x 1/2*

***($600,000-$30,000) = $570,000; ($250,000 x 1/2) + ($320,000 x 2/3) = $338,333*

If Beverley dies after June 24, 2024, the proposed capital gains inclusion rate rules will apply and the capital gain arising on the deemed disposition of the investments will be subject to the two-thirds inclusion rate, with the exception of the first $250,000 that will effectively be subject to the existing one-half inclusion rate.[8]

Since the higher two-thirds inclusion rate applies to part of the deemed disposition of the investments, Beverley will have an additional income inclusion of $53,333 (i.e., $338,333 less $285,000), resulting in additional tax payable of $28,549 (i.e., $180,588 less $152,039). Because she is also deemed to have received the RRIF proceeds immediately before her death, her income for purposes of her terminal return will be relatively high.

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[7] Federal and provincial income tax was calculated using [EY's 2024 Personal Tax Calculator](), assuming the only nonrefundable credit Beverley was entitled to claim in 2024 was the basic personal amount.

[8] Under the proposed rules, technically a two-thirds capital gains inclusion rate will apply since Beverley's only net capital gains for the year arise after June 24, 2024. However, a special annual capital gains reduction is then applied to effectively reduce the capital gains inclusion rate to one-half on the first $250,000 of capital gains.

Cottages and investment properties

One of the higher-value types of property an individual may hold is real estate. Although an individual who sells their home may be able to shelter any resulting capital gain using the principal residence exemption, secondary properties like investment or vacation properties may not qualify for the exemption, or the individual may prefer to hold back the exemption to use when they sell their home instead.[9]

Selling real estate can give rise to a large, one-off capital gain, and if the individual has total capital gains exceeding $250,000 in a taxation year, under the proposed capital gains inclusion rate changes they will be subject to the new higher inclusion rate of two thirds on the excess.

Example

Jim, a resident of Ontario, is 60 years old and is single with no children. In 2002, Jim's grandfather died and left Jim the family cottage in his will. The cottage's fair market value in 2002 was $100,000 and it is now worth $800,000 even though Jim has not made any upgrades to it.

Jim earns $60,000 per year in employment income and has modest savings. He is finding the cottage too costly to maintain and wants to sell it to his cousin at market value to fund his retirement.

Jim also owns a condo in downtown Toronto that he bought in 2001 and that also has a substantial unrealized gain. He plans to sell the condo and buy another place out of the city within the next two years.

The fair market value of Jim's real estate properties in May 2024 is as follows:

	Fair market value	Adjusted cost base	Unrealized gain
Condo	$1,500,000	$300,000	$1,200,000
Cottage	$800,000	$100,000	$700,000

Jim intends to claim the principal residence exemption on the condo for all years of ownership since it has the larger unrealized gain. As a result, Jim does not designate the cottage as a principal residence. Assume Jim has no other capital gains or losses for 2024.

Jim's taxable income in 2024 would be as follows:

	Scenario 1: Jim sells the cottage before June 25, 2024	Scenario 2: Jim sells the cottage after June 24, 2024
Capital gain on cottage	$700,000	$700,000
Taxable capital gain on cottage	$350,000*	$425,000**
Employment income	$60,000	$60,000
Total income	$410,000	$485,000
Federal and provincial income tax[10]	$176,127	$216,275
Effective tax rate	42.96%	44.59%

($800,000-$100,000) x 1/2

***($800,000-$100,000) = $700,000; ($250,000 x 1/2) + ($450,000 x 2/3) = $425,000*

[9] For 1982 and later years, only one individual in a family unit may designate a property as a principal residence for a particular year. If the family's primary home is designated for a particular year, the principal residence exemption would not be available for that year in respect of other properties.

[10] Federal and provincial income tax was calculated using EY's 2024 Personal Tax Calculator, assuming the only nonrefundable credit Jim was entitled to claim in 2024 was the basic personal amount.

If Jim sells the cottage after June 24, 2024, the proposed capital gains inclusion rate rules will apply and the gain arising on the sale of the cottage will be subject to the two-thirds inclusion rate, with the exception of the first $250,000 that will effectively be subject to the existing one-half inclusion rate. Since the higher two-thirds inclusion rate applies to part of the disposition of the cottage, Jim's taxable capital gain will be $425,000 instead of $350,000, resulting in additional tax payable of $40,148 (i.e., $216,275 less $176,127).

If Jim and his cousin can agree to spread the payment of the proceeds over a period of up to five years, Jim may be able to use the capital gains reserve mechanism to lower the realized gain each year and could benefit from the one-half inclusion rate on the first $250,000 of gains each year.

Thinking of leaving? Don't forget about departure tax

Another life event that can lead to unexpected tax results is when you leave Canada permanently and become nonresident. An individual who emigrates from Canada should consider the departure tax rules, which in some cases can result in a large capital gain being realized on the date of departure.

Generally, when an individual ceases to be a resident of Canada, the taxpayer is deemed to have disposed of all property owned at that date for proceeds equal to its fair market value at that time. There are some significant exclusions from this rule: for example, real or immovable property situated in Canada, inventory of a business carried on through a permanent establishment in Canada, and funds held in registered plans such as TFSAs or RRSPs.

If you have an unrealized loss on certain types of property that are excluded from departure tax, you may be able to elect to have the deemed disposition apply to that property nonetheless, allowing you to offset the loss against any gains resulting from the application of the departure tax rules.

In the year you emigrate from Canada, any accrued gains at the date of departure on property that is not excluded property are subject to departure tax. Instead of paying the tax liability resulting from the deemed disposition immediately, you may file an election and post security with the CRA, in which case the tax is payable when you actually sell the property. However, security is not required for the tax payable, computed at the highest marginal tax rate, on the first $50,000 of taxable capital gains resulting from the deemed disposition.

Example

Ash is 39 and has been a resident of Alberta since birth. Ash has spent the last year co-founding with his brother a consulting business, which operates as a Canadian-controlled private corporation. Ash owns half the shares in the corporation.[11]

Ash and his spouse recently decided to move overseas in 2024 to take care of elderly relatives. They expect to live outside Canada for several years, maybe permanently. Ash plans to keep his shares in the company since his brother is not in a financial position to buy him out and does not want Ash to sell the shares to a third party. The fair market value of Ash's shares is $1,000,000 and the cost basis is $10,000. Assume Ash has no other property subject to departure tax and no other capital gains or losses for 2024.

Ash's taxable income from the deemed disposition of his shares would be as follows:

	Scenario 1: Ash's date of departure from Canada is before June 25, 2024	Scenario 2: Ash's date of departure from Canada is after June 24, 2024
Capital gain on shares	$990,000	$990,000
Taxable capital gain on shares	$495,000*	$618,333**

[11] The shares are not qualified small business corporation shares for purposes of the lifetime capital gains exemption due to their short holding period. The shares are also not taxable Canadian property for purposes of the exclusions from departure tax.

**($1,000,000-$10,000) x 1/2*

***($1,000,000-$10,000) = $990,000; ($250,000 x 1/2) + ($740,000 x 2/3) = $618,333*

Ash will be deemed to have disposed of all his property (except for excluded property) at fair market value on the date of his departure from Canada. If his departure date is on or after June 25, 2024, he will be subject to the higher inclusion rate on the part of the gain on the shares that exceeds $250,000. This will result in an additional $123,333 being subject to tax at Ash's top marginal tax rate.

Assuming his marginal tax rate is 48%, the resulting income tax could be as much as $59,200 higher, depending on what deductions and credits are available to Ash during the resident portion of the year. Ash can make an election to defer the tax liability but will be required to post security for the tax payable, other than the portion payable on the first $50,000 of taxable capital gains.

Conclusion

The proposed changes to the capital gains inclusion rate are complex and may result in a higher-than-anticipated tax liability when you dispose of property that is not eligible for any exemptions or deferrals.

The changes will not affect everyone equally, and individuals who have large unrealized gains on real estate properties or on investments in non-registered accounts should review their tax position carefully.

It's important to be aware that there are some situations where a deemed realization under the *Income Tax Act* is unavoidable, and to be prepared for the additional tax that may now arise as a result of the increased capital gains inclusion rate.

Tax tips

- Review your estate plan with your EY advisor to make sure you understand how the increase in the capital gains inclusion rate may affect your family, especially if you hold real estate in addition to your principal residence or have investments in non-registered accounts.
- Remember that if you hold property jointly with other individuals, each of you benefits from a $250,000 threshold each year from 2024 onwards in relation to the capital gains inclusion rate. The threshold is not prorated for 2024 even though the higher inclusion rate only began to apply on June 25, 2024.
- If you hold investments with large unrealized capital gains in non-registered accounts, discuss your realization strategy with your EY advisor to make the most of your $250,000 annual threshold.

Publications and articles

Tax Alerts – Canada

Tax Alert 2024 No. 47 – Canada imposes surtaxes on imports of Chinese EVs, steel and aluminum products, and considers surtaxes on critical manufacturing goods

Tax Alert 2024 No. 48 – Distributed investment plans required to request certain investor information by 15 October 2024

Additional resources

Digital services tax – 2024 jurisdiction activity summary
An updated version of EY's DST jurisdiction activity summary is now available. The summary outlines the status, scope, rate, thresholds, exclusions and effective dates for 24 jurisdictions. It also includes links to relevant EY Global Tax Alerts and EY contact details.

EY's activity summary provides the latest information correct as of April 1, 2024.

EY Climate Cash and Tax Barometer 2022
The EY Climate Cash and Tax Barometer analyzes spending by governments and businesses on policies designed to forward climate goals.

Expanded Green Tax Tracker now available
The EY Green Tax Tracker provides an overview of the sustainability incentives, carbon pricing regimes and other environmental taxes in effect in an ever-growing number of jurisdictions.

EY's Worldwide Personal Tax and Immigration Guide 2023-24
Governments worldwide continue to reform their tax codes at a historically rapid rate. Taxpayers need a current guide, such as the Worldwide Personal Tax and Immigration Guide, in such a shifting tax landscape, especially if they are contemplating new markets. The content is straightforward. Chapter by chapter, from Albania to Zimbabwe, we summarize personal tax systems and immigration rules in more than 150 jurisdictions. The content is current as of September 1, 2023, with exceptions noted.

EY's Worldwide Capital and Fixed Assets Guide 2024
Capital expenditures represent one of the largest items on a company's balance sheet. This guide helps you reference key tax factors needed to better understand the complex rules relating to tax relief on capital expenditures in 30 jurisdictions and territories.

EY's Worldwide Estate and Inheritance Tax Guide 2024
This guide summarizes the gift, estate and inheritance tax systems and describes wealth transfer planning considerations in 44 jurisdictions and territories.

Worldwide Corporate Tax Guide 2023
Governments worldwide continue to reform their tax codes at a historically rapid rate. Chapter by chapter, from Albania to Zimbabwe, this EY guide summarizes corporate tax systems in more than 150 jurisdictions.

Worldwide VAT, GST and Sales Tax Guide 2024
This guide summarizes the value-added tax (VAT), goods and services tax (GST) and sales tax systems in 150 jurisdictions, including the European Union.

Worldwide R&D Incentives Reference Guide 2024
The Worldwide R&D Incentives Reference Guide offers taxpayers the information necessary to identify and leverage opportunities to benefit from available incentives, especially relevant if they are contemplating new or expanded investments in R&D, innovation and sustainability.

Worldwide Transfer Pricing Reference Guide 2022-23
This publication is designed to help international tax executives identify transfer pricing rules, practices and approaches.

The information included in the guide covers 123 jurisdictions. It is meant to provide an overview for the covered jurisdictions regarding their transfer pricing tax laws, regulations and rulings; OECD Guidelines treatment; documentation requirements; transfer pricing returns and related-party disclosures; transfer pricing documentation and disclosure timelines; BEPS Action 13 requirements; transfer pricing methods; benchmarking requirements; transfer pricing penalties and relief from penalties; statutes of limitations on transfer pricing assessments; possibility of transfer pricing scrutiny and related audits by the tax authorities; and opportunities for advance pricing agreements (APAs).

The content for the guide is updated as of June 30, 2023.

EY Center for Board Matters
The EY Center for Board Matters supports board members in their oversight role by helping them address complex boardroom issues.

EY TradeFlash

Welcome to EY's latest edition of TradeFlash, a companion to EY TradeWatch. This new publication provides a roundup of the latest developments in global trade around the world.

EY TradeWatch Issue 2, 2024

EY TradeWatch provides information about customs and international trade developments to help you develop strategies to manage duty costs and the risks of global trade, to improve trade compliance and to increase the operational effectiveness of international supply chains.

Websites

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Online tax calculators and rates

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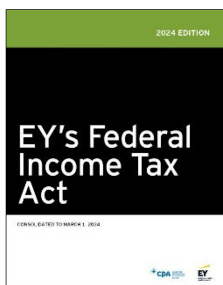
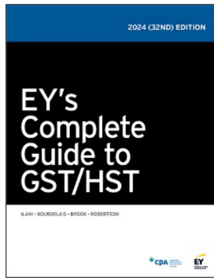


EY's Federal Income Tax Act, 2024 Edition

Editors: Albert Anelli, Janette Pantry, and Linda Tang

Now available.

Included with this edition: interactive online features and purpose notes for selected provisions. Purchase of a print book includes access to an online updated and searchable copy of the federal *Income Tax Act* as well as the pdf eBook. Consolidated to March 1, 2024, this edition contains amendments and proposals, including December 20, 2023 legislative proposals [2023 fall economic statement measures], Bill C-59, *Fall Economic Statement Implementation Act, 2023*, August 4, 2023 legislative proposals [budget 2023 and other proposals and technical amendments], and Bill C-47 (2023, c. 26), *Budget Implementation Act, 2023, No. 1*.



EY's Complete Guide to GST/HST, 2024 (32nd) Edition
Editors: Jadys Bourdelais, Thomas Brook, Sania Ilahi, David Douglas Robertson

Available October 2024

Canada's leading guide on GST/HST, including GST/HST commentary and legislation, as well as a GST-QST comparison. Written in plain language by a team of EY indirect tax professionals, the guide is consolidated to July 1, 2024 and updated to reflect the latest changes to legislation and CRA policy.

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