Note • Budget 2024

Increasing the Capital Gains Inclusion Rate

Legislative Costing Note

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Budget 2024 introduced an increase in the capital gains inclusion rate from one half to two thirds for corporations and trusts, and from one half to two third on the portion of capital gains realized in the year that exceed $250,000 for individuals.[1] This policy is in effect for capital gains realized on or after June 25th, 2024.

The Parliamentary Budget Officer (PBO) estimates an increase of $17.4 billion in income tax revenues from 2024-25 to 2028-29.

5-Year Cost

$ millions

Fiscal year	2024-25	2025-26	2026-27	2027-28	2028-29	Total
Personal Income Tax	-2,020	-265	-838	-1,287	-1,355	-5,765
Corporate Income Tax	-2,982	-1,042	-1,993	-2,752	-2,913	-11,681
Total costs	**-5,001**	**-1,307**	**-2,830**	**-4,039**	**-4,268**	**-17,445**

Notes

· Estimates are presented on an accrual basis as would appear in the budget and public accounts.

· A positive number implies a deterioration in the budgetary balance (lower revenues or higher spending). A negative number implies an improvement in the budgetary balance (higher revenues or lower spending).

· Totals may not add due to rounding.

Estimation and Projection Method

Using tax returns data from the Canada Revenue Agency, the historical ratio of capital gains on the total tax base was calculated for each of the following taxpayer groups: Canadian-controlled private corporation (CCPCs), non-CCPCs,[2] individuals and trusts.[3] These ratios were combined with PBO's internal fiscal projections from the March 2024 Economic and Fiscal Outlook (EFO) to project forward capital gains realizations over the costing horizon.

PBO's analysis accounted for a behavioural response due to the introduction of the increased inclusion rate. A change in the timing of realizations was made to account for the 10-week window taxpayers had to realize capital gains that would still be subject to the 50% inclusion rate. Considering the limited timeframe for tax planning strategies and the illiquidity of several types of asset holdings, the PBO estimated in 2024 a 15% increase in capital gains realizations for corporations and a 10% increase in capital gains realizations for individuals and trusts. Most of the increased realizations in 2024 were assumed to come from assets that would otherwise have been disposed of in the following year and a smaller portion coming from later years.[4] The realizations in those following years were adjusted downward accordingly. It was assumed that corporations would see a more significant increase in realized capital gains before June 25, because all their capital gains will be subject to the higher inclusion rate after that date. In contrast, individuals have more options to mitigate the impact of the higher inclusion rate over the long term, as only the portion of capital gains exceeding $250,000 in a year is subject to that higher rate.[5]

In addition to the increase in realizations from taxpayers selling assets they had not originally planned to dispose of before June 25, it was also assumed that a portion of gains that would otherwise have been realized in the latter half of 2024 would now be realized within the 10-week period.

The PBO assumed a net-of-tax elasticity parameter of 0.85 for corporations and 1.48 for individuals and trusts beginning in 2025.[6] These elasticities further reduce capital gains resulting from changes in asset allocation, the volume of realizations, the holding period of capital gains (lock-in effect) and taxpayers relocating to other jurisdictions (or foreign investors divesting from Canada).

Lastly, non-CCPCs facing a higher tax burden because of the increased inclusion rate will have lower after-tax income available for distribution through dividends.[7] This will slightly reduce Part XIII tax revenue resulting from the distribution of dividends to non-residents[8] and personal income tax revenue from dividends distributed to taxable Canadian individuals that do not hold their shares through a tax-preferred account such as an RRSP or a TFSA. This offset in tax revenue was factored into our estimation.

Sources of Uncertainty

Capital gains are more volatile than other types of income, which makes them difficult to predict, as they are influenced by numerous factors such as market conditions, economic cycles, and changes in tax policy. The partial inclusion of capital gains results in a lower tax rate than other sources of income and taxpayers have often tried to recharacterize income as capital gains.[9]

Furthermore, several factors can limit the validity of the elasticity parameters determined in the academic literature. Differences in how capital gains are treated across countries, the specific context of the period during which the elasticity was estimated, and the timeframe of the estimation are key elements that restrict the ability to transpose the results from one period or country to another. There is also a possible asymmetry in the behavioural response to changes in the tax rates, i.e., the response to a tax increase may be different than to a tax decrease. Therefore, the magnitude of taxpayers' behavioural responses is highly uncertain. As a result, we have included a sensitivity table below to demonstrate how different elasticities assumptions affect the cost.

PBO’s cost estimate for personal income tax revenue includes the additional tax paid on capital gains realized by individuals above the $250,000 threshold as well as the additional tax paid on the increased amount of taxable dividends received from CCPCs. CCPCs can distribute the excluded portion of their capital gains (one half before the change and one third after) tax-free to their shareholders. Assuming no change in the dividend payout ratio, an increase in the inclusion rate leads to a higher amount of taxable dividends distributed by CCPCs.

CCPCs generally also face a tax rate of 30.67% on the taxable portion of the capital gain, which is refundable. This refundable tax is paid back to the corporation through a dividend refund when the corporation distributes ordinary taxable dividends to its shareholders. This refundable tax is part of the integration between corporate and personal income taxes with the aim of having individuals be indifferent between holding an investment directly or through a corporation. A change in the share of capital gains distributed by CCPCs has a negligible impact on the total cost of the measure for the federal government but will significantly affect the breakdown of additional revenue between personal and corporate income taxes. No behavioural change was assumed in the share of capital gains distributed by CCPCs as a result of the increased inclusion rate.

Budget 2024 was tabled on April 16, 2024, which provided taxpayers with approximately 10 weeks to tax plan before the change in the inclusion rate would apply on June 25, 2024. Certain assets are not easily liquidated such as real estate, unvested stock options or shares in private corporations. We assumed an increased realization of 15% for corporations and 10% for individuals given an analysis of the breakdown of types of assets held by taxpayers. However, these assumptions involve significant uncertainty due to the absence of draft legislation (which was only introduced on June 10, 2024), the limited time available for taxpayers to plan and the context of a minority government which introduces a level of uncertainty regarding the adoption of these legislative changes.

Lastly, the PBO's cost estimate is presented on an accrual basis. In other words, the increase in tax revenue is recognized in the same year as the capital gains are realized, regardless of when the actual tax payment occurs. Therefore, we do not take into consideration changes in tax installments which may impact the yearly profile.[10]

Sensitivity Table

Total Cost ($ millions)	Corporations – Elasticity of 0.85	Corporations – Elasticity of 1.07
Individuals – Elasticity of 1.48	-17,445	-16,109
Individuals – Elasticity of 1.6	-16,992	-15,656

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Data Sources

Elasticities

Wolswijk (2009) "The short- and long-run tax revenue response to changes in tax bases" (European Central Bank)

Bernier & Perrault (2024) "Responsiveness of taxable income to changes in the corporate income tax rate of small businesses" (PBO)

Coles, Patel, Smith & Seegert (2020) "How Do Firms Respond to Corporate Taxes?"

Auten, Splinter & al. (2016), "Reactions of High-Income Taxpayers to Major Tax Legislation"

Agersnap & Zidar (2021) "The Tax Elasticity of Capital Gains and Revenue-Maximizing Rates"

Lesica (2022) "Tax elasticity of capital gains realization: Empirical evidence for Canada" (Working paper)

Corporate Income Tax Base
T2 administrative data obtained through Statistics Canada, PBO's March 2024 EFO

Personal Income Tax Base
IR0787 to the Canada Revenue Agency, PBO's March 2024 EFO

Trusts Income Tax Base
T3 Trust Statistics from the Canada Revenue Agency

Foreign Ownership of Canadian Corporations
Statistics Canada Table: 33-10-0570-01

Effective Federal Tax Rate
SPSD/M, T2 administrative data

T-LEG-4.0.0e
LEG-2425-010-S

[1] The capital gains deduction (for the disposition of qualified small business corporation shares and qualified farm or fishing property), along with the net capital losses from previous years, are subtracted from the total capital gains before determining the amount that exceeds the $250,000 threshold. Additionally, stock options are included in calculating the amount in excess of the threshold.

[2] Non-CCPCs refer to other private corporations, public corporations, corporations controlled by a public corporation and all other corporations.

[3] A 10-year average for corporations and 5-year average for individuals was used. The calculations account for usage of net capital losses from previous years for both individuals and corporations. Additionally, for individuals, the capital gains deduction and the stock option deduction are also considered.

[4] There is an opportunity cost associated with realizing the gain earlier, as the taxpayer will need to pay tax on the taxable portion of the capital gain in that year. This money, if not used to pay taxes, could have been invested elsewhere, potentially generating returns that might exceed the additional tax burden from the higher inclusion rate when the asset is eventually disposed of.

[5] For example, they could smooth their capital gains realizations over multiple years to stay beneath the threshold.

[6] The academic literature on elasticities of taxable income generally uses the net-of-tax rate (that is 1 minus the tax rate) in the estimations. A net-of-tax elasticity of 1.48 implies that if the net-of-tax rate decreases by 10%, realizations will decrease by 14.8%. This elasticity can be converted back to a tax elasticity using the following formula: $\varepsilon_\tau = -\tau/(1-\tau)*\varepsilon_{(1-\tau)}$ where τ is the tax rate, ε_τ is the tax elasticity and $\varepsilon_{(1-\tau)}$ is the net-of-tax elasticity.

[7] Because of the integration between corporate income tax and personal income tax, this is less of an issue for CCPCs as they are mostly owned by taxable Canadian residents.

[8] Taxable dividends distributed to non-resident are subject to part XIII withholding tax at a rate of 25%. This rate is usually reduced to 15% for non-residents in countries with which Canada has signed a tax treaty and to 5% for residents in those same countries that have an important participation in the Canadian corporation (generally more than 10% of the shares of that corporation).

[9] The courts often had to rule on the nature of income in disputes between taxpayers and tax authorities in cases where taxpayers had declared income as a capital gain. Surplus stripping is another scheme through which revenue generated in a corporation is realized as a capital gain in the hands of the shareholder rather than as a taxable dividend.

[10] Corporations as well as some individuals need to pay monthly or quarterly tax installments which are usually determined by their previous year’s tax liability. When filing their tax return after their year-end, they will get a refund if the sum of tax installments paid over the tax year is greater than their actual tax liability for that same year.