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Tax Alert — Canada

Government releases legislative details on the proposed changes to the capital gains rules

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 10 June 2024, a notice of ways and means motion (NWMM) was tabled by Deputy Prime Minister and Minister of Finance Chrystia Freeland to implement the increase in the capital gains inclusion rate that was announced in the 2024 federal budget (Budget 2024) but that was not part of Bill C-69, *Budget Implementation Act, 2024, No. 1*.[1]

The NWMM and two accompanying backgrounders cover the main features of the proposed changes to the capital gains inclusion rate, as well as the increase in the lifetime capital gains exemption (LCGE) and the reduction of the employee stock option deduction that were both announced in Budget 2024, and several other consequential and related amendments. The NWMM and the accompanying backgrounders also address various elements of the submission made on 1 May 2024 by the Joint Committee on Taxation of The Canadian Bar Association and Chartered Professional Accountants of Canada (the Joint Committee). The government indicated that further technical or consequential changes (for example, consequential changes to the alternative minimum tax rules) need to be made. These further technical or consequential changes should not, according to the government, materially affect the design of, or introduce new features to, the measures in the NWMM.

[1] For more information on the income tax measures included in Bill C-69, refer to EY Tax Alert 2024 Issue No. 27.

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Although there are no accompanying explanatory notes to date, one backgrounder (the Backgrounder) provides various examples describing the intended mechanics of the various provisions, including an example of net capital gains realized before 25 June 2024 (Period 1) and after 24 June 2024 (Period 2) and the interplay with the new $250,000 threshold for individuals.

However, as described below in section "2024 – A transitional year", the transitional rules dealing with taxation years that straddle 25 June 2024 are complex and include a formula averaging the total net capital gains inclusion rate for the two periods. This averaging rule was not specifically noted in the Budget 2024 papers and can produce unexpected results. In particular, this net capital gains inclusion rate averaging rule may give rise to issues with respect to the computation of the capital dividend account (CDA) where net capital gains or net capital losses are realized in Period 1 and Period 2. This averaging rule may also impact safe income and other aspects of tax planning. Consequently, careful consideration should be given to the current transitional rules before implementing any proposed transactions.

The government indicated that the legislative details contained in the NWMM, which was adopted on 11 June 2024, will be followed by the release of updated draft legislation by the end of July 2024 for consultations with stakeholders. The updated draft legislation will include the missing technical or consequential changes described above. Once the summer consultations are completed, a bill will eventually be introduced in the House of Commons — most likely this fall. It is our understanding that the technical concerns highlighted above with respect to the net capital gains inclusion rate averaging rule have been brought to the attention of the Department of Finance.

Measures that remain unchanged

The government reaffirmed its intention to implement previously announced changes to increase the capital gains inclusion rate from one-half to two-thirds for corporations and most trusts, and from one-half to two-thirds on the portion of capital gains realized in the year that exceed $250,000 for individuals and some trusts, for capital gains realized on or after 25 June 2024.

However, in an accompanying backgrounder, the government provided the following summary of measures that **are not changing** as a result of the forthcoming legislation and Budget 2024's proposed changes to the taxation of capital gains:

- **Principal residence exemption continues** – The principal residence exemption will continue to be available to taxpayers, allowing for capital gains realized on such dispositions to be exempt from capital gains taxes, provided all relevant conditions are met.

- **No elective provisions** – The current legislation and proposed legislative measures do not generally allow taxpayers to elect to realize capital gains or losses without the legal transfer of property. The government confirmed that it does not intend to implement such elective measures. Taxpayers wanting to crystallize capital gains at the current one-half inclusion rate should speak with their tax advisors prior to 25 June 2024 to consider if planning opportunities are available.[2]

- **No capital gains averaging** – Individuals (and certain trusts) will not be permitted to average capital gains realized over multiple years to remain below the $250,000 annual threshold to benefit from the lower capital gains inclusion rate.

- **No sharing of the $250,000 threshold** – Capital gains realized by corporations and most types of trusts on or after 25 June 2024 will be subject to the two-thirds inclusion rate. The $250,000 annual threshold available to individuals and certain trusts cannot be shared or allocated to corporations and other trusts.

- **No exemption for specific assets or corporations** – The two-thirds capital gains inclusion rate will apply to all assets and corporations uniformly such that there will be no exemptions for assets or corporations in certain sectors.

- **No time-based or other distinctions** – The same inclusion rates for capital gains will apply irrespective of the length of time the asset is held or other distinctions.

Furthermore, although not specifically addressed by the government, the following is a summary of certain recommendations made by the Joint Committee that were **not introduced** in the NWMM or the backgrounders:

- **No grandfathering** – There are no grandfathering provisions that would allow taxpayers who have entered into binding agreements prior to 16 April 2024 to sell capital property but for which the closing date will not take place prior to 25 June 2024 to benefit from the one-half capital gains inclusions rate.

- **No carryforward of the threshold** – The $250,000 threshold available to individuals and certain trusts is an annual threshold; unused amounts cannot be carried forward.

- **No indexation** – The proposed measures do not include the indexation of the $250,000 annual threshold.

- **No continuation of the one-half stock option deduction for Canadian-controlled private corporation (CCPC) stock options exercised prior to 25 June 2024** – The CCPC stock option deduction is reduced to one-third where the acquired shares are disposed of or exchanged on or after 25 June 2024 (subject to the $250,000 annual threshold).

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[2] For more information on potential opportunities to crystallize inherent capital gains, see EY Tax Alert 2024 Issue No. 28.

What is included in the draft legislation

Along with the NWMM, the government provided additional details on the main features of the proposed changes in the Backgrounder.

The following is a summary of the main proposed changes covered in the Backgrounder and the NWMM.

$250,000 threshold for individuals (and certain types of trusts)

The government has clarified that in addition to individuals, graduated rate estates (GREs) and qualified disability trusts (QDTs) will be eligible for the one-half inclusion rate on the first $250,000 of capital gains realized in the year, provided that such capital gains are not allocated to a beneficiary in the year.

The Backgrounder confirms that the $250,000 threshold would apply to capital gains brought into income from a capital gains reserve or allocated by a partnership or trust.

In addition, the Backgrounder confirms that the $250,000 threshold is net of any capital losses for the year.

Net capital losses

Net capital losses may be carried back three years and forward indefinitely to offset capital gains of other taxation years.

The government has clarified that a capital loss realized when a different inclusion rate applied can still fully offset an equivalent capital gain realized in a year during which another inclusion rate applied. This is achieved by having an adjustment factor applied to the net capital losses of other taxation years when utilized in the current taxation year to be offset against capital gains.

When an individual (or a GRE or QDT) is subject to multiple capital gains inclusion rates in a particular year because the $250,000 annual threshold has been exceeded, net capital losses from previous years applied in the current year are effectively applied first to offset capital gains subject to the higher inclusion rate (i.e., applied to capital gains that exceed the $250,000 annual threshold).

2024 – A transitional year

The new capital gains inclusion rate rules are generally effective on or after 25 June 2024, resulting in the need for special rules for taxation years that start before 25 June 2024 and end after 25 June 2024.

The Backgrounder explains that taxpayers will be required to separately identify (i) capital gains and losses realized before 25 June 2024; and (ii) capital gains and losses realized on or after 25 June 2024. Gains and losses from Period 1 and Period 2, respectively, would then be netted against each other to arrive at a net gain or loss for each period.

The government has confirmed that the annual $250,000 threshold for individuals (and GREs and QDTs) will be fully available in 2024 (i.e., it will not be prorated) and will apply only in respect of net capital gains realized in Period 2 less any net capital losses from Period 1.

However, the rules for the transitional year are mathematically complex, and the anticipated effect of the proposed changes may operate in a manner that differs from one's expectation.

For example, the proposed changes to section 38 of the *Income Tax Act* (ITA) in respect of taxation years ending after 24 June 2024 include a modification to the computation of taxable capital gains from the disposition of any property to provide that the taxable capital gain is two-thirds of the taxpayer's capital gain for the year. However, the coming-into-force rules provide that for taxation years that end after 24 June 2024 and that include 25 June 2024 (i.e., a "straddle year"; for example, a typical 1 January 2024 to 31 December 2024 taxation year), in certain circumstances, the two-thirds fraction is replaced with the following fraction:

$$(1/2 \times A + 2/3 \times B) \div (A + B)$$

where

> A is the net capital gains or the net capital losses, as the case may be, of the taxpayer from dispositions of property in Period 1; and
>
> B is the net capital gains or the net capital losses, as the case may be, of the taxpayer from dispositions of property in Period 2.

Therefore, there is a single blended inclusion rate to be used in respect of capital gains realized in a straddle year when determining a taxpayer's taxable capital gain amount. This can yield some unexpected consequences. For instance, where a Canadian private corporation realizes a capital gain in Period 1, one may expect that one-half of such capital gain would be non-taxable and thus be added to the corporation's CDA, which a shareholder of the corporation may access during the year. Although the CDA balance is computed at a point in time (i.e., it may be calculated at any point in a taxation year), it appears that the proposed legislative changes as drafted would require the blended rate to be applied for all dispositions in the taxation year in determining additions and reductions to the CDA.

An illustration of this is as follows:

Assume a Canadian private corporation — having a 31 December year-end — realizes a $100 capital gain in Period 1 and pays a capital dividend from its CDA at the end of Period 1 of $50. The Canadian private corporation also realizes a $100 capital gain in Period 2. Under the proposed legislative changes, the blended inclusion rate for the taxation year using the above formula would be 58.33% in respect of all capital gains realized in the year. Therefore, the Canadian private corporation's CDA balance at the time it paid the capital dividend was only $41.67 (i.e., $100 Period 1 capital gain × (100% - 58.33% blended inclusion rate)). Consequently, the Canadian private corporation would have paid a capital dividend in excess of its CDA balance, thereby giving rise to tax under Part III of the ITA in respect of the excess amount of $8.33, unless the corporation, with the concurrence of the shareholders who received the dividend, makes an election under subsection 184(3) to treat the excess as a separate taxable dividend.

It should also be noted that, as explained below under "Debt forgiveness", the net capital gains inclusion rate averaging rule may impact the inclusion rate to be used for debt forgiveness purposes, and any debt forgiveness may impact the inclusion rate for net capital gains or net capital losses. In addition, net capital gains or net capital losses in respect of partnerships and allocated by trusts would also impact the calculation of the computation of the inclusion rate.

Employee stock option deduction

Under the current rules, although the full amount of a stock option benefit is taxed as employment income, the employee may claim a deduction of one-half of the stock option benefit, provided certain conditions are met.[3] This results in stock options that meet the necessary conditions effectively being taxed at the same rate as capital gains. To reflect the new capital gains inclusion rate, the employee stock option deduction is reduced to one-third of the stock option benefit for stock options exercised on or after 25 June 2024.

[3] The stock option benefit is equal to the amount by which the fair market value of the shares at the time of acquisition exceeds (i) the amount paid by the employee for the shares, and (ii) any amount paid by the employee to acquire the option. The benefit is included in employment income under section 7 of the ITA. Generally, if the exercise price is no less than the fair market value of the shares at the date the option is granted, and certain additional conditions are met, the employee can claim a deduction under paragraph 110(1)(d) of the ITA. These rules are modified in the case of CCPC stock options to the extent that the conditions described in subsection 7(1.1) and paragraph 110(1)(d.1) are satisfied.

In the case of CCPC stock option benefits that satisfy the employment benefit deferral exception (i.e., stock options that are not subject to income tax until the year the employee disposes of or exchanges the acquired shares), the stock option deduction is reduced to one-third where the share is disposed of or exchanged on or after 25 June 2024. As noted above, the government did not implement comments made by the Joint Committee to include a continuation of the one-half deduction for CCPC options exercised prior to 25 June 2024, irrespective of the year in which the employee disposes of the acquired shares.

Eligible individuals may claim an increased deduction of one-half of the stock option benefit up to a combined annual limit of $250,000 for both employee stock options and capital gains. The annual $250,000 threshold applies only in respect of net capital gains realized[4] and stock options exercised (or where the acquired share is disposed of or exchanged, in the case of CCPC options) on or after 25 June 2024.

The Backgrounder indicates that where the total employee stock option benefits and capital gains exceed $250,000 in a taxation year, the employee will be able to elect the allocation of the preferential tax treatment (i.e., the lower capital gains inclusion rate and higher stock option deduction) between the capital gains and the stock option benefit.

Lifetime capital gains exemption

Under the current rules for 2024, the LCGE may shelter capital gains realized on the disposition of qualified farm and fishing property or qualified small business corporation shares of up to $1,016,836. As proposed in Budget 2024, the LCGE limit will increase to $1,250,000 with respect to dispositions that occur on or after 25 June 2024. The indexation of the LCGE will resume in 2026.

As a result of the increase in the inclusion rate for capital gains realized on or after 25 June 2024 and the increased lifetime limit, the effective maximum lifetime deduction available to individuals rises from $508,418 (i.e., $1,016,835 × 1/2) to $833,333 (i.e., $1,250,000 × 2/3).

Capital gains realized on the disposition of qualifying properties on or after 25 June 2024 that are subject to the one-half inclusion rate (i.e., due to the $250,000 annual threshold) will be eligible for a deduction similarly computed using the one-half inclusion rate for purposes of claiming the LCGE.

[4] To the extent these net capital gains are not offset by a net capital loss incurred before 25 June 2024.

For example, an individual with no other capital gains or employee stock options who realizes a capital gain of $1,250,000 in 2025 on the disposition of qualified small business corporation shares should have an income inclusion of $791,667 (i.e., $250,000 × 1/2 + $1,000,000 × 2/3). The individual should therefore be eligible for an LCGE deduction of $791,667 in computing taxable income. Notwithstanding the maximum deduction available to individuals of $833,333 computed using the two-thirds inclusion rate, since a portion of the capital gains was subject to the one-half inclusion rate, the full amount of the individual's LCGE limit will be reduced.

Allowable business investment losses

Generally, a taxpayer may incur a business investment loss from the disposition to an arm's length person of shares or debts of a small business corporation, or from the deemed disposition of bad debts or shares of a bankrupt small business corporation. Allowable business investment losses (ABILs) are the portion of the business investment losses that may be deductible against other income (such as employment, business and property income) and may be carried back three years and carried forward 10 years. After 10 years, the loss reverts back to an ordinary net capital loss, which may be carried forward indefinitely to offset capital gains only.

Business investment losses incurred prior to 25 June 2024 and after 24 June 2024 should be considered ABILs at an inclusion rate of one-half and two-thirds, respectively. As such, ABILs will not be subject to an adjustment to account for the inclusion rate for the taxation year in which the loss is claimed, which differs from the treatment of net capital losses carried forward. More specifically, business investment losses incurred prior to 25 June 2024 will be included in computing ABILs at a one-half inclusion rate, even if the ABIL is applied in a period on or after 25 June 2024. Similarly, business investment losses incurred after 24 June 2024 will be included in computing ABILs at a two-thirds inclusion rate, even if the amount is carried back to a period prior to 25 June 2024.

Capital gains reserves

When capital property is disposed of, a portion of the proceeds of disposition may be payable over a certain number of years. Under the current rules, a taxpayer is generally permitted to include the capital gain in income over a maximum period of five years, with a minimum cumulative income inclusion of 20% per year. However, the annual reserve claimed must be reasonable in the circumstances for the above maximum reserve to be permitted. There are certain circumstances (e.g., gains realized on the disposition by an individual of certain farm or fishing property, shares of a family farm or fishing corporation, an interest in a family farm or fishing partnership, or shares of a qualified small business corporation to the individual's children, grandchildren or great-grandchildren) where a reserve may actually be claimed over 10 years, with a minimum cumulative income inclusion of 10% per year.

Mechanically, the full capital gain is included in income when realized, with (in most situations) a maximum reserve of four-fifths of the capital gain then being claimed. In the subsequent year, the full prior year reserve is brought back into income, and the taxpayer may consider claiming a new reserve. The inclusion rate of the capital gain is determined when the capital gain is recognized, not when the capital property disposition occurred.

Under the proposed rules, there is a deeming provision for taxation years that include 25 June 2024, such that a reserve included in income from a prior year would be considered to be a capital gain on the first day of the taxpayer's taxation year for purposes of determining the inclusion rate. As a result, for taxation years that straddle 25 June 2024, the one-half inclusion rate should be available to prior year reserves included in income in that year.

Final return on death and net capital losses

Special rules apply in respect of the application of net capital losses in an individual's final return, being their tax return in respect of their year of death (the Terminal Year). These rules provide that if unapplied net capital losses remain after being applied to any taxable capital gains in the Terminal Year, net of certain amounts previously claimed (such as the LCGE deduction, proposed employee ownership trust exemption and proposed Canadian entrepreneurs' incentive exemption), the unapplied net capital losses may be applied to offset other income in the Terminal Year and the immediately preceding taxation year. Net capital losses applied to non-capital income in these years are determined based on the inclusion rate that applied in the year the capital loss was incurred and are not adjusted for the inclusion rate that applied in the year the non-capital income being offset was earned.

Non-arm's length transfer or change in use of depreciable property

Generally, where depreciable property is acquired from a non-arm's length party, or as a result of a change in use of a property from a non-income-earning purpose to an income-earning purpose, the recipient's cost of such property is deemed to be equal to the transferor's capital cost plus one-half of any capital gain realized by the transferor on the disposition or deemed disposition. There is also a carve-out from the cost of the property to the recipient for any capital gains against which the transferor claimed the LCGE, if applicable.

In general, under the proposed rules, the amount added to the recipient's cost of the depreciable property will be increased from one-half to two-thirds to align with the increase in the capital gains inclusion rate.

However, additional special rules are required where the transferor is an individual because if the transferor was an individual, the one-half inclusion rate could apply on the disposition due to the $250,000 threshold. To avoid the transferor being taxed on only one-half and the transferee being entitled to an addition to cost based on two-thirds, individuals would be subject to the two-thirds inclusion rate on these types of dispositions or deemed dispositions unless an election is made with the transferee. This election ensures that if the one-half inclusion rate applies on the disposition or deemed disposition, the one-half inclusion rate would also apply on the acquisition or deemed acquisition. More specifically, where a portion of the capital gain realized by the transferor does not exceed the $250,000 annual threshold subject to the one-half inclusion rate, only one-half of the capital gain would be added to the cost of the depreciable property for the recipient, similar to the currently enacted legislation.

Partnerships

Broadly speaking, the income and losses allocated to each partner from a partnership are included as income and losses of the partner for the partner's taxation year in which the partnership's fiscal period ends. Consequently, taxable capital gains, allowable capital losses and ABILs allocated by a partnership to its partners are generally treated as taxable capital gains, allowable capital losses and ABILs of each partner for the partner's taxation year in which the partnership's fiscal period ends.

Under the proposed rules, each taxable capital gain, allowable capital loss and ABIL realized by a partnership with a fiscal period that begins before 25 June 2024 and ends after 24 June 2024 will be grossed up and deemed to be a capital gain, capital loss and business investment loss, respectively, upon allocation from the partnership to each partner. Amounts realized prior to 25 June 2024 will be grossed up by a factor of 2, and amounts realized after 24 June 2024 will be grossed up by a factor of 1.5.

A partnership with a fiscal period that begins before 25 June 2024 and ends after 24 June 2024 will be required to disclose to its partners the period (i.e., before 25 June 2024 or after 24 June 2024) in which the dispositions took place in respect of the deemed capital gain, capital loss and business investment loss allocated to its partners.

If the partner is an individual, each partner's $250,000 annual threshold will apply in determining the applicable inclusion rate for capital gains allocated from the partnership in respect of the period on or after 25 June 2024.

Personal trusts

Broadly speaking, a trust resident in Canada may designate at the end of the trust's taxation year any part of its net taxable capital gains realized in the year to one or more of its Canadian-resident beneficiaries. The character of taxable capital gains is generally preserved when the amounts are allocated by the trust to its beneficiaries, provided certain designations are made.

Under the proposed rules, net taxable capital gains realized by a trust with a fiscal period that begins before 25 June 2024 and ends after 24 June 2024 and designated to Canadian-resident beneficiaries will be grossed up and deemed to be capital gains realized by each beneficiary in the period in which the trust disposed of the relevant capital property. Net taxable capital gains realized prior to 25 June 2024 will be grossed up by a factor of 2, and net taxable capital gains realized after 24 June 2024 will be grossed up by a factor of 1.5.

In addition, such trusts will be required to disclose to their beneficiaries in prescribed form the period in which each disposition took place in respect of the allocated deemed capital gains. If this information is not disclosed, the deemed capital gains will be deemed to have been realized after 24 June 2024. Interestingly, the rules for partnerships do not appear to have this same deeming provision in the event the required disclosures are not made.

There is a special rule for commercial trusts whereby they would have the option of electing that capital gains allocated to beneficiaries be realized proportionally between the two periods based on the number of days in each period.

If the beneficiary is an individual, each beneficiary's $250,000 annual threshold will apply in determining the applicable inclusion rate for capital gains allocated by the trust.

Mutual fund corporations and mortgage investment corporations

Provided the appropriate conditions are met, a mutual fund corporation (MFC) may elect to treat dividends payable to its shareholders as capital gains dividends with respect to its capital gains realized. In turn, the capital gains dividends are deemed to be capital gains realized by the shareholder.

Under the capital gains refund mechanism, an MFC may also be entitled to a refund on capital gains that are flowed to shareholders in order to reduce or eliminate double taxation in certain circumstances. As a consequence of the adjustment to the capital gains inclusion rate, the formula in computing the *capital gains redemptions* amount pursuant to subsection 131(6) of the Act has been modified.

An MFC with a fiscal period that begins before 25 June 2024 and ends after 24 June 2024 will be required to disclose the period (i.e., before 25 June 2024 or after 24 June 2024) in which the underlying disposition took place in respect of the capital gains dividend paid. If the information is not disclosed, the capital gains of the shareholder receiving the dividends will be deemed to have been realized after 24 June 2024.

Alternatively, the MFC has the option of electing for the capital gains dividend distributed to shareholders to be realized proportionally within the two periods based on the number of days in each period divided by the number of days in the MFC's taxation year.

In the Backgrounder, the government notes that further adjustments will be made to certain values used in the computation of the capital gains refund mechanism for taxation years ending after 24 June 2024.

The Backgrounder also states that the proposed tax treatment for mortgage investment corporations, and for shareholders receiving capital gains dividends from these entities, will be similar to the treatment proposed for MFCs.

Mutual fund trusts

Taxable capital gains realized by mutual fund trusts (MFTs) may be designated as taxable capital gains realized by their investors.

An MFT may also be entitled to a refund on capital gains that are flowed through to its unitholders in order to reduce or eliminate double taxation in certain circumstances. As a consequence of the adjustment to the capital gains inclusion rate, the formula in computing the *capital gains redemptions* amount pursuant to subsection 132(4) of the Act has been modified.

An MFT with a fiscal period that begins before 25 June 2024 and ends after 24 June 2024 will be required to disclose the period (i.e., before 25 June 2024 or after 24 June 2024) in which the underlying disposition took place in respect of the deemed capital gains allocated to beneficiaries. If the information is not disclosed, the deemed capital gains will be deemed to have been realized after 24 June 2024.

Alternatively, MFTs will have the option to elect for the deemed capital gains allocated to their unitholders to have been realized proportionally within the two periods based on the number of days in each period divided by the total number of days in the MFT's taxation year.

Related segregated fund trusts

Under the proposed rules, capital gains or capital losses deemed to be realized by a policyholder on the disposition of a property by a related segregated fund trust will be subject to similar rules as are applicable to MFCs and MFTs, as described above.

Debt forgiveness

The debt forgiveness rules in section 80 of the ITA generally apply where a debtor's commercial obligation is settled or extinguished without payment, or by payment of an amount that is less than the lesser of the amount for which the obligation was issued and the principal amount of the obligation.

The forgiven amount is applied to reduce certain of the debtor's tax attributes, including loss balances carried forward, resource expenditures and the tax cost of certain capital properties. Any remaining unapplied balance is generally included in the debtor's income in the year the debt is settled or extinguished at a one-half inclusion rate under subsection 80(13), unless the debtor is a partnership.

Under the proposed legislation, the inclusion rate for this calculation will increase from one-half to two-thirds. For taxation years straddling 25 June 2024, the fraction to be used will be the same as that for net capital gains, as discussed above in "2024 – A transitional year". However, any remaining unapplied portion of the forgiven amount before including any portion under subsection 80(13) will be deemed to be a capital gain for the purposes of determining the fraction to be used under the transitional rules. Thus, it will impact the net capital gains inclusion rate averaging rule, and the fraction obtained under the formula will give the inclusion rate to be used for both net capital gains and for debt forgiveness purposes.

Discount on certain obligations

In certain circumstances, funds are borrowed with a stated rate of interest and a commitment to pay a larger amount when the obligation is repaid. When the obligation is repaid, there may be a partial or full deduction under paragraph 20(1)(f) to the debtor for the difference between the initial amount borrowed and the larger amount repaid, known as the discount. Whether a full or partial deduction is permitted will be based on the extent of the discount.

Under currently enacted legislation, the partial deduction is available at one-half. This rate is increased to two-thirds under the proposed legislation.

Taxable Canadian property

The applicable withholding tax rate for nonresidents disposing of certain types of taxable Canadian property (TCP) will be increased from 25% to 35% for dispositions of TCP that occur on or after 1 January 2025. The increased withholding tax rate will apply regardless of whether a section 116 certificate of compliance is received. Interestingly, this change is effective for dispositions that occur on or after 1 January 2025 (rather than on or after 25 June 2024).

The increased withholding tax rate is intended to reflect the approximate increase in the combined federal and provincial taxes payable for capital gains subject to the highest marginal personal tax rates.

Foreign affiliates and hybrid surplus

The following changes are proposed with respect to foreign affiliates and the computation of hybrid surplus:

Foreign accrual property income (FAPI) – The computation of FAPI will be amended to incorporate the proposed change to the capital gains inclusion rate in respect of capital gains and losses on the disposition of property that is not excluded property.

Dividends paid out of hybrid surplus – Hybrid surplus of a foreign affiliate generally includes capital gains and losses from the disposition of certain shares of a foreign affiliate, certain partnership interests and certain financial instruments relating to such shares and partnership interests.

Under the current legislation, a corporation resident in Canada is entitled to a deduction equal to one-half of any dividends paid out of a foreign affiliate's hybrid surplus as well as an additional amount for hybrid underlying tax and foreign withholding tax.

The Backgrounder proposes that (i) dividends received by a corporation resident in Canada out of hybrid surplus on or after 25 June 2024 relating to capital gains and losses in respect of pre-25 June 2024 dispositions would continue to be eligible for the one-half deduction, and (ii) dividends received out of hybrid surplus relating to capital gains and losses in respect of dispositions on or after 25 June 2024 would be entitled to a deduction equal to one-third of the dividend. Consequently, there are two types of hybrid surplus pools (pre-25 June 2024 dispositions by a foreign affiliate and post-24 June 2024 dispositions) that Canadian resident corporations will be required to track in respect of a foreign affiliate.

The proposed changes for the hybrid surplus were not included in the NWMM.

Also, as noted in the Backgrounder, various rules with respect to foreign affiliates will be amended, as needed, as a result of the proposed changes to the capital gains inclusion rate.

Conclusion

While the NWMM and the accompanying backgrounders appear to address many features of the proposed changes to the capital gains inclusion rate, the increase in the LCGE and the reduction of the employee stock option deduction, several consequential amendments remain outstanding.

The proposed measures are complex; taxpayers will need to carefully review the proposals to fully assess their impact. Consult your EY advisor for assistance in determining how the NWMM and the main features of these proposed changes may impact you and your business, and what planning opportunities may be available to you.

Learn more

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