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Christopher,

Political developments this past week call into question whether the capital gains change will in fact become law for 2024, or ever.

With the Conservatives, Bloc Quebecois and, as of last Friday, the NDP all committed to bringing down the current Liberal Government, the proposed changes could be dead. While the changes have been introduced in draft legislation, they are not law. They have no status until passed into law.

When and if Parliament reconvenes in late January, there is a slim chance that a Bill could navigate the parliamentary system and be passed into law. This would be an uphill battle and there are much more important issues confronting the current Government. Survival is one of them. There is even some likelihood that an election could be called before Parliament reconvenes.

What are the Changes?

There are 3 changes:

- Increase the capital gains inclusion rate from 1/2 to 2/3, with consequential changes that have a ripple effect in many areas (capital dividend account, stock option deduction moving to 1/3);
- Increase the capital gains exemption to $1,250,000 up from around $1,000,000; and
- The Canada Entrepreneur's Incentive to effectively reduce the capital gains inclusion rate from 2/3 to 1/3, starting in 2025, phased in at $400,000 per year over 5 years.

Of these changes, the main one on people's minds is the inclusion rate. In Ontario, this moves the tax on capital gain from about 27% to about 36% (at the top tax bracket). This is a 9% increase. A similar result applies across all provinces. Corporations are affected in roughly the same way.

Given that the change was announced on April 16, to be effective on and after June 25, 2024, many people took preemptive steps to realize capital gains before the transition. These strategies will need to be reexamined if the change does not go through. In many cases, gains were triggered in a way that could be reversed. If so, they can be undone and, in all likelihood, will be. For others, you may be stuck unfortunately with what you did.

What Happens Next?

Assume this legislation is not passed and we are into an election by say February, 2025. It will be too late, realistically, for the change to be effective from June 25, 2024. That ship has sailed. By the time a new Parliament gets down to work, personal tax filings for 2024 will be over or at least in full swing. Too late to retroactively change the rules.

CRA has not yet approved the necessary software to file tax returns on a 2/3 inclusion rate basis. This is, in part, because the change is not law. Shortly CRA will have no choice but to adopt a position and approve software for filing or face chaos in March/April. All of this is to say that any change will likely occur for 2025, if at all.

Why Do We Say This?

There are several reasons. First the inclusion rate issue:

- The Conservatives voted against the change, and it would be an abrupt about-face to then reintroduce it;
- The change was very unpopular among people who are affected, and most others just shrugged it off;
- The change was not anchored in any sound theory. It was basically arbitrary and designed to raise tax revenue;
- The rules are complex, at a time when we should be trying to simplify our tax system;
- Many have made a convincing case that this is bad economic policy; and
- In the U.S. there is a proposal to actually lower the tax rate on capital gains. It is not sensible policy for us to go in the opposite direction. We have already seen unprecedented interest among Canadians in moving to the U.S. Taxation is one of the reasons.

Next, the capital gains exemption.

Historically when a favorable tax change is announced, it carries through. This is not always the case. The Conservatives introduced tax relief on home mortgage interest and the incoming Liberal Government dropped the idea. (The tax forms were even printed and some people actually filled out claims which were of course ignored.) But generally, when taxpayers have an expectation based on some tax benefit that has been announced, it usually happens.

Entrepreneurs' Incentive

This idea runs into trouble if the inclusion rate remains at 1/2. It was to reduce the rate from 2/3 to 1/3 so it will have to be changed. Across the world there are many versions of entrepreneur tax relief, so there are lots of models to pick through. There is no rush on this, because it was not to start until 2025.

Mistakes Made

It is unusual to see major pieces of legislation announced in a federal budget and then fail to become law. So what went wrong here?

Aside from the political situation (minority government, non-confidence motion, etc.), here are three reasons why this legislation ran into trouble:

- It may have been a latecomer to the April budget. The rumour is that when the spending numbers were added up, there needed to be something to offset the deficit. If you don't raise tax rates, you broaden the tax base (more is subject to tax but the actual tax rate remains the same). The legislation was not drafted at the time of the April budget and it took 2 months to do so. By then Parliament was almost off on summer vacation. It lost momentum and was delayed, which may now prove fatal;
- Poor messaging. First, there was the claim that the change would only affect 0.13% of people; that is around 30,000 - 50,000 individuals. This was widely questioned as being unrealistic. The revenue projections were also undermined by the Parliamentary Budget Officer as being too high; and
- A backlash. There was widespread criticism, especially from provincial governments in support of farmers.

In all, the change was very unpopular among those affected and produced no real change in voter intentions. It was not a political win in any sense.

What To Do?

Reevaluate any strategies based on the capital gains inclusion rate change. A reset in thinking may be required. Whether that is a soft or a hard reset may depend on what has been done, especially leading up to June 25th.

Be strategic. There is still uncertainty over this matter.

Keep the cards in your hand. Don't commit until you have to. In some cases, there will still be time to determine elections to make and how to file.

Get advice. The change itself was complex. Now, adopting a strategy based on the possibility of the change not happening is going to make navigation even more difficult.

Best wishes for the holidays and the new year,
Cadesky Tax Seminars Team

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