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The Clear-Cut: Tax

Capital Gains Strip

The federal election is over and we now have a minority federal government. Given the various federal party's tax positions, there is a lot of speculation when it comes to tax rates. One of the most discussed potential tax changes is an increase in the capital gains inclusion rate to 75%. This change is anticipated to be included in Budget 2020 (due between February and April 2020).

The proposal to increase in the inclusion rate is because the highest marginal tax rate for dividends is 44.64% (BC rate) as compared to capital gains rates which are only 24.90%. If the inclusion rate were increased to 75%, then this would increase the capital gains rate to closer to 37.4%.

There are a couple of ways to plan for a potential change in the tax rates for capital gains:

Disposing of Capital Property in the Near Future

You could consider triggering a disposition earlier to ensure that the disposition is subject to the 50% inclusion rate versus a 75% rate.

For example, you own a warehouse that it listed for sale and the estimated gain is $1,000,000. You could undertake a transaction to trigger the gain early through the transfer of the beneficial ownership to another party. If the gain is triggered at the 50% inclusion rate, the estimated taxes would be approximately $249,000. If the gain is triggered after the change of the inclusion rate to 75%, the estimated taxes would be approximately $374,000 (approximately $125,000 higher).

In addition, if the capital gains inclusion rate is increased to 75%, then the inclusion to the capital dividend account would be decreased to 25% for any new capital gains.

Capital Gains Strip

A "capital gains strip" is where you specifically undertake a transaction to get the benefit of capital gains rates versus dividend tax rates. There are a couple of different transactions to achieve a capital gains strip. One such route is where you exchange a portion of your shares for new shares, but structure the transaction to specifically fall outside the provisions of Section 86. Assuming that it is not a Section 51 or 85 exchange, there would be a capital gain on those shares and taxed accordingly (note: capital gains exemption is not claimed). The promissory note created on the transaction is used to effectively "strip" the funds from the company.

Further, if the company is a Qualified Small Business Corporation (QSBC), this type of planning may be used to avoid the TOSI (Tax on Split Income) rules. Capital gains from QSBCs are not subject to the TOSI rules. Therefore, you may be able to covert a dividend that was subject to TOSI to a capital gain.

Note: These types of transactions are extremely complex and the risks should be thoroughly discussed with clients prior to implementation. Further, the changes to the inclusion rate for capital gains are rumored or speculated changes - the government could decide not to change the rates.

Disclaimer: Information is current to November 26, 2019. Tax legislation, interpretations, and administrative positions change constantly, therefore there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future.

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