Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Planning considerations for individuals selling securities prior to June 25, 2024

Canada's recently unveiled 2024 federal budget proposes to increase the capital gains inclusion rate to 66.67% from 50%. Knowing tax efficiency plays a key role in building wealth, you're likely wondering how this change may affect you. This article focuses on the impacts this change may have on individuals and briefly outlines several planning strategies you may wish to consider implementing before June 25, 2024.

For a more robust discussion of each planning consideration, plus the extensive impacts of these proposed changes on corporations, estates, trusts and more, please ask your RBC advisor for the comprehensive article titled "2024 Federal Budget – Planning for the proposed increase to the capital gains inclusion rate."

While the budget document outlined the capital gains changes in a general way, there are still many unanswered questions given there was no accompanying draft tax legislation on the changes. The government stated that additional design details will be released in the coming months. As of the date of writing, Quebec is the only province or territory that has announced its intention to harmonize with the federal increase.

Any reference to a spouse in this article also refers to a common-law partner.

The effects of the proposed changes on individuals

You have a capital gain when you sell, or are considered to have sold, securities for more than the total of its adjusted cost base and the outlays and expenses incurred to sell the security. Capital gains have preferential tax treatment, as only a portion of the gain is taxable. The capital gains inclusion rate is the percentage of taxability that's applied to a capital gain. The result, known as a taxable capital gain, is included in taxable income.

Any capital gains realized prior to June 25, 2024, (Period 1) will have an inclusion rate of 50%. However, the 2024 federal budget proposed that any capital gains realized on or after June 25, 2024, (Period 2) will have an inclusion rate of 50% on the portion up to $250,000 (regardless of the amount of capital gains realized in Period 1) and an inclusion rate of 66.67% on any portion above $250,000.

The proposed higher inclusion rate on capital gains would effectively increase the average federal-provincial marginal tax rate on capital gains above $250,000 at the top marginal tax rate to 33.8% from 25.3%. The annual $250,000 threshold for individuals would be fully available in 2024 (i.e., it would not be prorated) and would apply only in respect of net capital gains realized in Period 2.

There was no mention of the $250,000 threshold being indexed to inflation.

Consider alternative minimum tax (AMT)

It's important to consider the impact that AMT may have on any personal capital gains you will trigger. In the 2023 federal budget, the government proposed several changes to the AMT calculation that were also aimed at high-income individuals. One consequence of the change was that generating a significant amount of capital gains would likely trigger AMT. Although the AMT you pay is creditable against regular income tax for up to seven years, if you don't have sufficient regular taxes payable in the next seven years, the AMT you paid becomes a permanent tax. That said, the 2024 proposed increased inclusion rate for capital gains may lessen the impact of AMT, but it is possible there may be further amendments to AMT once the draft legislation on the capital gains inclusion rate is released.

Before taking action: ask "big picture" questions

It's important to consider the power of tax deferral as one of the fundamental tools of tax planning. A tax deferral takes advantage of the time value of money. All else being equal, the longer your tax can be deferred, the less the discounted present value of your tax liability. For example, $25,000 in tax deferred for 20 years at an assumed 5% interest rate has a discounted present value of $9,422.

With a tax-deferred investment strategy, the money that might otherwise go to pay current taxes remains invested for greater long-term growth potential and benefits from the power of compounding. In other words, selling now will result in a pre-payment of tax and a smaller after-tax amount to reinvest. Furthermore, triggering capital gains tax in 2024 may result in increased instalment payment reminders from the Canada Revenue Agency (CRA).

Given the importance of tax deferral, before acting, it may be helpful to revisit your goals and timelines before making a change. For example, are your goals the same as when your portfolio was constructed? Is your portfolio aligned with your risk tolerance? Does your portfolio have an appropriate level of diversification? The best approach for your situation will be unique to you.

Considerations for selling securities prior to June 25

If, in your regular review of your portfolio, you determine that a portfolio rebalancing is appropriate, consider whether to implement the rebalancing before the increase to the inclusion rate. If there's a high probability that the inclusion rate for the future capital gain is likely to be 50%, because of your ability to take advantage of the $250,000 threshold for individuals, it's not recommended to realize an early capital gain.

Keep in mind that the trades would need to settle before June 25; therefore, ensure that trading dates are factored in to meet this deadline. This way, any capital gains triggered from the rebalancing would be subject to the current 50% inclusion rate.

For securities you've not previously considered disposing of this year or next, the decision to sell should be analyzed with a detailed cost/benefit analysis based on your specific circumstances to determine your "break-even holding period." This is the point in time when, assuming all other things being equal, your after-tax portfolio value will be the same regardless of whether you sell prior to June 25, 2024, or maintain your portfolio and sell in the future.

Break-even analysis example

Let's look at an example of an individual selling securities before June 25 at the 50% inclusion rate, versus holding the security until a future date and selling when the inclusion rate is 66.67%. This example assumes the individual has already realized capital gains this year, and the additional sale of securities would result in capital gains entirely in excess of the $250,000 threshold.

Let's assume:

- The fair market value of the securities is $300,000.
- The adjusted cost base of the securities is $100,000.
- Their marginal tax rate today and in the future is 50%.
- The expected future rate of return is 5% (100% deferred capital gains, no interest, no dividends).
- AMT does not apply.

If the individual were to sell today, they would be subject to capital gains tax of $50,000, leaving them with only $250,000 of after-tax proceeds for reinvestment. Alternatively, the individual could hold/not sell and keep the full $300,000 invested.

The lower the future expected rate of return, the longer the break-even holding period will be. Conversely, the higher the future expected rate of return, the shorter the break-even holding period. As such, if you hold a security with a higher rate of return and you plan to hold on to this security for the long term, it likely doesn't make sense to sell just to take advantage of the lower inclusion rate.

The following table shows the difference in after-tax value between selling now at the 50% inclusion rate versus holding and selling the security at a future date at the 66.67% inclusion rate.

Option 1: Sell now at 50% inclusion rate and reinvest proceeds				Option 2: Hold and sell at 66.67% inclusion rate				
Year of sale	Future value	Tax on future gain at 66.67%	After-tax value	Year of sale	Future value	Tax on all gain at 66.67%	After-tax value	Difference in after-tax value
1	$262,500	$4,167	$258,333	1	$315,000	$71,670	$243,330	$15,003
5	$319,070	$23,025	$296,046	5	$382,884	$94,300	$288,585	$7,461
8	$369,364	$39,790	$329,574	8	$443,237	$114,418	$328,819	$755
9	$387,832	$45,946	$341,886	9	$465,398	$121,806	$343,593	($1,707)

The preceding table shows the individual can expect the difference in after-tax value to be the same sometime between the eighth and ninth year. Therefore, if the individual expects to keep the securities for at least nine years, they will be better off not selling now and rather holding the investment. In other words, if the individual plans to hold the security for less than nine years, they will be better off selling it before June 25 at the 50% inclusion rate.

The following table shows the break-even holding period for the preceding example using the same assumptions but at various capital growth rates of return.

Rate of return	Break-even holding period*
3%	14 years
5%	9 years
7%	6 years
9%	5 years

*Rounded to the nearest whole year

If you're deciding whether to sell before June 25 or continue to hold, important considerations will be the expected rate of return, your time horizon and the potential incremental capital gains tax.

The lower the future expected rate of return, the longer the break-even holding period will be. Conversely, the higher the future expected rate of return, the shorter the break-even holding period. As such, if you hold a security with a higher rate of return and you plan to hold on to this security for the long term, it likely doesn't make sense to sell just to take advantage of the lower inclusion rate.

Planning strategies to consider

When selling securities, remember that realized capital losses will reduce capital gains realized in the same year. For tax purposes, there appears to be no benefit to proactively realizing capital losses before June 25, 2024, in order to realize losses at the 50% inclusion rate. There also appears to be no downside to waiting to realize the loss on or after June 25, 2024, at the 66.67% inclusion rate.

If an unrealized capital gain has accrued in your name, you can also consider transferring the appreciated securities to your spouse or transferring the appreciated securities to a Canadian partnership or holding company before June 25, 2024. If the increase to the inclusion rate introduced in the budget receives royal assent, you may be able to elect to trigger the unrealized gain and be subject to the 50% inclusion rate. If the proposal doesn't pass into law, you can elect to transfer the security at cost.

Conclusion

Given the 2024 federal budget proposal to increase the capital gains inclusion rate, and in continuing to proactively plan for the future, it's important to discuss your situation with your qualified tax advisors to understand the significance of the potential impacts based on your personal situation and to determine if it makes sense to take action prior to June 25, 2024.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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