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Postponing the Increase in Canada’s Capital Gains Inclusion Rate: What It Means for Investors and the Economy

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Background of the Capital Gains Inclusion Rate Change

The proposed change in the capital gains inclusion rate was designed to increase federal revenues by targeting individuals realizing large capital gains as well as most trusts and corporations realizing any amount of capital gains. Specifically, under the initial plan:

a) The capital gains inclusion rate for individuals would increase from 50% to 67% on gains exceeding $250,000 per year.

b) Corporations and most types of trusts would see the new 67% rate apply to all capital gains realized in the future.

c) The change was set to take effect on June 25, 2024, prompting many investors to accelerate sales of shares and other capital assets to avoid the higher tax rate.

The proposed change faced significant opposition from businesses, industries, and economists, who warned it could deter investment in Canada. Many feared that increasing capital gains taxation could drive investors to move their money elsewhere, reducing economic activity and job creation within the country. Political challenges further complicated its implementation. In particular, the measure failed to pass in the House of Commons due to a political impasse before Prime Minister Justin Trudeau's proroguing of Parliament left the legislation hanging in limbo. Despite these hurdles, the Canada Revenue Agency (“CRA”) had been collecting the increased tax since the intended implementation date

Why Did the Government Defer the Change?

Despite its initial commitment to raising the inclusion rate, the Government faced legislative and political roadblocks that ultimately delayed its implementation:

a) Parliamentary Challenges: The proposed inclusion rate increase needed to be confirmed by the House of Commons. However, political opposition and a divided Parliament made it difficult to push the legislation forward. Furthermore, the proroguing of Parliament by the Prime Minister prevented the changes from being

passed into law prior to the deadline for taxpayers to file their 2024 tax returns.

b) Business and Economic Backlash: Economic experts and business groups warned that the tax hike could reduce investment in Canada, discouraging entrepreneurs and investors from taking risks.

c) Public and Political Pressure: Although the CRA has generally taken the position that they will enforce changes in taxation laws where the underlying Notice of Ways and Means Motion has been tabled in the House of Commons but not passed, the breadth of the proposed capital gains inclusion rate increase caused politicians, interest groups and taxpayers to demand such changes receive Parliamentary approval before their enforcement. With an upcoming election and growing dissatisfaction from middle-class Canadians, the Government reconsidered the timing of the change, ultimately deciding to postpone it until 2026.

Financial Implications of the Deferral

Not surprisingly, the announcement of the proposed increase had already triggered a wave of asset sales. Many investors and business owners sought to realize capital gains after the April 16, 2024 federal budget date and before June 25, 2024 when the higher inclusion rate would take effect, leading to a surge in the realizaton of taxable capital gains. This led to billions in additional tax revenue for the Government, despite the increase never having been legally implemented. Indeed, the Government of Canada would have known from past experience that substantial tax revenues would be triggered before the June 25, 2024 effective date of the planned increase in the capital gains inclusion rate.

This scenario highlights the psychological and economic impact of taxation policy. Tax professionals, investors and corporations often react to anticipated changes in tax laws, altering their behavior to optimize financial outcomes. In this case, the Government benefited from the capital gains surge without actually enacting the tax hike.

Key Provisions to Mitigate the Impact of the Increase

To soften the blow of the proposed inclusion increase and provide relief to taxpayers, the Federal Government has nonetheless maintained or introduced several exemptions and incentives:

a) Principal Residence Exemption: Canadians will continue to be exempt from capital gains tax when selling their primary home.

b) $250,000 Annual Threshold: Beginning January 1, 2026; Individuals will still be able to realize up to $250,000 in capital gains annually that will remain subject to the 50% inclusion rate. This means that for a couple selling jointly owned property with $500,000 in accrued capital gains, the additional tax burden would not apply.

c) Lifetime Capital Gains Exemption Increase: Effective from June 25, 2024, the exemption threshold for small business corporation shares and farming or fishing properties increased from $1,016,836 to $1.25 million.

d) Canadian Entrepreneurs’ Incentive: Starting in the 2025 tax year, this program will allow eligible entrepreneurs to benefit from a reduced inclusion rate of one-third on up to $2 million in lifetime capital gains, incentivizing business ownership and economic growth.

What This Means for Canadians

The deferral of the capital gains tax increase provides investors and business owners with additional time to plan. While the delay means individuals will not immediately face a higher tax burden, it also leaves uncertainty about future taxation policies. Investors should stay informed and consider consulting McLeod Law LLP’s tax lawyers to optimize their strategies in light of potential tax changes.

For entrepreneurs, the deferral and the introduction of new incentives provide opportunities to leverage tax exemptions when selling businesses or reinvesting capital. The Government's decision to balance increased taxation with targeted relief measures aims to minimize negative economic impacts while still addressing revenue needs.

Looking Ahead: What's Next?

The Canadian Government remains committed to reassessing and possibly implementing the inclusion rate increase in 2026. However, the deferral leaves room for further political debates, economic considerations and potential policy adjustments before the new date arrives.

As Canada navigates its fiscal challenges, taxpayers should keep a close eye on future budget announcements, political shifts and potential legislative developments. The ongoing discussion around capital gains taxation underscores the broader conversation about balancing economic growth with equitable tax policies.

In the meantime, Canadians should take advantage of current tax structures, exemptions and incentives to optimize their financial positions. Whether the proposed increase ultimately takes effect or is further revised remains to be seen, but one thing is certain: tax policy will continue to be a critical issue shaping Canada's economic landscape.

If you have any questions, our tax team at McLeod Law LLP is ready to assist you in navigating the capital gains increase and any other Canadian income tax planning challenges that you encounter.

In addition, keep an eye out for the decision of the Federal Court of Canada in relation to an application brought by two Nova Scotia residents challenging the entitlement of the Prime Minister to prorogue Parliament. Their application asks the Court to override that pro rogation, citing the urgency of the United States Government's threat of imposing steep tariffs on goods imported from Canada.