Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Planning for a possible increase to the capital gains inclusion rate

Increased government spending has been essential in response to the COVID-19 pandemic. However, this may mean that governments will need to find a way to boost revenues. They can indirectly raise revenues by boosting economic activity, income, and wealth. They can also directly raise revenues by increasing tax rates, reducing tax breaks, expanding the tax base, improving tax enforcement and levying new taxes. Increasing the capital gain inclusion rate may be one tax change the Canadian government could consider in order to boost tax revenues. This has Canada speculating, again, if a hike to the capital gains inclusion rate may occur in the next federal budget.

If a change to the capital gain inclusion rate is announced in the upcoming budget, it is not known whether it would be effective immediately, be retroactive, or start at a future date. If you would like to plan for a potential increase in the inclusion rate, the following article details some planning items (not necessarily exhaustive) you may wish to consider along with your qualified tax advisor. It is important that you consult with your qualified tax advisor to assist you in assessing the costs and benefits of implementing any planning strategies.

History of the capital gains inclusion rate

The capital gains inclusion rate is the percentage that is applied to a capital gain you realize. The result, known as a taxable capital gain, is included as your taxable income. The taxable capital gain is subject to tax at your marginal tax rates. Since tax on capital gains was introduced in 1972, this inclusion rate has changed four times as shown below:

Time Period	Inclusion Rate
1972 to 1987	50%
1988 to 1989	$66\,^{2}/_{3}\%$
1990 to February 27, 2000	75%
February 28 to October 17, 2000	$66\,^{2}/_{3}\%$
After October 17, 2000	50%

Source: Federal legislation

Planning ideas

You and your qualified tax advisor may want to consider the following strategies (not necessarily exhaustive) assuming there is an increase to the capital gains inclusion rate for transactions on or after the budget date.

Consider the timing for rebalancing your portfolio

If in your regular review of your portfolio, you determine that a rebalancing is appropriate, and there are large unrealized capital gains, consider whether to implement the rebalancing before the federal budget date. Keep in mind that the trades would need to settle before the budget date. This way, any capital gains triggered from the rebalancing would be subject to the current 50% inclusion rate. Although this rebalancing may be appropriate from an investment standpoint, it does result in a pre-payment of tax (albeit at a potentially lower tax rate) and loss of tax deferral. Furthermore, triggering capital gains tax in 2020 may result in increased instalment payment reminders from the CRA.

If you have securities in a capital loss position, you may wish to defer rebalancing these securities until after the budget date to benefit from any potential increased inclusion rate.

Transfer appreciated securities to a holding company

You may wish to consider transferring appreciated securities to your holding company before the federal budget date. If you do not have an existing holding company, then you must first consider the initial cost of

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setting up the corporation and the ongoing tax compliance costs. In general, the steps for this planning strategy involve transferring securities to the corporation in exchange for shares of the corporation. A tax election form (T2057) must be completed and filed if you are electing to transfer the securities at the adjusted cost base (ACB) or somewhere between the ACB and fair market value (FMV). The deadline to file form T2057 is the earliest date on which any of the parties to the election has to file an income tax return for the taxation year in which the transfer occurred (generally, April 30th for individuals or within six months of the corporation's taxation year).

If there is a change in the inclusion rate introduced in the budget, you may be able to elect to trigger the unrealized gain and be subject to the 50% inclusion rate. If there is no change to the inclusion rate, you can elect to transfer the security at cost.

In addition to the initial and ongoing costs of having a holding company, you must consider the advantages and disadvantages of earning investment income through a corporation. For example, currently the integrated tax rate for interest income, foreign income and capital gains earned through a corporation and paid to its shareholder is higher than the personal tax rate for this income in all provinces and territories. This tax rate disadvantage may change from year to year depending on the current year's tax rates and your province or territory of residence. Another consideration is whether the investment income earned from the transferred securities will affect the small business limit for your corporation. Under new rules, a Canadian-controlled private corporation (CCPC), together with associated corporations, can earn up to $50,000 in passive investment income per year without affecting its small business limit.

Also, without proper planning, there is the potential for double taxation when a shareholder dies holding private corporation shares. First, there is personal tax payable on the deemed disposition of the shares. Second, there is corporate tax payable on the disposition of the company's assets and tax payable by the estate or beneficiaries on the wind-up and distribution of corporate assets to the estate or beneficiaries. Post-mortem tax planning strategies may be considered to help mitigate the double tax burden. In addition, you should also consult with your legal advisor as to whether this planning strategy would have any effect on your current estate plan.

Transfer appreciated securities to a spouse or common-law partner

If an unrealized capital gain has accrued in one spouse's name alone, a planning strategy to transfer the appreciated securities to the other spouse could be considered.

Let's assume a situation where you transfer appreciated securities to your spouse. Transfers between you and your spouse (where both legal and beneficial ownership are transferred) are generally not taxable for income tax purposes. The default option is that your spouse will receive the property at your ACB. However, you and your spouse have the option of electing to report the transfer at FMV. If the assets are in an accrued gain position and the election is made, you will need to report the capital gain on your income tax return. The deadline to file the election (there is no prescribed form) is the income tax return deadline for the taxation year in which the transfer occurred, generally April 30th. The ACB of the property for your spouse will be the FMV of the assets on the date of the transfer.

If there is a change in the inclusion rate introduced in the budget, you may be able to elect to trigger the unrealized gain and be subject to the 50% inclusion rate. If there is no change to the inclusion rate, you would not make an election and the security would transfer at cost.

As a general rule, when your spouse earns investment income (loss) and capital gains (losses) from the securities you transferred to them, the income or loss and capital gains or capital losses will attribute back to you. However, there will be no attribution on future investment income if you elect to report the transfer at FMV, trigger gains and also receive FMV consideration from your spouse. FMV consideration could be in the form of cash received from your spouse or even a loan receivable at the CRA prescribed interest rate.

Before implementing this strategy you should seek professional legal advice regarding the potential application of family law and whether this planning strategy would have any effect on your current estate plan. In addition, you should consult with your qualified tax advisor to determine the tax consequences for a potential transfer, including whether there are any U.S. gift tax or estate planning considerations.

Donate securities in-kind

If the above strategies are not appropriate or you are unable to trigger a capital gain before the capital gains inclusion rate increases, then you could consider the tax savings from charitable giving. To encourage individuals to increase their charitable giving, there is a tax incentive for those who donate publicly traded securities. These securities include shares, debt obligations or rights listed on a designated stock exchange, mutual funds, interests in related segregated funds and Government of Canada or provincial government bonds donated to charitable organizations, public or private foundations. The capital gains triggered upon the donation of these securities may be eliminated. As such, if you have appreciated securities that may be subject to a higher inclusion rate if sold, you may wish to consider donating these securities directly to charity instead.

The following table compares donating publicly traded shares directly to selling the shares and donating the cash proceeds for a resident in the province of Ontario who has taxable income over approximately $210,000 (indexed annually).

	Sell shares and donate cash		Donate shares directly	
	50% inclusion	75% inclusion	50% inclusion	75% inclusion
FMV of donation (a)	$50,000	$50,000	$50,000	$50,000
ACB	$10,000	$10,000	$10,000	$10,000
Capital gain	$40,000	$40,000	$40,000	$40,000
Taxable capital gain	$20,000	$30,000	$0	$0
Tax on capital gain @ 53.53% (b)	$10,706	$16,059	$0	$0
Tax savings from 50.41% donation tax credit (c)	$25,205	$25,205	$25,205	$25,205
Total cost of donation = (a) + (b) – (c)	$35,501	$40,854	$24,795	$24,795

The table illustrates that if you donate the security directly to the charity, the after-tax cost of donation will be the same regardless of the capital gain inclusion rate.

Be sure to consult with your qualified tax advisor before making a gift of securities as charitable tax credits vary by province/territory. Further, before making a donation in-kind, contact the charity and verify that they can accept in-kind donations.

Takeaway

Given the current economic climate, Canadians are wondering what changes lie ahead. There are speculations as to what may or may not be included as tax changes in the upcoming federal budget, but as always, we will only know for certain on budget day. Speak with your qualified tax advisor to explore any opportunities or strategies that may mitigate effects of any potentially adverse tax changes to the capital gains inclusion rate.

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.

Appendix – Top 2020 marginal tax rates for capital gains and dividends

The following table illustrates the current top marginal tax rate on capital gains by province/territory, as well as the potential top marginal tax rate on capital gains if the inclusion rate increases to 66 $^{2}/_{3}$% or 75%. The table also shows the top marginal eligible and non-eligible dividend tax rates for comparative purposes.

	50% inclusion (current)	66 $^{2}/_{3}$% inclusion (speculative)	75% inclusion (speculative)	Eligible dividends (current)	Non-eligible dividends (current)
Alberta	24.00%	32.00%	36.00%	31.71%	42.31%
British Columbia	24.90%	33.20%	37.35%	31.44%	44.64%
Manitoba	25.20%	33.60%	37.80%	37.78%	46.67%
New Brunswick	26.65%	35.53%	39.98%	33.51%	47.75%
Newfoundland and Labrador	25.65%	34.20%	38.48%	42.61%	44.59%
Nova Scotia	27.00%	36.00%	40.50%	41.58%	48.28%
Nunavut	22.25%	29.67%	33.38%	33.08%	37.79%
NWT	23.53%	31.37%	35.29%	28.33%	36.82%
Ontario	26.77%	35.69%	40.15%	39.34%	47.74%
Prince Edward Island	25.69%	34.25%	38.53%	34.22%	45.22%
Quebec	26.66%	35.54%	39.98%	40.11%	47.14%
Saskatchewan	23.75%	31.67%	35.62%	29.64%	40.37%
Yukon	24.00%	32.00%	36.00%	28.93%	42.17%

Source for current rates: Federal and provincial/territorial legislation, 2020. Speculative rates are calculated by RBC Wealth Management Services.