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Summary of Issues Identified
Capital Gain Inclusion Rate Draft Legislation

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The following document provides a compilation of the feedback we received from members of the CBA-CPA Canada Joint Committee on Taxation and others in the tax community upon their review of the amendments to the Capital Gains Inclusion Rate, which were included in the August 12, 2024 release from the Department of Finance. We welcome a follow up call with Finance to discuss this feedback in greater detail.

1. Calculation of capital cost after changes in use or non-arm's length transfers

Subsections 2(1), (2), (3) and (4) amending 13(7)(b)(ii)(B), 13(7)(d)(i)(B), 13(7)(e)(i)(B), 13(7)(e)(ii)(B)

Paragraph 13(7)(b) applies when a taxpayer acquired a property for some other purpose and began to use it for the purpose of gaining or producing income. Paragraph 13(7)(d)(i) applies on a partial change in use where the use by the taxpayer for the purpose of gaining or producing income has increased. Both paragraphs increase the capital cost of depreciable property after the change in use by the taxable capital gain resulting from the change in use.

Paragraph 13(7)(e)(i) applies when an individual resident in Canada (or certain partnerships) transfers, directly or indirectly, in any manner whatever depreciable property of a prescribed class to a person whom the individual did not deal at arm's length. Subparagraph 13(7)(e)(ii) applies where a transferor that is not an individual resident in Canada (and is not a partnership meeting certain criteria) transfers depreciable property to a taxpayer that did not deal at arm's length. The capital cost to the transferee is limited to the capital cost to the transferor plus the taxable portion of the capital gain realized by the transferor.

In all cases, the capital cost to the taxpayer post-change in use, or to the transferee on post-transfer, is determined by a formula. The formulas in the proposed legislation appear to create an illogical result. The illogical result is illustrated by the following example involving a full change in use.

Paragraph 13(7)(b), post amendment, would be as follows:

> where a taxpayer, having acquired property for some other purpose, has begun at a later time to use it for the purpose of gaining or producing income, the taxpayer shall be deemed to have acquired it at that later time at a capital cost to the taxpayer equal to the lesser of
>
> **(i)** the fair market value of the property at that later time, and
>
> **(ii)** the total of

(A) the cost to the taxpayer of the property at that later time determined without reference to this paragraph, paragraph 13(7)(a) and subparagraph 13(7)(d)(ii), and

(B) the amount determined by the formula

A + B – C – D

where

A is 1/2 of the elected amount in respect of the property under subsection (7.7),

B is 2/3 of the amount, if any, by which the fair market value of the property at that later time exceeds the elected amount in respect of the property under subsection (7.7),

C is the cost to the taxpayer of the property as determined under clause (A), and

D is 1.5 times the amount deducted by the taxpayer under section 110.6 in respect of the amount, if any, by which the fair market value of the property at that later time exceeds the cost to the taxpayer of the property as determined under clause (A);

Suppose an individual changes the use of property such that the property is now depreciable property (cost amount of $200,000, FMV $1,000,000). Assuming no election is made under subsection 13(7.7), the capital cost after the application of 13(7)(b) logically should be $733,333 being the original $200,000 cost amount plus the taxable portion of the taxable gain of $533,333 [$800,000 x 2/3]. The formula appears to produce a capital cost of $666,667 calculated as follows:

The lesser of:

(i)	FMV of property		$1,000,000	$666,667
(ii)	The total of			
	(A) cost to the taxpayer =		$200,000	
	(B): A + B – C – D			
	A = nil B = 2/3 x ($1,000,000 – 0) = $666,667 C = $200,000 D = 1.5 x deduction under 110.6 = nil		466,667	
			$ 666,667	

The illogical result would persist if an election is filed under 13(7.7). Assuming the same facts as earlier but assume that an election is filed under 13(7.7) in the amount of $250,000.

The limit under 13(7.7) is the lesser of:

(i)	The capital gain in respect of the disposition	$800,000	
(ii)	A – B		
	A = amount under 38.01(a)	$250,000	
	B = amount under 38.01(b) w/o reference to 13(7.7)		
	A – B – C – D + E		$250,000
	A = 1.5 x TCG = $800,000		
	B = n/a	0	
	C = n/a		
	D = capital gain from 13(7)(e) = $800,000		
	E = n/a		
		$ 250,000	

The capital cost to the transferee logically should be $691,667 being the capital cost to the transferor ($200,000) plus the taxable portion of capital gain on the first $250,000 ($250,000 x 50% = $125,000) plus the taxable portion of the remaining $550,000 ($550,000 x 2/3 = $366,667). The formula appears to produce a capital cost of $625,000 calculated as follows:

The lesser of:

(i)	FMV of property	$1,000,000	
(ii)	The total of		
	(A) cost to the taxpayer =	$200,000	
	(B): A + B – C – D		
	A = 1/2 of the elected amount = $125,000		$625,000
	B = 2/3 x ($1,000,000 – 250,000) = $500,000	425,000	
	C = $200,000		
	D = 1.5 x deduction under 110.6 = nil		
		$ 625,000	

This formula in Clause (B) could be changed to A + 2/3 (B - C- D) with B and D representing full amounts.

This amended formula appears to produce the correct result:

(i)	FMV of property	$1,000,000	
(ii)	The total of		
	(A) cost to the taxpayer =	$200,000	$691,667
	(B): A + 2/3 (B – C – D)		
	A = 1/2 of the elected amount = $125,000		
	B = $750,000 ($1,000,000 – 250,000)	491,667	
	C = $200,000		
	D = deduction under 110.6 = nil		
		$ 691,667	

Recommendation: Revisit the formulas in ITA 13(7)(b)(ii)(B), 13(7)(d)(i)(B), 13(7)(e)(i)(B) and 13(7)(e)(ii)(B).

2. <u>Section 38.01 and the transferee of depreciable capital property under 13(7)(e)</u>

Paragraph 13(7)(e) applies where a person or partnership has, direct or indirectly, in any manner whatever, acquired (otherwise than as a consequence of the death of the transferor) a depreciable property (other than a timber resource property) of a prescribed class from a person or partnership with whom the person or partnership does not deal at arm's length and, immediately before the transfer, the property was capital property. This paragraph ensures that the capital cost to the transferee is not increased by the non-taxable portion of any capital gain realized by the transferor.

Section 38.01 allows an individual (other than a trust), a graduated rate estate or a qualified disability trust to deduct an amount so that the inclusion rate on the first $250,000 of capital gains ends up taxed at a 50% inclusion rate. Capital gains triggered by 13(7)(b), (d) or (e) are excluded from the capital gain that is eligible for this reduction [variable "D"]. However, capital gains triggered by one of those paragraphs become eligible for the 50% inclusion rate (in whole or in part) if an election is filed under 13(7.7) [variable "E"].

Variable "E" of the formula in 38.01(b) seems to allow a taxpayer that has <u>acquired</u> capital property and made a joint election with the transferor under 13(7.7) to deduct up to 50% of the amount covered by the election even though the transferee realized no gain on the transfer. Variable "E" refers to the amount covered under the election under 13(7.7) but appears to apply to both transferor and transferee.

Recommendation: Limit Variable "E" of the formula in 38.01(b) to the transferor of depreciable property.

3. <u>Effective date of amendment to the stop-loss rule in 112(3.2)(a)(iii)</u>

<u>Clause 25(1) which amends 112(3.2)(a)(iii)</u>

Subsection 112(3.2) is a stop-loss rule that reduces the capital loss of a trust (including an estate) on the disposition of a share that is capital property. For a graduated rate estate in the first taxation year, the amount of denied loss is reduced by the lesser of 1/2 the lesser of (i) the loss determined without reference to this subsection and (ii) the individual's capital gain from the disposition of the share immediately before death. The proposed amendment will change the fraction to 1/3 for dispositions occurring on or after June 25, 2024.

We suggest that this clause should only apply to the graduated rate estates of taxpayers who died on or after June 25, 2024. Graduated rate estates of taxpayers who passed away before June 25, 2024 and that realized a capital loss on or after June 25, 2024 could be worse off for no apparent policy reason.

Recommendation: Amend the effective date so that it applies to graduated rate estates of taxpayers that died on or after June 25, 2024.

4. <u>Partner capital gain inclusion rate when partnership year-end is before June 25, 2024</u>

Subsection 96(1.7) adjusts the taxable capital gain, allowable capital loss or business investment loss of a partner of a partnership to use the capital gains inclusion rate of the partner when the partnership itself has used a different inclusion rate.

Proposed subsection 96(1.72) overrides subsection 96(1.7) where a taxpayer is a member of a partnership during a fiscal year of the partnership that <u>begins before June 25, 2024 and ends after June 24, 2024</u>. This transition rule deems partners of partnerships with taxation years that straddles June 25, 2024 to have realized capital gains, capital losses and business investment losses in the same period that the partnership itself realized those capital gains, capital losses and business investment losses (e.g., before June 25 or after June 24).

There appears to be no transitional rule to deem partners of a partnership with a taxation year ending before June 25, 2024 to have realized any allocated capital gains, capital losses or business investment losses from the partnership in period 1. A partner that is allocated a capital gain by a partnership with a taxation year ending before June 25, 2024 and that realized no other gains or losses would seem to have a capital gains inclusion rate of 2/3 under proposed Clause 4(a)(ii).

Consider the following example:

- Corporation A has a June 30, 2024 year-end
- Corporation A is a member in Partnership B
- Partnership B has a March 31, 2024 taxation year-end
- Partnership B realized a capital gain on March 1, 2024 of which $30,000 is allocable to Corporation A
- Corporation A did not realize any other capital gains, capital losses or business investment losses

In this case, Clause 4(a)(ii) of the proposed legislation would deem Corporation A to have a capital gains inclusion rate of 2/3. The formula in 96(1.7) would then deem Corporation A to have realized a taxable capital gain of $20,000 [$30,000 x 2/3].

It seems reasonable that this capital gain should be deemed to have been realized in period 1. Proposed subsection 96(1.72) addresses this issue for partnership taxation years that straddle June 25, 2024. The policy intent behind many of the transition rules in the proposed legislation is to apply an inclusion rate of 1/2 to capital gains realized before June 25, 2024.

Corporation A might also have declared a capital dividend on April 1, 2024 ahead of the budget date and could now be facing a penalty under Part III for an excessive election. Since the capital dividend preceded the 2024 federal budget, this result should be inappropriate.

Recommendation: Include a deeming rule so that capital gains, capital losses and business investment losses realized by partnerships with taxation years ending before June 25, 2024 are included in period 1 when allocated to partners.