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A Kafkaesque Tax Quagmire: Why We Need to Defer or Abandon the Failed Capital Gains Changes

by John Tobin and Carl Irvine

- The federal government's proposed increase to the capital gains inclusion rate has created a nightmarish scenario for taxpayers.
- The Canada Revenue Agency has been administering the changes since June 25, 2024, as though the proposal is law, even though the government failed to enact the proposal into legislation before Parliament was prorogued.
- With the likelihood of a spring election, taxpayers face a choice: pay at the higher rate now and struggle to recoup overpayments if the measure dies, or follow existing law and risk interest and penalties should it eventually pass.
- The proposed rules affect not only individuals with large gains but also trusts, corporations, and non-residents, creating complex reporting requirements under an uncertain legal framework. Software updates, tax slips, and filing instructions are already being tailored to legislation that does not yet exist. This administrative limbo erodes public confidence in the tax system, as taxpayers and tax preparers struggle with a rule that might never be legally enacted.
- The government should abandon the proposed increase. If it will not, it should delay the effective date to at least January 1, 2025, to spare taxpayers the gamble of filing 2024 returns under a measure that may never pass.
- This deferral would reduce needless compliance costs. If the government insists on retroactive application, the CRA should provide relief by waiving interest and penalties for taxpayers who file under current rules. Canadians deserve a predictable tax system, not one that forces them to hedge bets on unpassed legislation.

In the April 2024 federal budget, the government announced a proposed increase in the portion of realized capital gains that would be included in income for tax purposes (the "capital gains inclusion rate" or CGIR). Specifically, the proposals would increase the CGIR from 50 percent to 66 2/3 percent for capital gains realized on or after June 25, 2024.[1] An unprecedented feature of the

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1 This effective date differed from the approach taken in the late 1980s, the last time the CGIR was increased, when the increased CGIR applied only as of January 1 of the next following year.

proposal was to apply the higher CGIR to individuals only to the extent their gains realized in a particular year exceed $250,000. In contrast, for all other taxpayers, namely corporations and trusts, the higher CGIR applies to all realized gains.[2]

The detailed legislation for the proposed increase in the CGIR was not included with the budget materials (suggesting this controversial measure was inserted late in the budget preparation process), nor was this proposed change included in the first budget implementation bill, which received Royal Assent in June 2024. While detailed draft legislation was later released (and that draft legislation includes over 40 pages of complex consequential changes), and a Notice of Ways and Means Motion (NWMM) was adopted in the House of Commons in September 2024 approving the measure, no bill has ever been tabled in (much less, approved by) Parliament to give effect to the CGIR increase.

With the recent proroguing of Parliament until March 24, 2025, it is clear the proposals will not be enacted into law before many taxpayers must calculate and pay their income tax liabilities for periods affected by the proposed CGIR increase. Furthermore, tax reporting slips will have to be issued and tax preparers will be in the advanced stages of preparing trust, personal and corporate tax returns before Parliament resumes. Meanwhile, the Canada Revenue Agency (CRA) has said it will administer the *Income Tax Act* (ITA) as though the proposals were in effect. This has left Canadian taxpayers in a bizarre and menacingly complex situation – having to decide how to file their taxes in the face of a political proposal that may never become law.

The best solution to this problem would be for the government to drop the proposals altogether. If it cannot or will not drop them, it should delay their effective date until January 1, 2025, at the earliest. Although Parliament is prorogued, the government is still active and it has the ability to announce that the measure will not proceed.

Complex Tax Conundrum, Compliance Nightmare

We are sympathetic to the staff of the CRA and the Ministry of Finance staff who are caught in politics. The Minister of Revenue's decision to enforce the proposals, communicated by the CRA on January 8, 2025, is consistent with a long-standing practice for dealing with proposed legislation with retroactive effect.[3] As noted above, a NWMM was approved in September 2024, but no bill has been presented to Parliament. In more normal times, taxpayers could have high confidence that unenacted retroactive legislation will eventually be enacted and they would voluntarily comply. In light of the overall context, these are not normal times. Prorogation means that any bill to implement the CGIR increase will have to be introduced in the next session of Parliament. It is evident that there is a high likelihood of a spring election and a change of government before enactment of any such bill, and hence a significant likelihood that the capital gains tax changes will never occur.

In this environment, do taxpayers voluntarily report gains at the higher rate now and risk overpaying their taxes if the changes never occur, or do they report under current law and then risk being reassessed and subject to punitive interest on unpaid taxes if the changes are subsequently legislated?

One complicating aspect of this is "legislative authority." The capital gains proposals are not currently law. The law as it exists today is clear. One-half of realized capital gains are included in income for tax purposes, not

2 The proposed measure therefore strangely introduces a new disconnect between the taxation of investment income earned personally rather than through a holding company.

3 https://www.canada.ca/en/revenue-agency/news/newsroom/tax-tips/tax-tips-2025/top-changes-affecting-business-taxes-2025.html.

66 2/3 percent. The increased CGIR will become law only when the relevant legislation passes Parliament and receives Royal Assent. Indeed, it cannot be otherwise. The bedrock principle that taxation may be imposed only by Parliament and not by executive fiat is a fundamental principal of Anglo-Canadian constitutional law dating back to the Magna Carta. But, if they are passed in their current form, they will have retroactive application. So, at least for the moment, compliance with the proposed rules is "voluntary." Such retroactive application would make the tax applicable to 2024 gains and would make the tax payable retroactively.

Another complicating aspect is that there are other rules that are currently law. Trusts (including mutual funds, segregated funds and ETFs) are required to make a return in "prescribed form" and recently announced T3 filing requirements for electronic filing, which "prescribe the reporting requirements" for electronic filing, require a trust to report its various types of pre-June 25, 2024, and post-June 24, 2024, capital gains in separate boxes.[4] This seems to indicate for trusts that are required to file electronically, that CRA will require them to provide the relevant information about when gains were realized (regardless of whether the capital gains rules are enacted effective for dispositions in 2024). We expect that financial institutions will provide whatever information is prescribed. Taxpayers may therefore see many different (and new) boxes on their reporting slips.

Tax reporting software approved by the CRA and used by many tax preparers may not have functionality to be overridden in order to avoid voluntarily paying tax based on the proposed changes. Second, as noted, numerous consequential changes to the ITA flow from the proposed CGIR increase.

While the CGIR increase is presented by supporters of the proposals as an issue only for those few taxpayers who realized more than $250,000 in capital gains, this is simply incorrect, and in fact the measure has much broader application (Mintz 2025). The impact is likely to be visited on hundreds of thousands or even millions of Canadians who, as the familiar phrase goes, risk being "caught in the cogs of a remote, irrational, and soulless bureaucracy" when trying to recover overpaid taxes or fighting interest on retroactively imposed taxes. If slips are produced that report higher gains based on the expectation that the CGIR changes will be enacted for 2024 gains and they are not, how will the CRA unscramble that egg?

The proposals have further implications that exacerbate the dilemma caused by the uncertainty of potential passage. The increased CGIR also affects non-residents who sell certain Canadian real estate or resource properties (including shares and other interest that derive their value from such property), and their counterparties. One consequential change increases the withholding rate under section 116 of the ITA for foreign sellers of Canadian real estate or resource properties from 25 percent to 35 percent effective January 1, 2025. But without that higher rate having been enacted in law, on what legal basis could counterparties withhold at that rate?[5] At what rate should tax be withheld and remitted to the CRA during this protracted period of limbo, the rate currently required in law, or the proposed higher rate? A Canadian who purchases real property from a non-resident today, in compliance with existing law, could potentially be liable for failing to withhold at the proposed rate, as well as

4 See https://www.canada.ca/en/revenue-agency/services/e-services/filing-information-returns-electronically-t4-t5-other-types-returns-overview/upcoming-year-t619/t3-2025.html.

5 We note that while subsection 227(1) of the ITA protects taxpayers who withhold in compliance or intended compliance with the ITA, it is unclear how it would apply here where the higher withholding tax is clearly not contemplated by the ITA. It is worth nothing that the effective date for the higher withholding rate is January 1, 2025, not June 25, 2024. This suggests that the Department of Finance was aware of the difficulties of imposing withholding requirements in the absence of legislative authority and expected (hoped?) that the proposals would be enacted before this provision came into effect precisely to avoid these problems.

to interest and penalties. How can we punish people who comply with the law? And would a foreign tax authority deny a foreign tax credit for taxes that are effectively paid on a voluntary basis? What kind of a message does this chaotic situation send to potential foreign (and Canadian) investors in Canadian real estate or resource properties?

Some have called for administrative relief. The Minister of Revenue has authority to alleviate hardship in the form of fairness. In the absence of any announcement by the government authorities that they plan to defer on these proposals, the Minister of Revenue should exercise her administrative authority to ensure the fair and proper administration of the ITA by announcing that interest and penalties will not apply to any taxpayers who file based on the existing legislation until 90 days after Royal Assent, and that taxpayers who withhold under section 116 based on the current law are not prejudiced The CRA has already announced some relief by deferring interest and penalties on tax filings by corporations and trusts until March 3, 2025.

The CRA's general practice of administering the tax system on the basis of a NWMM may be practical and reasonable when a government has solid support in Parliament (i.e., a majority government,[6] or a minority with a supply arrangement ensuring Parliamentary support) or in respect of proposed legislation containing remedial or uncontroversial technical or "housekeeping" fixes which have high likelihood of being enacted by the next government if not the current one. That is plainly not the case with respect to the highly controversial CGIR proposals.[7] Taxpayers face a substantive (and controversial) change to the tax system advanced by an unpopular government that tried – and failed – to get it passed before prorogation. The degree of uncertainty is beyond normal and taxpayers risk facing serious consequences whatever they do. If they voluntarily pay tax based on the proposed changes, they will be faced with onerous compliance costs in refiling and seeking recovery of overpaid taxes if the measure never becomes law. If instead they file based on current law, they face potentially onerous compliance and interest costs if the measure ultimately is adopted as proposed. Either way, a large number of taxpayers will be faced with inappropriate uncertainty and costs.

Learning from History

Generally, in normal circumstances, it is prudent for taxpayers and the CRA to voluntarily act as if unenacted legislative proposals will be enacted. However, as Michael Lukyniuk, a former Principal Clerk of the House of Commons, observed in a 2011 article in the Canadian Parliamentary Review, "[t]his practice is not supported by any statutory authority but is simply a convention known as the 'provisional implementation of taxation'. Fundamentally, the system is voluntary" (Lukyniuk 2011).

This issue is not new, but it is serious when it arises. Indeed, in the mid 1980s the Mulroney Government acknowledged that the practice of administering proposed tax law without any legislative basis was problematic. In a Discussion Paper released in 1985, the Department of Finance observed that:

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6 Note that under accounting rules, during a minority government, proposals are not treated as "substantively enacted" until they have passed third reading. This presumably reflects the uncertainty surrounding tax legislation under a minority government.

7 Some argue that the delays in enacting this legislation lay with the government, which "mismanaged" the proposals by introducing a mid-year implementation date with no "transitional" relief; separating the legislation from "An *Act* to implement certain provisions of the budget tabled in Parliament on April 16, 2024" for what appeared to be political reasons; and allowing the fall session to effectively be shut down by not acceding to a legitimate House procedural request for information on an unrelated matter.

> [T]he absence of statutory authority presents a range of problems – difficulties of enforcement for tax collectors and of compliance for the taxpayer. A number of taxpayers have questioned the propriety and, indeed, the legality of a government seeking compliance with a voluntary system… No taxpayer can be compelled to pay a provisional tax. Taxpayers who provisionally pay taxes do so voluntarily and are under no obligation to comply until the law is passed. It is also inimical to our system of justice and to the Charter of Rights for a taxpayer to be made liable to any offence, criminal or otherwise, for failure to pay a provisional tax. (Canada 1985a.)

Those concerns have not gone away. Indeed, modern tax practitioners will appreciate the timeless lament made in a commentary in respect of the Discussion Paper by leading practitioners of the mid 1980s to the effect that:

> Long delays between a budget and the introduction of implementing legislation, as well as in the enactment of tax changes, have sometimes involved the introduction of new amendments before the previous year's amendments have been disposed of. These delays have led to uncertainty and confusion for taxpayers and for the officials of Revenue Canada who are responsible for administering the tax system. (Arnold et al. 1986.)

To address those concerns, the Discussion Paper proposed legislation which would have provided a foundation for administering proposed tax changes prior to their enactment. The concept of specific legislative support for so-called provisional taxation (i.e., collection of taxes for a period before adoption of definitive legislation) is hardly novel. In the UK, the *Provisional Collection of Taxes Act 1968*[8] specifically authorizes provisional taxation for a limited period of time in certain circumstances. Interestingly, one of the events that may terminate the authority to collect taxes not supported by definitive legislation is the prorogation of Parliament.

In Canada, a statute like the UK one was never enacted. The 1985 draft required that the proposed measure receive first reading in the House of Commons before it could be administered and then imposed a tight timeline for the Minister of Finance to advance the relevant legislation. If it was not enacted within 180 sitting days of introduction, the authority to administer such proposed tax legislation would be *void ab initio*.

This proposal was considered by the House of Commons Standing Committee on Procedure and Organization (the "Standing Committee"), which published a report making a number of recommendations (Canada 1985b). First, it recommended that that taxes should not be collected until implementing legislation had been enacted. Second, it recommended that the authority to administer proposed legislation be limited to those taxation measures which, if not immediately implemented, would result in great loss of revenue for the government. Third, it recommended that the provisional authority to administer proposed legislation be effective for only 120 calendar days from the date on which it received first reading. If the proposed bill was not enacted within that period, the proposed legislation would be considered *void ab initio*. They further recommended that, in that instance, any tax collected by the government based on the proposed legislation that was not enacted in a timely fashion should be returned to taxpayers.

These ideas, however, bore no fruit. So we are left in a situation where the CRA will be administering a tax proposal that has no legal effect and which the CRA has no current authority to enforce while telling Canadians to voluntarily overpay their taxes.

It is interesting to compare the current circumstances to those set forth in the recommendations of the Standing Committee (albeit that were never enacted). The CGIR proposals are not intended to prevent a great loss

8 See https://www.legislation.gov.uk/ukpga/1968/2/contents

of revenue for the government or otherwise protect the integrity of the tax system; in contrast, they give rise to a tax increase. They were not enacted within 120 days of receiving first reading (indeed, they have not even received first reading – no bill was ever introduced to give effect to the proposals). Finally, there is real concern about the ability of the CRA to efficiently refund any excess tax paid by Canadians who chose to file voluntarily on the basis of the proposals if the required legislation never passes. How will the CRA identify those taxpayers in order to reassess them to ensure they only pay the taxes they actually owe? Are they going to reassess everyone who reported capital gains? Will Canadians be forced to seek out their own refunds? Will taxpayers need to protectively file notices of objection to their initial tax assessments, potentially flooding the CRA with a mountain of objections? If investment funds issue slips based on the higher inclusion rate, how will the CRA address the mismatch in reported gains?

Conclusion: Abandon the Proposals – or at Least Defer Them

The uncertainty about the CGIR proposals forces stakeholders to bet on potential outcomes. Having to make such a bet undermines the government's credibility and public confidence in the tax system. As noted above, in normal times, the likelihood of passage of introduced tax legislative changes is close to 100 percent, so it is prudent for taxpayers to fully comply with proposals and for CRA to "provisionally" administer on that basis. As that likelihood drops off, taxpayers will need to decide whether they are better off to file based on the law as it exists on the filing deadline. If they bet correctly, they will have nothing further to do. If they bet incorrectly, they will have to refile and either (i) report more income and pay interest or (ii) claim a refund and receive some partial interest, depending on the direction of the political outcome they bet upon.

Frustratingly, while the prorogation and resulting legislative limbo for the capital gains changes were not foreseeable, the likelihood that the proposals would be unworkable was evident right after the 2024 budget (Robson 2024). With time, moreover, it has become clearer that the changes would affect far more taxpayers than the government claimed, raise less tax revenue than anticipated, and will hurt Canadian investment and incomes (Mintz 2025, Laurin and Dahir 2024).

The most prudent step at this point would be for the government to announce that it will abandon the proposals entirely. Interestingly, the hoped-for spike in government revenues for 2024 may turn out to be realized even if the measure is abandoned, as many taxpayers prematurely realized gains (at the 50 percent CGIR) before the June 2024 effective date. If the government will not abandon the proposal, it should announce that the changes will take effect for dispositions on or after January 1, 2025, at the earliest, thereby preventing the chaotic situation now facing taxpayers for 2024 (with further deferrals for section 116 withholding until such proposals are enacted). Postponing the effective date would give everyone a chance to see whether Parliament ultimately enacts the capital gains taxation proposals in their current form during 2025 (and long before 2025 returns are due). Canadians would not have to bet on the outcome of an election and the policies of an unknown future government when they file their 2024 taxes this spring. Postponing would also eliminate the complications investments funds and other taxpayers face in reporting split tax periods before and after an arbitrary date last June.

Taxpayers need certainty and should not have to bet on political outcomes with retroactive effect. The government should drop or delay changes to capital gains changes now.

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John Tobin is a tax partner at Torys LLP and Co-Director of the Osgoode Hall Law School LLM in Tax Program.

Carl Irvine is a Toronto-area tax lawyer and a member of C.D. Howe Institute's Fiscal and Tax Policy Council.

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