Manulife Private Wealth

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How will the changes to capital gains affect you?

Speaker Participants

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Presentation

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Hello, everyone. Welcome, and thank you for taking the time to join us at this quarter's Manulife Private Wealth Webinar. My name is Leslie Brophy, and I'm the AVP of Manulife Private Wealth, responsible for the investment platform and the investment and sales team.

The government has proposed raising the inclusion rate on capital gains over $250,000 from 50% to 66.7% for individuals. It's also proposed raising the tax rate to 66.7% on capital gains earned by trusts and corporations. As you know, capital gains are incurred when assets which have appreciated value are sold at a profit.

The capital gains increase dominated headlines following the tabling of the federal budget in April. However, details on the specifics of the policy were delayed. This past weekend, the government announced its plan to release the specifics of the policy in a motion before the House of Commons today, June 10th. In this episode of our quarterly webinar, we'll discuss how the proposed changes might affect you and provide suggestions on how to prepare and what to consider before these changes take effect later this month. As always, this event is prepared solely for your information.

For those interested in a replay or in sharing this information with others, we are recording the segment, and a copy of the recording will be available on our website at ManulifePrivateWealth.ca or LinkedIn at Manulife Private Wealth.

We will have time for questions at the end of the session. Please submit any questions through the button at the bottom of your screen. If you wish to remain anonymous, of course, you can select that option before submitting.

I'm very happy to introduce our speaker today, no stranger to Manulife Private Wealth Webinars, Hemal Balsara, Head of Tax, Retirement, and Estate Planning at Manulife.

Hemal provides tax, retirement, estate, and insurance planning support to advisors regarding complex cases in the affluent individual and business markets. He joined Manulife in 2011 after spending six years at a national accounting firm where he researched and analyzed complex tax issues. Welcome, Hemal. Over to you.

Hemal Balsara CPA, CA, CFP, TEP, FEA
Head of Tax, Retirement, and Estate Planning, Manulife

Great. Thanks, Leslie. It's really good to be here today sharing about the capital gains, inclusion rate increases. And in particular, this is really Special to me because at the end of the day, what ended up happening for me was I was in the budget lockup back in April, on April 16th, when these changes were announced. What a budget lockup is, is effectively getting access to the budget documents early so that different tax practitioners can work on the publications for their firms. For myself, we were like, in terms of the room, the front of the room was here. In fact, we were maybe two-thirds of the way in. What quickly happened was people were put... In terms of getting the budget documents, you get the budget documents on a USB key, and people were putting the budget documents into their computer and starting to read, and you could hear a buzz in the room. That buzz really was... You just heard rumblings like capital gains, capital gains, capital gains. What was funny was, we weren't expecting anything on that front this year. By the time I got my USB key, it was "What's going on? What's going on?".

I'm hearing people rumblings about capital gains. Put my USB key in. First thing I see is capital gains, inclusion rate increases. It was like, wow, they actually did it this year. So your next question for me is, what does this all mean? From a very macro perspective, this is going to lead to both higher terminal tax obligations, but also higher inter vivos tax obligations. The other thing is from a macro lens, moving investments into tax-deferred vehicles is that can include life insurance policy, take advantage of your RSPs, TFSAs, all those vehicles, really good. Then the other thing, too, is this postmortem planning is ultimately going to work.

But if we look at this, changes to the gains inclusion rate, what does this all mean? We're looking at increasing the capital gains inclusion rate from being 50% in today's environment to two-thirds. What was interesting with the budget was they effectively announced this increase, but they gave a couple of little nuggets. When I say little nuggets, they effectively increased the lifetime capital gains exemption on qualified small business, corporation shares, and qualified farm and fishing property. It increased from $1.016 million to $1.25 million for dispositions that occur after June 25th, 2024.

In addition to that, they followed through on the whole Employee Ownership Trusts rules, where if somebody sells their qualifying business to an Employee Ownership Trust, there can be $10 million of capital gains sheltered. And then the other thing that they did was they introduced the Canadian Entrepreneurs' Incentive, which effectively reduces your capital gains inclusion rate by 50%. So effectively, if we're going into a two-thirds capital gains inclusion rate environment, effectively for up to $2 million, we would be able to benefit from capital gains at one-third.

Those were some of the more macro changes that occurred. Effectively, they hit you with the big stick of the capital gains inclusion rate increase, and then they gave you a couple of small nuggets to provide a little bit of relief.

In terms of what does this all mean, and Leslie alluded to this at the very beginning of the session, but for individuals, what's going to end up happening is we're going to have the first $250,000 of capital gains be included at a 50% inclusion rate. It'll be like it is today. But the moment we get above and beyond $250,000, that first $250,000 is still going to stay at 50%, but each incremental dollar above and beyond $250,000 of capital gains is going to be taxed at a two-thirds inclusion rate.

We're going to actually, later on in this presentation, look at tables as to what that actually means for both individuals and corporations. The other piece of the puzzle is you're going to be able to crystallize capital gains before June 25th, 2024, in order to take advantage of the slower inclusion rate. That's good news from the sense of CRE has already commented saying they won't apply GAAR, assuming that this is really just a crystallization transaction. But one of the things that we do need to consider, and this is from the 2023 budget which was introduced, and then the rules in the 2024 budget effectively say we're applicable as of January 1st, 2024, which is the Alternative Minimum Tax Rules or AMT. We have a numerical example of how that also plays out in a little bit. One of the things as individuals, we just have to be careful. If we have high amounts of capital gains income relative to other income, what ends up happening is now AMT could become a consideration, and we might be hit with a cash tax bill that we would have not otherwise expected. Then the other piece of the puzzle here is for corporations and trusts.

For corporations and trusts, they don't benefit from this $250,000, 50% inclusion rate exception. Effectively, every single dollar that's going to be taxed in corporations and trusts, subject to draft legislation, is going to be subject to a two-thirds inclusion rate from dollar one. Again, no legislation has been issued yet. We're expecting something later on today. We'll see how it plays out.

Long story short, this week, we have something coming, and they're going to likely force a vote, and effectively, the motions are going to be likely coming out later today. It's coming.

So how does this actually look? This is a table that shows you the impact to A, trust, and B, individuals for capital gains greater than $250,000. If we look at this by province, I'll focus in on Ontario first, just because that's the province that I reside in. Effectively, what we're looking at is we're going from a 26.76% effective tax rate to 35.69%. This translates to about 8.93% extra in taxes, which equates to on a per million basis of capital gains, $89,300. If we look at the results across the country, the province with the lowest increases, or the territory with the lowest increases, Nunavut at $74,200.

The province that's most impacted is Newfoundland at $91,300. For BC, we're looking at $89,200, and in Alberta, we're looking at $80,000. For Quebec, we're looking at about $88,900. Overall, what we're seeing is the tax increasing. But the other thing that I wanted to highlight here really quickly is if we look at what's happening, if you bring it back to Ontario, we're going up by about 8.93%. The reality is in terms of that, we're effectively going from a 26.76% to 35%. The tax that's actually being increased is actually it's going up by a third in terms of absolute percentage points. Something to look out for over there. Overall, this just really means that we're going to have greater tax bills owing when we dispose of assets that have capital gains, and then also on a terminal basis as well in terms of when we pass away, we're going to have higher capital gains exposure as a result of this increase.

Another question you might have for me is, how does this play out in corporations? For those of you who are familiar with corporations, you know that corporations get taxed separately. For capital gains in a corporation, they're treated as investment income.

In terms of what we're looking at as well, in Ontario, we're going up from a 25.09% tax rate to 33.44%. That's about 8.35% or $83,500. Meanwhile, some of the other provinces of interest, Quebec, were up by about 8.35%, $83,500 per million. In BC, we're looking at 8.44% or $84,400. It's one of those things, where again, consistently across the board, we're seeing these increases have an impact. The other thing that I wanted to highlight here is for corporations, as you can appreciate, because capital gains are treated as investment income, there is a portion of refundable tax that is available when you pay a taxable dividend out to the shareholder.

Let's actually see this in action. We've got A who purchased a family cottage for $175,000 in 1982. A is a widow and the children are grown. Really, A is retired and has no active sources of income besides a modest pension. A received an offer for a cottage for $2 million with a closing date of July 1st, 2024. Let's assume that A is unable to claim the principal residence exemption on the cottage as it is a second home, and the accountants have figured out that the other home that he lives in will be more valuable for the principal residence exemption.

If we look at this, how things play out here is in the situation of a 50% inclusion rate, effectively, what happens is we have a capital gain at $1.825 million. It's going to have a 50% inclusion rate, and we're going to end up with cash taxes owing, assuming that he's at the top marginal tax rate of $489,000. We're looking at a 26.77% effective tax rate. Now, under the proposed rules, a two-thirds inclusion rate, what happens here is $200,000 or $2 million is going to be our proceeds. We're going to have $175,000 of ACB, similar to the previous example. But what happens is the first $250,000 will be eligible for a 50% inclusion rate, and then everything above and beyond, so $1.575, is subject to a two-thirds inclusion rate. All in, we're looking at about $629,000 of total tax, 34.46% effective tax rate. So effectively, this ended up costing A, about $160,000 because he had a closing date of July 1st, 2024, as opposed to June 24, 2024.

As we've seen already the comments in this presentation or subject to change, depending on what the draft legislation ultimately says. But at the end of the day, in Ontario, we're looking at 35.69% versus 26.76% after $250,000.

This is about an $89,000 increase per million dollars of gross capital gains. The reality is, I work on the insurance side of the business as well. One of the things that I like to highlight is moving dollars into a tax-deferred environment such as an insurance policy. It doesn't have to be an insurance policy. It could be a TFSA, it could be an RSP. At the end of the day, this could be valuable as capital gains inclusion rates It's increased. What does this mean? Does it make sense to actually look at triggering capital gains prior to June 25th, 2024? You have to think about... Like anything in tax, the answer isn't just yes or no. It's a maybe, and it's going to come back to the circumstances of the individual making that decision. The first thing that I have to say is, did you have an intention to sell already? And realize that capital gain sooner rather than later. If the goal was or the answer to that question was yes, then maybe it's worth thinking about it. The reality is we're 14 days out, so we've got two weeks to actually really do this. It's really more applicable for marketable securities or liquid investments rather than something that's more fixed in nature, such as a real estate property.

I'd say it'll probably be a little bit more challenging to do that. At the individual level, at the trust level, we have to think about alternative minimum tax. So AMT is a nasty tax. What happens is, is effectively there's two types of tax. There's the regular way of calculating tax, and there's the alternative minimum way, a minimum tax way of calculating tax. At the end of the day, you end up paying the higher of the two amounts. The good thing with AMT is you can actually recover the AMT in future years to the extent that you have AMT taxes that would otherwise be owing. But the drawback with the AMT is you only have seven years to recover that tax. If you don't recover it, effectively, it becomes a permanent tax. For corporations, we don't have to worry about ANT. That's good news. At the end of the day, This is where I think from an action perspective, we will likely see more clients looking at triggering gains in their corporations, especially on liquid investments, because effectively, what we're going to see, and I'm going to highlight a little bit later on, is there's actually a permanent tax cost to running capital gains through a corporation under the new tax rate regime.

Effectively, the other thing that I also wanted to highlight is Capital Dividend Account, CDA. It's the Holy Grail of all tax attributes. The reality is, effectively, with the CDA, what happens is, effectively, one half of the capital gains inclusion rate environment, you get 50% being credited to your capital dividend account. Under the new tax rate environment, you'll only get one-third of the gain credited. We'll look at an example of that also later on. But if we look at this, AMT, if we had $500,000 of capital gains income before June 25th, 2024, effectively, we would have $57,000 of regular tax. Under old AMT, we would have had $54,000. Now, under new AMT, we'd actually have $66,993. Because $66,993 is higher than $57,278, you actually have to pay the $66,993, which would result in $9,715 of extra taxes that are owing. If we look at this in a two-thirds inclusion rate environment, effectively, what ends up happening is our regular tax ends up being $71,303, which is greater than the $66,993. So effectively, what ends up happening is under a two-thirds inclusion rate, we're not subject to AMT.

Another way of looking at AMT is actually to look at these percentage points. So effectively, you're in a tax rate environment, so AMT applies if you have more than $173,000 of taxable income. What happens here is if the tax rate on income is, in Ontario, for example, it's going to be 27.4% as their AMT rate. If our tax rate on income is higher than 27.4%, you really don't have to worry about AMT. But if you're below that threshold, you do have to worry about it. Similarly, that number is 27.41% in BC. So similarly, it becomes a consideration over there as well. As I mentioned earlier, CRA has commented crystallization. What does crystallization mean? Crystallization means you trigger your capital gain and you realize your capital gain prior to the June 25th, 2024 deadline. Effectively, CRA has commented they said they wouldn't apply the general anti-avoidance rule, so that's good news. The delay in implementation of the inclusion rate increase, it was actually a deliberate policy choice so that they could actually realize more cash taxes, go figure. Anyways, that's good news from a taxpayer perspective.

What are our options? If you reached out and you said, "What can we do in terms of actually planning?" The first thing is for individuals, you can actually sell the asset for cash. That's the simplest thing to do. Another option is looking at variations on crystallization transactions. Now the question is, what can you do? Some of the things that you could look at doing is transferring the asset to a corporation without an election. What that means is you're going to trigger a gain in your hands personally. This works really well for marketable securities. It's a little bit more challenging with real estate because real estate has land transfer tax. Similarly, transferring the asset to a partnership without an election, you actually have to legally form the partnership. Another option is exchanging shares for a different class of shares in a corporation and electing a gain under Section 85 of the Income Tax Act. Another option could be actually transferring assets to a spouse and electing out of the 73 rollover. This basically, from a tax perspective, means any time you give the asset to your spouse, it's a tax-deferred rollover to that spouse. However, you can elect out of that rollover and you'd like to have that transfer happen at fair market value. If that occurs, you can trigger a gain. The issue with this approach is effectively, you have to consider the attribution rules at the end of the day.

In terms of the other piece of the puzzle here is you can also look at gifting the asset to adult children. Again, this is going to trigger taxes in your hands. You may not have the cash to fund that tax. This can be good if you have cash to fund the taxes, but if you don't, then this may not be a favorable option. In terms of corporations, one of the things is we can do similar actions. So effectively transfer the asset to another corporation without an election, transfer to a partnership without an election, or doing a share reorganization with the Section 85. Again, all of these things can be done to trigger gains. Another option could be looking at transferring an asset out of the corporation to a shareholder and doing it as a dividend in kind. So effectively, these are some of the ways that are commonly used to trigger the gains. What happens is when we trigger gains in a corporation, we have to look at a bunch of different attributes. With the attributes, there's one referred to as a capital dividend account. This is the Holy Grail of all tax attributes because what happens with CDA is it's not located anywhere on the financial statements.

It's not really located on the tax return. Effectively, it's a notional tax account, and it is used to track favorable tax attributes. In particular, things that get credited to our CDA include the non-taxable portion of capital gains. We also get life insurance proceeds, less the adjusted cost basis of the life insurance contract. At the end of the day, the whole point of this is to the extent that we have balances, positive balances in our capital dividend account, amounts can be cycled out of the corporation tax-free in favor of the shareholder. Instead of triggering dividend tax. If we look at this, let's just say, for example, we had a Holdco, and they bought Manulife Corporation shares at $1,000, and now they're going to be sold for $4,000. Before June 25th, 2024, effectively, we'd have a 50% inclusion rate, which means that we would have $1,500 of CDA. Meanwhile, June 25th onwards, effectively, our CDA credit is going to basically be one-third, which represents a two-thirds inclusion rate minus one, which is one-third. So effectively, we end up with $1,000 of CDA. So we actually end up with $1,500 less, which is going to result in a higher integrated tax cost to running that capital gain through the corporation.

Let's actually see how this plays out. From a macro lens, what happens here is if we had... There's a lot of numbers on this slide here, but if we look at the far right column first, I'm sorry, the left column first, so the green ones, if prior to June 25th, individuals will be subject to tax 26.77%, assuming that they're at the top marginal tax rate. Meanwhile, if we're at the top marginal tax rate under a two-thirds inclusion rate, we're looking at 35.69%. Meanwhile, if we compare that to running it through a corporation, prior to June 25th, we're looking at 28.97%, and now we're looking at 38.62% after the fact.

Effectively, what's happening here is this is actually increasing the gap between corporations and individuals. Effectively, what we're looking at is from an integrated perspective, it's actually much better to run capital gains through the personal side of the house as opposed to on the corporate side of the house. Switching gears here, this is a topic that gets very complicated in a real hurry. I'm going to touch on the high points just to give you a takeaway, and we could flush out more details as part of the question and answer period.

But effectively, the whole point of post-mortem planning is when you pass away owning private corporation shares, effectively, you end up with potentially three layers of tax. There's personal tax that's owing on the terminal tax return, but you actually haven't got any cash out of the corporation. To sell investments in the corporation, there's a layer of corporate tax, and then there's dividend tax to cycle the money out. So effectively, you end up with three layers of tax that could significantly erode the value of the estate. The good news is in the estate planning world, there's various techniques that are available. One includes the redemption loss carryback, which eliminates the capital gain at death, but you're stuck with the corporate tax and the dividend tax. Then the other option is the pipeline strategy, which is often combined with the bump, which eliminates the corporate tax and the dividend tax, but you're stuck with the capital gains tax. Then there's hybrid planning, which is a combination of both. When we layer on life insurance to these strategies, ultimately, it actually can optimize the results, improve liquidity, and at the end of the day, reduce the effective tax rate to the deceased.

In terms of the option here, we've got A, owning a million dollars of frozen shares, and there's no insurance, and then there's $1 million of insurance with $1 million of CDA. If we look at these numbers, what happens here is under a one-half inclusion rate environment, the insurance results actually enhanced the results. No planning, double tax is the worst case scenario, 74.5%. With insurance, we end up with a better solution than without under both the redemption loss care back in the pipeline scenario. Under a two-thirds rate environment, what we've noticed is rates are increasing all across the board. But what happens is when the insurance is integrated into this plan and CDA creation, we end up improving the results. At the end of the day, the whole point of this exercise is one where postmortem planning still works and it will be enhanced if we have some CDA creation in the corporation, which is largely often attributable to life insurance, but doesn't necessarily always have to be. I know we covered off a lot, and I know we went relatively quickly through the content. The reality is we're at a critical junction where effectively we've got two weeks to figure out if it's worth triggering gains or not.

Going through this thought process for individuals and trust we're in a situation where we have to think about AMT along the way. For corporations, AMT is not a consideration. On an integrated basis, you may be better off having that capital gain triggered sooner rather than later. The only thing is from a corporate perspective, just got to make sure that it makes business sense if you were going to actually sell the asset to begin with. So anyways, with that, let's maybe open it up to questions. So let's do that.

Leslie Brophy
AVP, Head of Investments and Sales, Manulife Private Wealth

Okay, thanks, Hemal. Just as a reminder for our audience today, you can submit any questions through the question and answer button at the bottom of your screen. And if you wish to remain anonymous, you can choose to do so before submitting. And I do see that we have a couple of questions, Hemal. So I'll start with the first one. I'll get you warmed up.

Kevin asks, does the changes in capital gains inclusion rate apply to my primary residence?

Hemal Balsara CPA, CA, CFP, TEP, FEA
Head of Tax, Retirement, and Estate Planning, Manulife

Yeah. And the short answer is, to the extent that we have a property that qualifies for the principal residence exemption, this won't impact you. Effectively, you're going to be in a situation where there's not going to be an impact and you're not going to have to pay additional cash taxes because the principal residence exemption ensures that you effectively don't pay capital gains taxes on that growth and value. The one thing that I would qualify that statement with is if you have multiple properties. Let's just say, for example, you have a city home and a country home, and you're looking at splitting the principal residence exemption between the two homes. Now, all of a sudden, to the extent that you don't have values sheltered by the principal residence exemption, what's going to end up happening is those additional values will be exposed to the higher inclusion rate. But if you only have one property, the short answer is there shouldn't be any impact.

Leslie Brophy
AVP, Head of Investments and Sales, Manulife Private Wealth

Thanks, Hemal. Next question is from an anonymous attendee. Husband and wife want to sell their small business, which is incorporated, to their kids with an estimated value currently around 1.2 million. Will this affect them or not?

Hemal Balsara CPA, CA, CFP, TEP, FEA
Head of Tax, Retirement, and Estate Planning, Manulife

Yeah. So I mean, that question is full of lots of interesting nuances because the first question whenever I deal with a corporation like this one is to figure out whether this is actually what we call a qualified small business corporation or qualified farm and fishing property, because if you are, that is good news. In order to qualify as a qualified small business corporation, you have to meet certain tests. So 24 months prior to any sale of the business, we have to have at least 50% or more of the fair market value of the assets being used in the active business of Canada. At the time of the sale, that's 90% of the fair market value of the assets being in the Act of Business Canada. Assuming that we qualify, remember at the beginning, we saw one of the special concessions. One of that special concessions that they made was effectively increasing the lifetime capital gains exemption to $1.25 million. If this business qualifies, all of a sudden, your client can actually walk away with paying nominal income tax, there will be likely some alternative minimum tax available or owing as a result of that.

But at the end of the day, that can actually become a very, very favorable result for the husband and wife in this situation. But in order to actually meet the criteria, you actually have to meet those criteria for the assets being used in the active business in Canada. Then the second thing is that both the husband and wife have to have their lifetime capital gains exemptions available. If they don't, let's just say they used it during their lifetime, then they might not be able to shelter all of the gain. But at the end of the day, my answer is, it is going to affect them, but one of the outs could be the lifetime capital gains exemption, which could help them shelter some of the gains.

Leslie Brophy
AVP, Head of Investments and Sales, Manulife Private Wealth

Perfect. Our next question is about rental property. And the question reads: if rental property is owned 50% by each spouse, is the capital gains split 50%?

Hemal Balsara CPA, CA, CFP, TEP, FEA
Head of Tax, Retirement, and Estate Planning, Manulife

Yeah, the short answer is, I'm assuming that the 50% income allocation was because each of them were equal owners in the property. So similarly, when they do exit the property, there's going to have to be a 50% split on the disposition of that property.

Leslie Brophy
AVP, Head of Investments and Sales, Manulife Private Wealth

Okay. And the next question comes from Reck: do you recommend corporations taking capital gains on the 50% rate so they can do one last transfer through the CDA? Talking about a securities account.

Hemal Balsara CPA, CA, CFP, TEP, FEA
Head of Tax, Retirement, and Estate Planning, Manulife

I would say definitely. Especially if, and again, there's the tax decision and there's also the financial decision to any of this. The financial decision, it has to make sense from a financial perspective to exit the security. But assuming that you have something that makes sense, it definitely can make a lot of sense because on an integrated basis, there's actually going to be a tax cost to running capital gains through the corporation. So benefiting from the 50% inclusion rate can make a lot of sense. Also getting that 50% CDA credit associated with 50% of the gain just ends up creating a very favorable result. My short answer is, especially for corporations where we don't have to consider alternative minimum tax, it's effectively, assuming that we've got a liquid investment and we're not in a forced liquidation scenario, I'd say it's definitely worth considering strongly to trigger the gain and strip up the values from the Corporation by the CDA.

Leslie Brophy
AVP, Head of Investments and Sales, Manulife Private Wealth

Okay, I think we're done with questions. There are some here that are asking about the slide deck and recording, and we'll address that separately. So on that, Hemal, thank you very much for sharing your insight on this very hot topic currently. As a reminder for our listeners today, there will be a recording of this event posted at ManulifePrivateWealth.ca, as well as LinkedIn, Manulife Private Wealth. It's curious with our clients and advisors, oftentimes there's a lot of discussion about the complexity of financial matters as wealth increases. As a reminder, Manulife private wealth professionals can provide guidance and investment expertise to support your needs.

I hope today's session was insightful. Should you wish to learn more about the strategies presented in this webinar or the private wealth platform at Manulife, please reach out to your investment counselor or a member of the Manulife private wealth team. Thank you for joining, and we look forward to hosting you at our next webinar. Thank you very much, and have a good afternoon.

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