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Even the dead wouldn't be spared from Canada's capital gains hike

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Canada's proposed increase to its capital gain inclusion rate is likely to impact a wide cross-section of taxpayers, not just the "wealthiest" individuals and "a small minority" of Canadian businesses, as the government has asserted.

In its latest budget, Canada has proposed to raise the capital gain inclusion rate from one-half to two-thirds for dispositions on or after June 25. The higher rate would apply to all dispositions by corporations and trusts. Individuals would also be subject to the higher rate on realized gains that exceed CA$250,000 (about $182,000) in a year.

The budget bill that was tabled on April 30 didn't include the proposal. Rather, the government stated it intends to introduce the increase in a standalone bill.

Canada also suggested the proposed change is unlikely to affect most of the population, estimating only 0.13% of Canadians would pay more personal income tax in 2025. But this assertion belies the impact this change would likely have.

Proposal outlook

Those who sell a vacation or investment property would be among those who feel the change most acutely.

According to a 2023 survey by Royal LePage, a real estate company, more than one in 10 Canadians own an investment property. Although sales of principal residences are exempt from capital gains tax, sales of second properties are not. The gains from dispositions of these properties above CA$250,000 would be subject to the proposed rate hike.

The increased rate also would have a significant impact on what happens upon death. Subject to certain limited exceptions, taxpayers are generally deemed upon death to have disposed of their property for fair market value, and the property is immediately deemed to be acquired by the estate.

This results in the recognition of any gain that has accrued on property to date. With Canada's aging population, taxing two-thirds of all gains on death (exceeding CA$250,000) instead of one-half would obviously affect the available remaining assets that could be

passed on to the next generation — jeopardizing existing estate planning arrangements.

To alleviate some impact of the increased rate for individuals and "encourage entrepreneurship," the budget introduces an entrepreneurship incentive that reduces the inclusion rate to 33.3% on up to CA$2 million of gains over an individual's lifetime.

However, the conditions to access this incentive are strict. They include requiring that the individual be a founding investor of the corporation and have directly owned more than 10% of the voting power and fair market value of the corporation at all times. Numerous types of businesses would be excluded from the incentive, including financial, insurance, and real estate businesses. The incentive also would be phased in over 10 years.

As a result, the new entrepreneurship incentive would in practice do little to relieve the impact of the increased rate for most taxpayers.

For corporations, all dispositions of capital property on or after June 25 would be subject to the higher rate. Canadian resident individuals own and control hundreds of thousands of private corporations. Capital gains realized by those corporations would be subject to the new rate with no ability to access the one-half inclusion rate on the first CA$250,000 of gains or offsetting incentives.

Individual shareholders would ultimately feel the increased tax burden from these dispositions. For example, professionals such as doctors, lawyers, and accountants may carry on business through a corporation, which might hold investments or real estate.

The eventual dispositions of these properties would be subject to the two-thirds inclusion rate, significantly decreasing the after-tax proceeds available to the owner. This could impact retirement plans.

Finally, public corporations that realize capital gains would bear a higher tax burden, meaning fewer funds would be available to reinvest in the business or pay dividends to shareholders.

An obvious response to the increased rate may be to dispose of capital properties before June 25, triggering a gain that is subject to the lower one-half inclusion rate under the existing rules. However, this is easier said than done. Even the most motivated seller would have just over two months to find a buyer and complete the sale.

Outlook

The budget materials offer limited information on how the increased inclusion rate would be implemented, noting that additional "design details" will be released in the coming months.

Given the centrality of the capital gains rules to the Canadian tax system, the change would require significant and complex legislative amendments — the impacts of which can't be fully measured until final legislation is released. Based on the government's projections, the change is substantial, as it would lead to an increase in federal revenues of CA$19.4 billion over five years.

This budget proposal marks the fifth change in the capital gain inclusion rate since capital gains tax was introduced in 1972. If history is any indication, the increased inclusion rate, if implemented, may not be permanent. Because its lifespan is currently indeterminate and its impact is widespread, taxpayers and their advisers may need to navigate it for the foreseeable future.

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