UNDERSTANDING THE IMPACT OF 2024 FEDERAL BUDGET'S CAPITAL GAINS TAX CHANGES

April 2024

On April 16, 2024, the Canadian government announced a significant update to taxation policies within the latest budget, reflecting a strategic shift in the taxation of capital gains. This change, set to take effect on June 25, 2024, is aimed at corporations, trusts, and high-earning individuals, modifying how capital gains are taxed in a bid to balance fairness in the tax system and encourage prudent investment strategies. As investors and corporate executives assess the implications, it's crucial to understand the detailed mechanics of these changes and their potential impacts on personal and corporate financial planning.

Overall Summary

In a nutshell, capital gains will be taxed more due to an increase in inclusion rates, as outlined in the key changes below:

- **Increase in Inclusion Rate**: Capital gains inclusion rate raised from 50% to 66.7% for:
  - Individuals: Applies only to capital gains exceeding $250,000 annually
  - Corporations and Trusts: Applies universally
- **Implementation Date**: Changes effective for gains realized on or after June 25, 2024 (no proration for 2024)
- **Stock Option Deduction**: Adjustment of the employee stock option deduction to align with the new inclusion rates for combined gains over $250,000
- **Exemptions Unchanged**: Lifetime Capital Gains Exemption (LCGE) remains unaffected
- **Loss Deductions**: Net capital losses remain deductible, adjusted to match new inclusion rates

Learn more about the capital gain tax changes

I) Impact on Long-term Incentives

As the federal government introduces adjustments to the capital gains taxation in Budget 2024, HR committees, HR leaders, and executives need to be acutely aware of the ramifications these changes bring to compensation strategies.

Most long-term incentives (e.g**., performance share units, restricted share units and deferred share units**) are largely unaffected as they are typically settled in cash and are not considered a capital gain.

In some cases, executives may hold shares post-settlement and the gain from the sale of shares would be considered a capital gain and subject to the new rates. Holding equity beyond vesting is generally considered an individual investment decision and can be managed by the participant independent of the long-term incentive design.

The new tax regulations impact the tax efficiency of **stock options**. With the inclusion rate increasing from 50% to 66.7% for taxable benefits exceeding $250,000, the attractiveness of stock options as a form of executive compensation may decrease. The adjustment to the stock option deduction mirrors the changes to capital gains and applies only to qualified stock options (which took effect in July 2021).

These stock options changes are in addition to the previous changes separating qualified and non-qualified options. The previous changes limit the number of qualified options at the time of grant while these new changes are applied based on the gain realized at the time of exercise. For non-qualified stock options (i.e. most impacted participants being high earners), the gain will retain their current treatment (fully taxable) and may not have much of an impact on stock options attractiveness for those participants.

It is unclear whether these changes will apply to stock option grants made after June 25, 2024, or retroactive to all outstanding stock options. If retroactive, then it may encourage executives to exercise their options and sell shares prior to this date, which may raise some questions with respect to executive share ownership.

For more details about stock option taxation considerations – refer to our previous article: *https://www.southlea.com/canadian-stock-option-tax-changes-are-here-what-you-need-to-know/*

Recommended Action: Generally, no changes are necessary. Compensation practices are not typically influenced by tax policies, particularly when the impact is dependent on participant behaviours and investment decisions (e.g., timing of capital gains).

Having said that, these changes reduce the tax advantage associated with stock options and may support other creative forms of long-term incentives, e.g., market share units which are longer-vesting shares based on absolute total shareholder returns (TSR).

ABOUT SOUTHLEA

Southlea Group is a national independent compensation advisory firm that provides global perspectives as a GECN Group company. We are headquartered in Toronto with an office in Montreal serving clients across Canada, representing all industries and organization structures. Our team of advisors is multi-disciplined with diverse backgrounds and experiences. We are proud to be a certified Women's Business Enterprise by WBE Canada and to be Rainbow Registered as an LGBT+ friendly organization.

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