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Tax Alert – Canada

Finance releases revised legislative details to implement changes to increase the capital gains inclusion rate

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The Department of Finance released several packages of draft legislative proposals for public comment on 12 August 2024, including the much-anticipated revised draft legislative proposals to implement changes to increase the capital gains inclusion rate (the August proposals).

The government had announced, when it released a notice of ways and means motion (NWMM) and two accompanying backgrounders on 10 June 2024 (the June proposals), that further technical or consequential changes would be introduced this summer, but that these changes would not materially affect the design of, or introduce new features to, the measures in the NWMM.[1] While the August proposals are generally consistent with this statement, taxpayers should nonetheless be aware that certain changes included in the August proposals could impact the tax consequences of recognizing capital gains in certain circumstances.

[1] For more information on the NWMM and the backgrounders released on 10 June 2024, see EY Tax Alert 2024 Issue No. 33.

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In this Tax Alert, we review some of the key changes contained in the August proposals and certain measures that have been expanded since their initial release on 10 June 2024. In general, the principal changes include:

- Changes to the capital dividend account (CDA) mechanism to ensure that the CDA operates correctly for taxation years that start before 25 June 2024 and end after 24 June 2024 and to include a new provision adjusting the CDA in circumstances where capital losses are carried forward or back to taxation years having different inclusion rates;
- Technical changes to retain the previously enacted capital gains inclusion rates for alternative minimum tax purposes and to ensure the new inclusion rate rules[2] and certain tax incentive items associated with capital gains — e.g., the lifetime capital gains exemption, the exemption for qualifying transfers to employee ownership trusts, and the Canadian entrepreneurs incentive — all properly interact with each other; and
- Changes to the foreign affiliate hybrid surplus regime, and certain consequential amendments, to reflect the new inclusion rate.

The focus of this Tax Alert is on the CDA and hybrid surplus amendments.

Interested parties are invited to provide comments to the Department of Finance on the proposed legislative amendments by 3 September 2024.

For more information on the other draft legislative proposals released on 12 August 2024, refer to EY Tax Alert 2024 Issue No. 42, *Finance releases draft legislation for 2024 budget and other measures*.

Capital dividend account

The proposed increase to the capital gains inclusion rate is effective for transactions occurring on or after 25 June 2024, which requires the need for transitional rules[3] for taxation years that begin before 25 June 2024 and end after 24 June 2024 (i.e., a transition year).

In general terms, the proposals released by the Department of Finance included a modification to the computation of taxable capital gains (and allowable capital losses) from the disposition of property in a transition year by imposing (i) a single blended inclusion rate to be used where the taxpayer has only net capital gains (or net capital losses) in the portion of the transition year that ends on 24 June 2024 (Period 1) and in the portion of the transition year that ends after 24 June 2024 (Period 2) or (ii) in all other cases, a fixed inclusion rate (ranging from one-half to two-thirds). In all cases, the determination of the capital gains inclusion rate for the transition year can only be made at or after the end of the transition year.

[2] Including the preferential inclusion rate for individuals on the first $250,000 of capital gains.
[3] As outlined in the application notes for proposed section 38, which are provided in subsection 4(4) of the August proposals, for the inclusion rate to be used for a transition year.

This can yield unexpected consequences when considering other sections of the *Income Tax Act* (Canada) (the ITA) that use the inclusion rate in their application. For instance, the calculation of the CDA of a Canadian private corporation (CPC) is a point-in-time calculation, and such balance is accessible at any point in time. Thus, when a capital gain (or loss) is realized by a CPC at a point in time during a taxation year, one would expect that a CPC should be able to determine the amount added to the CPC's CDA at that time with accuracy.

As noted above, the proposed changes to section 38 of the ITA in the proposals require the taxable capital gain (or allowable capital loss) in a transition year to be based on the transitional inclusion rate, which is only determinable at or after year-end. This resulted in the inability for a CPC to determine its CDA at any point in time in the transition year.

The Department of Finance has released additional updates and new proposals to the legislation in its August proposals, which appear to have resolved this previously identified issue in respect of the inability to determine the CDA balance at a particular point in time in a transition year.

However, there are some important observations taxpayers and tax practitioners should consider in light of the August proposals. These observations and considerations are discussed below.

Updates to CDA for 2024 transition years

As part of the August proposals, new subsection 89(1.4) of the ITA is added in determining the CDA for a transition year. The Department of Finance[4] acknowledged the incompatibility of the June proposals with the determination at any point in time of the CDA in the transition year.

Newly proposed paragraph 89(1.4)(a) of the ITA specifies that, for the purposes of determining the CDA at any point in time in a transition year (irrespective of the taxable capital gains and allowable capital losses determined using the transitional inclusion rate for general purposes of the ITA), the CPC's taxable capital gain or allowable capital loss from the disposition of any property in respect of a transition year is deemed to be (i) one-half of the corporation's capital gain or loss for dispositions occurring in Period 1 and (ii) two-thirds of the corporation's capital gain or loss for dispositions occurring in Period 2.

This new transitional provision allows a CPC to be able to determine its CDA at a point in time (either in Period 1 or Period 2) for purposes of paying a capital dividend, thus eliminating the risk of attracting Part III tax — which generally applies to the extent a capital dividend exceeds the CDA balance immediately before the time of payment — solely as a result of the retroactive application of the transitional inclusion rate.

[4] See the accompanying Explanatory Notes on new proposed subsection 89(1.4) of the ITA.

However, there are additional amendments to newly proposed subsection 89(1.4) to also consider when computing and accessing the CDA of a CPC, which have the overall effect of maintaining integration if there is a difference at the end of the year between the CDA balance using the approach in paragraph 89(1.4)(a) — i.e., one-half for Period 1 and two-thirds for Period 2 — and the transitional inclusion rate.

Specifically, newly proposed paragraphs 89(1.4)(b) and 89(1.4)(c) of the ITA (and relevant reading rules in paragraph 89(1.4)(d)) introduce adjustments to be made to the CDA if there ultimately is a difference between the deemed inclusion rate under new paragraph 89(1.4)(a) and the inclusion rate determined at the end of the transition year under the application rules in proposed section 38. These adjustments are made by deeming the CPC (solely for purposes of determining the CDA) to realize either a capital gain or capital loss from the disposition of a property at the end of the transition year.

The following is a simplified summary of the example provided in the Department of Finance's accompanying Explanatory Notes to illustrate the operation of the rules in new proposed subsection 89(1.4).

Example

The CPC realizes in its transition year a: (i) $100 capital gain in Period 1 on the disposition of property 1, and (ii) $100 capital loss in Period 2 on the disposition of property 2.

Although not stated in the Explanatory Notes illustrative example, assume the CPC has a CDA balance of $300 immediately prior to the commencement of the transition year for purposes of the below discussion.

Section 38

Under the application rules for newly proposed section 38 of the ITA, the CPC is determined to have nil net capital gains and net capital losses and an inclusion rate for the transition year of two-thirds.

CDA calculation at time of disposition of property 1

Under newly proposed subparagraph 89(1.4)(a)(i), the CPC's taxable capital gain for purposes of determining the CDA is deemed to be one-half of the CPC's $100 capital gain from the disposition of property 1. Thus, the non-taxable portion of the deemed taxable capital gain under this new subparagraph is $50, which is added to the CPC's CDA at the time of the disposition of property 1.

Therefore, at this point in time (at the time of disposition of property 1), the CDA balance should be equal to $350.

CDA calculation at time of disposition of property 2

Under newly proposed subparagraph 89(1.4)(a)(ii), the CPC's allowable capital loss for purposes of determining the CDA is deemed to be two-thirds of the CPC's $100 capital loss from the disposition of property 2. Thus, the non-allowable portion of the capital loss under this new subparagraph is $33.33, which reduces the CPC's CDA at the time of the disposition of property 2.

Therefore, at this point in time (at the time of disposition of property 2), the CDA balance should be equal to $316.67, which ultimately results from the fact that, even though the inclusion rate for the transition year should ultimately be two-thirds pursuant to the application rules, the inclusion rate used for Period 1 was one-half. Accordingly, the CDA is overstated by $16.67.

CDA calculation at the end of the transition year

In order to rectify the overstatement of the CDA at the end of the transition year, the CPC is deemed under proposed paragraph 89(1.4)(c) to have realized a capital loss at the end of the transition year — in this case, in the amount of $50 — because the amount of its net allowable capital losses for the year determined under paragraph (a) of the CDA computation rules (i.e., $16.67) exceeds the amount determined under section 38 ($nil) pursuant to the application rules.

As a result of the deemed capital loss of $50 under proposed paragraph 89(1.4)(c), the CDA will be reduced by the non-allowable portion (being one-third), resulting in a reduction to the CDA of $16.67. Accordingly, at the end of the transition year, the CDA balance should be equal to $300.

Observations

The operation of the proposed legislative changes outlined in the August proposals is complex. Taxpayers and tax practitioners should carefully consider the CDA balance at particular points in time.

For instance, on the surface, in the example outlined above, a taxpayer may have an opportunity to access a CDA balance of $316.67 in Period 2 prior to a downward adjustment of $16.67 that occurs at the end of the transition year (which otherwise brings the CDA balance down to $300). Taxpayers would be advised to discuss the implications of this type of planning with their tax advisors to fully understand any associated risks prior to undertaking such planning.

Conversely, taxpayers and tax practitioners should be aware of situations opposite of the example outlined above. For example, where there is a $100 capital loss realized in Period 1 and a $100 capital gain realized in Period 2, the CDA balance would be $283.33 in Period 2, and only at the end of the transition year would there be an upward adjustment of $16.67 to the CDA. The delay in truing up the CDA to the blended rate could in certain cases create timing issues for dividends intended to be paid in Period 2.

Furthermore, even with this welcome fix to allow for the determination of CDA at a point in time in a transition year, there may still be some practical timing issues that can cause adverse tax consequences. For example, because a tax return for a corporate taxpayer's particular taxation year may not be due until six months after its year-end, the transitional inclusion rate may not in fact be determined until that time. However, the adjustment to the CDA under proposed paragraphs 89(1.4)(b) and (c) is made at the end of the applicable taxation year. Thus, if a capital dividend is paid after a year-end but prior to filing the corporation's tax return for that year, taxpayers would be advised to ensure that the transitional inclusion rate has nonetheless been calculated prior to paying that capital dividend. Otherwise, they may risk having an excessive capital dividend, which may give rise to Part III tax.

Updates to CDA for net capital loss carryover

The August proposals also include new subsection 89(1.3) of the ITA in determining the CDA. This new rule is analogous to subsection 111(1.1), the purpose of which is to reflect any difference between the taxpayer's inclusion rate for the year in which a net capital loss is incurred and the year in which the net capital loss is deducted.

New subsection 89(1.3) applies in respect of taxation years that end after 24 June 2024 and has implications to the CDA computation if the inclusion rate for the taxation year in which net capital losses are generated (a loss year) differs from the inclusion rate for the taxation year in which the net capital losses are deducted under paragraph 111(1)(b) against taxable capital gains. These adjustments are made by deeming the CPC, for purposes of determining the CDA, to realize either a capital gain or capital loss at a particular point in time, as follows:

1. Where net capital losses for a loss year are carried back to offset taxable capital gains in a prior taxation year that has a lower inclusion rate than the loss year, the CPC is deemed to have realized a capital loss at the end of the loss year — thus rectifying the CDA overstatement; and

2. Where net capital losses for a loss year are carried forward to offset taxable capital gains in a subsequent taxation year that has a higher inclusion rate than the loss year, the CPC is deemed to have realized a capital gain at the end of the subsequent taxation year — thus rectifying the CDA understatement.

The following is a simplified summary of the example provided in the Department of Finance's accompanying Explanatory Notes to illustrate the operation of newly proposed subsection 89(1.3).

Example

The CPC realizes a: (i) $100 capital gain in 2023 (where the inclusion rate is one-half), and (ii) $100 capital loss in 2025 (where the inclusion rate is expected to be two-thirds).

The CPC's 2025 net allowable capital losses are equal to its allowable capital loss (i.e., $66.67).

The CPC carries back its $100 capital loss in 2025 to fully offset its $100 capital gain realized in 2023 under paragraph 111(1)(b).

Although not stated in the accompanying Explanatory Notes illustration, assume the CPC has a CDA balance of $300 immediately prior to the commencement of the 2023 taxation year and has no further CDA adjustments until the capital loss is realized in 2025.

CDA calculation at the time the 2025 capital loss is realized

Under the current rules for determining the CDA at a point in time, the non-taxable portion of the capital gain realized in 2023 — in this case, $50 — is added to the CPC's CDA at that time, and the non-allowable portion of the capital loss realized in 2025 — in this case, $33.33 — is deducted from the CPC's CDA at that time.

Therefore, at the time the 2025 capital loss is realized, the CDA balance would be equal to $316.67 — even though the inclusion rate for the 2023 taxation year, which is the year the allowable capital loss is actually utilized, is one-half, thereby resulting in a CDA overstatement of one-third.

CDA calculation at the end of the loss year

Under newly proposed paragraph 89(1.3)(a), for the purposes of computing the CPC's CDA balance, the CPC is deemed to have realized a capital loss of $50 at the end of the loss year since the CPC's net capital loss for the loss year is carried back to offset capital gains in a prior year that has a lower inclusion rate.

Therefore, at the end of the loss year, the CDA balance should be equal to $300, as it will have been reduced by the non-allowable portion (being one-third) of the capital loss — in this case, $50 — deemed to be realized at the end of the loss year (i.e., 2025).

This reduction eliminates the excessive CDA balance generated by the capital gains realized in 2023 that was offset against capital losses in 2025.

Observations

As mentioned in the section *Updates to CDA for 2024 transition years* above, the operation of these newly proposed rules in respect of net capital loss carryovers is complex and requires taxpayers and tax practitioners to carefully consider the CDA balance at various points in time. Similar to the transition year examples described above, the CDA balance may be increased or decreased at year-end as a true-up to account for the inclusion rate applicable to the year in which a carryover was used.

Furthermore, similar practical issues to the transition year examples provided above may arise in this context. For example, if a capital dividend has been paid after the end of a loss year (and prior to filing a tax return for that year), but the decision to carry back a loss is not made until the time the tax return for the loss year is filed, the resulting adjustment under proposed subsection 89(1.3) could cause a portion of that capital dividend to attract tax under Part III of the ITA.

Updates to CDA for intercorporate dividend deductions

In addition to the above-noted changes, draft legislative proposals related to the calculation of CDA for Canadian-controlled private corporations (CCPCs) and substantive CCPCs were also released on 12 August 2024. These changes relate to measures that were first announced in the 2022 federal budget, which, among other things, propose to increase the CDA balance of a CCPC or substantive CCPC by the amount of intercorporate dividend deductions claimed with respect to hybrid surplus dividends (less withholding tax paid) received from its foreign affiliates, effective for taxation years that begin on or after 7 April 2022. With the proposed changes to the capital gains inclusion rate and the consequential changes to the hybrid surplus regime (discussed below), the CDA of a CCPC or a substantive CCPC is proposed to increase by the amount of intercorporate dividend deductions claimed with respect to successor hybrid surplus dividends (less withholding tax paid) received from its foreign affiliates after 24 June 2024.

Foreign affiliates and hybrid surplus

The proposed changes with respect to foreign affiliates and the computation of hybrid surplus were previously described in a backgrounder that was released with the June proposals (but were not part of the 10 June 2024 NWMM) — see EY Tax Alert 2024 Issue No. 33. The changes have now been incorporated into the draft legislation released on 12 August 2024. We observe that the draft legislative proposals are largely consistent with what was described in the backgrounder that accompanied the June proposals.

In particular, the proposed legislation introduces two sub-categories of hybrid surplus: *legacy hybrid surplus* and *successor hybrid surplus*. This amendment aims to address proper treatment of pre- and post-inclusion rate changes for capital gains and losses within the foreign affiliate system.

- **Hybrid surplus and deficit:** This pool of surplus previously included capital gains (and losses) realized by foreign affiliates from dispositions of shares of other foreign affiliates and partnership interests that are excluded property, as well as dividends received from other affiliates that were paid out of the hybrid surplus of such other affiliates. While the term *hybrid surplus* is not repealed under the proposed legislation, its application going forward has generally been limited to various computational rules. Instead, the hybrid surplus provisions have been largely adapted into *legacy hybrid surplus* and *successor hybrid surplus* throughout the ITA, and they must be separately tracked going forward. This adds additional complexity to the already complex foreign affiliate surplus regime.

- **Legacy hybrid surplus:** This pool of surplus generally includes gains (and losses) realized by foreign affiliates from dispositions of shares of other foreign affiliates and partnership interests that are excluded property, as well as dividends received from other affiliates that were paid out of the hybrid surplus of such other affiliates before 25 June 2024, maintaining the one-half inclusion rate. *Legacy hybrid underlying tax* follows a similar structure.

- **Successor hybrid surplus:** This pool of surplus generally applies to gains (and losses) realized by foreign affiliates from dispositions of shares of other foreign affiliates and partnership interests that are excluded property, as well as dividends received from other affiliates that were paid out of the hybrid surplus of such other affiliates after 24 June 2024, with a two-thirds inclusion rate. *Successor hybrid underlying tax* aligns with this framework. Separate tracking of taxes paid in respect of legacy hybrid surplus and successor hybrid surplus is required.

Ordering of dividends

Proposed subsection 5901(1) of the *Income Tax Regulations* (the Regulations) is amended to provide an additional ordering rule, under which any portion of a dividend that is deemed to be paid out of a foreign affiliate's hybrid surplus is first paid out of the affiliate's legacy hybrid surplus and then out of its successor hybrid surplus. For this purpose, where there is legacy hybrid deficit but successor hybrid surplus (or vice versa), only the net amount of the hybrid surplus may be distributed.

Dividends from legacy/successor hybrid surplus

Under the proposed amendments to subsection 113(1), the mechanics for computing deductions with respect to dividends paid out of a foreign affiliate's legacy hybrid surplus generally remain the same as the current legislation as it pertains to hybrid surplus — that is, one-half of the dividend amount is deductible and the deduction for legacy hybrid underlying tax is grossed up by the relevant tax factor less one-half. However, dividends paid out of a foreign affiliate's successor hybrid surplus will only qualify for a deduction equal to one-third of the dividend amount. In addition, the deduction for successor hybrid underlying tax will only be grossed up by the relevant tax factor less two-thirds.

Upstream loan rules

Subsection 90(9) provides relief from the upstream loan rules by allowing deductions to the extent they would have been available under subsections 113(1) or 91(5) if the upstream loan had instead been distributed as dividends. The following amendments are proposed to subsection 90(9):

- References to *hybrid surplus* have been replaced with *legacy hybrid surplus*. This change reflects that the deductions historically available for dividends paid out of hybrid surplus (based on the one-half inclusion rate) will continue to be available for dividends paid out of legacy hybrid surplus.
- A new clause 90(9)(a)(i)(B.1) has been added to account for deductions available for dividends paid out of successor hybrid surplus and is based on the new two-thirds inclusion rate.

These amendments apply to loans received and indebtedness incurred after 24 June 2024. The changes ensure that the upstream loan rules continue to align with the available dividend deductions under the foreign affiliate regime, taking into account the new sub-categories of hybrid surplus.

Other impacts

Various other foreign affiliate rules in the ITA and the Regulations that previously referenced hybrid surplus have been amended to incorporate the new legacy and successor hybrid surplus concepts.

Learn more

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