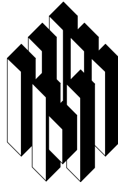

C.D. Howe Institute
Institut C.D. Howe

Communiqué

Embargo: For release *Thursday*, February 17, 2000, at 10:00 a.m.

Cut capital gains taxes to boost investment, entrepreneurship, says C.D. Howe Institute study

Ottawa must cut its capital gains tax. That is the clear message of a *C.D. Howe Institute Commentary* released today. Lower capital gains tax rates, says the study, will boost investment and entrepreneurship, raising Canadian productivity and living standards over the long term.

The study, “Capitalizing on Cuts to Capital Gains Taxes,” was written by Jack M. Mintz, President and CEO of the C.D. Howe Institute and Arthur Andersen Professor of Taxation at the University of Toronto’s Rotman School of Management, and by Thomas A. Wilson, Director of the Policy and Economic Analysis Program at the Institute for Policy Analysis, University of Toronto.

The authors explain that the capital gains tax, like any tax on savings, discourages new investment by individuals and businesses — and investment is key to improving Canada’s lagging productivity performance. Furthermore, say the authors, fixing the tax treatment of stock options must be part of improving the environment for risk taking, innovation, and entrepreneurship. This too will improve productivity, which, in turn, will bring long-run gains in Canadians’ incomes.

Mintz and Wilson note that the United States, Canada’s largest trade and investment partner, recently lowered its capital gains tax rate from 28 percent to 20 percent for assets held for more than 18 months. And that should be important to Canadians, because it affects the country’s competitive position as a home for entrepreneurship, growth, and jobs. As a starting point, say the authors, Canada’s rate should be reduced to 32 percent from its current 37 percent. This should be done by increasing from one-quarter to one-third the portion of capital gains income that is excluded from taxable income. That would also ease the current bias in the tax system that favors dividend payouts over business reinvestment, bringing even more help on the productivity front.

Simple rate cuts, however, will not be enough. The authors point out that, by itself, the rate reduction would still leave the effective capital gains tax rate at too high a level, given its impact on savings, entrepreneurship, and risky investment. They therefore propose further reforms to the tax system that would cut the capital gains tax rate to an effective 21 percent — close to the US tax rate on long-term capital gains.

Mintz and Wilson make several recommendations for long-term improvements to the tax system. A program of comprehensive business and personal tax reform and reduction should begin immediately, so that income from different sources is taxed more fairly and at lower rates. The labor-sponsored venture capital credit program should be ended, to be replaced by registered venture capital funds that operate alongside RRSPs. Employment-related stock option gains should no longer routinely be taxed more heavily than salary payments to employees, but the system should not favor selected industries or employees. The authors' package would lower taxes on all capital income, including capital gains, and is aimed directly at improving Canada's economic growth and Canadians' well-being.

* * * * *

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"Capitalizing on Cuts to Capital Gains Taxes," *C.D. Howe Institute Commentary* 137, by Jack M. Mintz and Thomas A. Wilson (February 2000). 27 pp.; $10.00 (prepaid, plus postage & handling and GST — please contact the Institute for details). ISBN 0-88806-470-5.

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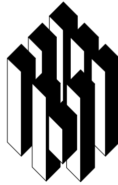

C.D. Howe Institute
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Communiqué

Embargo : à diffuser le *jeudi* 17 février 2000 à 10 h

Selon une étude de l'Institut C.D. Howe, il faut réduire les impôts sur les gains en capital pour stimuler l'investissement et l'entrepreneuriat

Ottawa doit réduire les impôts sur les gains en capital : tel est le message d'un *Commentaire de l'Institut C.D. Howe* publié aujourd'hui. Selon l'étude, une diminution du taux d'imposition sur les gains en capital stimulerait l'investissement et l'entrepreneuriat, améliorant à long terme la productivité et le niveau de vie des Canadiens.

Intitulée « Capitalizing on Cuts to Capital Gains Taxes » (« Comment tirer profit des réductions d'impôt sur les gains en capital »), l'étude est rédigée par M. Jack M. Mintz, président-directeur général de l'Institut C.D. Howe et professeur de fiscalité, titulaire de la chaire Arthur Andersen à l'École de gestion Joseph L. Rotman de l'Université de Toronto, et par M. Thomas A. Wilson, directeur du programme d'analyse politique et économique de l'Institut d'analyse politique de l'Université de Toronto.

Selon les auteurs, l'impôt sur les gains en capital, au même titre que tout autre impôt sur l'épargne, dissuade les particuliers et les entreprises de faire de nouveaux investissements; or, l'investissement est essentiel à l'augmentation de la productivité canadienne. De plus, affirment les auteurs, la rectification du traitement fiscal des options d'achat d'actions doit contribuer à créer un climat propice à la prise de risque, à l'innovation et à l'entrepreneuriat. Une telle mesure stimulerait la productivité, ce qui entraînerait des gains à long terme pour les revenus de la population canadienne.

MM. Mintz et Wilson rapportent que les États-Unis, le plus important partenaire commercial et d'investissement du Canada, a récemment ramené de 28 % à 20 % son taux d'impôt sur l'actif détenu pendant plus de 18 mois. Cette modification devrait être importante pour les Canadiens, car elle influe sur sa position concurrentielle à titre de pays ouvert à l'entrepreneuriat, à la croissance et à la création d'emplois. Comme point de départ, le taux canadien devrait être ramené de 37 % à 32 %. On y parviendrait en augmentant de un quart à un tiers la part du revenu sur les gains en capital qui est exclue du revenu imposable. On atténuerait ainsi la distorsion du régime fiscal qui favorise la distribution de dividendes plutôt que le réinvestissement, stimulant ainsi encore davantage la productivité.

Toutefois, une simple réduction d'impôt ne suffira pas. Les auteurs soulignent que, de manière isolée, elle laisserait encore le taux réel d'impôt sur les gains en capital à un niveau trop élevé, compte tenu de ses répercussions sur l'épargne, l'entrepreneuriat et les investissements à risque. Ils proposent donc d'autres réformes du régime fiscal qui réduiraient le taux d'impôt à un taux réel de 21 %, soit un taux presque égal au taux d'impôt américain sur les gains en capital à long terme.

MM. Mintz et Wilson recommandent plusieurs améliorations à long terme du régime fiscal. Ils proposent notamment un programme immédiat et détaillé de réforme et de réduction de l'impôt sur les particuliers et les entreprises, pour que les revenus provenant de différentes sources soient imposés de manière plus équitable et à un taux moindre. À leur avis, il faudrait mettre fin au programme de crédit d'impôt pour capital de risque de travailleurs et le remplacer par des fonds enregistrés de capital de risque qui fonctionneraient à la manière des REER. Il faudrait aussi cesser d'imposer automatiquement les gains sur les options d'achat d'actions plus lourdement que les salaires versés aux employés, et ne pas accorder de préférence à certains secteurs d'industrie ou à certaines catégories d'employés. L'ensemble des mesures proposées par les auteurs contribuerait à réduire l'impôt sur tout revenu sur le capital, dont les gains en capital, et vise directement une amélioration de l'essor économique du pays et du bien-être de la population canadienne.

* * * * *

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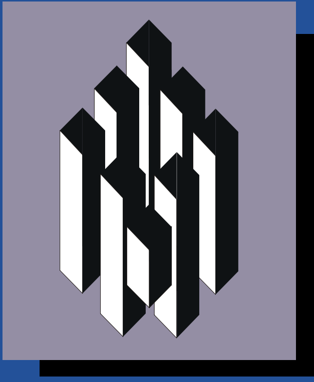

C.D. Howe Institute
Commentary

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Capitalizing on Cuts to Capital Gains Taxes

Jack M. Mintz
Thomas A. Wilson

In this issue...

The case for reducing Canada's capital gains tax, which deters productivity-enhancing investments by individuals and businesses.

The Study in Brief...

Recently, the United States lowered its federal capital gains tax rate from 28 percent to a regime with five different rates, the most general one being 20 percent for assets held by individuals for more than a year and a half. Should Canada reduce its capital gains taxation as well? Its current combined federal-provincial rate is three-quarters of the regular income tax rate. That is, for example, 37.5 percent at a marginal personal income tax rate of 50 percent.

This study presents the case for reducing Canada's capital gains tax. That tax, like other taxes on savings, deters productivity-enhancing investments made by individuals and businesses. Capital gains are now more highly taxed than dividends at the personal level, and the federal and provincial governments should act immediately to remove this disparity. The implication is that the inclusion rate for capital gains should be reduced from three-quarters to two-thirds.

Even this reduction would, however, leave capital gains tax rates at the personal level on the order of 32 percent for the residents of most provinces, a rate that is too high, given the impact of capital gains taxes on savings, entrepreneurship, and risk taking. It would still reflect the fact that Canadian governments impose relatively high corporate and personal tax rates, particularly with respect to investments and savings. The study, therefore, proposes a number of explicit reforms to the tax system that would reduce taxes on capital income. With smart changes to the tax system, Canada could achieve sharply lower capital gains tax rates — close to 20 percent for many investors.

Moving to lower taxes on capital income, including capital gains, would ultimately improve Canada's economic growth.

The Authors of This Issue

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The question is straightforward: should Canada reduce its capital gains tax rate? Recently, the United States lowered its federal capital gains tax rate, which had been 28 percent, and moved to a regime with five different rates, the most general one being 20 percent for assets held by individuals for more than a year and a half. Should Canada follow suit? The current combined federal-provincial rate is three-quarters of the regular income tax rate; that works out to, for example, 37.5 percent for taxpayers whose marginal rate of personal income tax (PIT) is about 50 percent.

We believe the case for reducing Canadian capital gains taxes is strong. Capital gains taxes, like other taxes on savings, deter productivity-enhancing investments made by individuals and businesses. Capital gains are now more highly taxed than dividends at the personal level, and we recommend that the federal and provincial governments act immediately to remove this disparity. The implication is that the inclusion rate for capital gains should be reduced from three-quarters to two-thirds.

At the personal level, however, even this reduction would result in capital gains tax rates in the order of 32 percent for the residents of most provinces, a rate that is still too high, given the impact of capital gains taxes on savings, entrepreneurship, and risk taking. Recall, however, that Canadian governments impose relatively high corporate and personal tax rates in the first place, particularly with respect to investments and savings. Therefore, we propose a number of explicit reforms to the system that would reduce taxes on capital incomes. With smart changes to the tax system, Canada could achieve sharply lower capital gains tax rates — close to 20 percent for many investors. Moving to lower taxes on capital income, including capital gains, would ultimately improve Canada's economic growth.

Our discussion in this *Commentary* proceeds in three parts. The first provides some background about the difficulty of getting the system right for taxing capital gains. The second considers the case for lowering the capital gains tax rate in Canada. The third sets out reform measures — both broadly based and selective — that we believe federal and provincial governments should consider.

The Capital Gains Tax Problem

The taxation of capital gains is one of the most difficult issues in tax policy in terms of getting the system "right." The problems range from whether they should be taxed at all, to what the rate should be, to how this taxation should (and does) interact with other components of the tax system.

We are grateful to the Heward Stikeman Institute and the John Dobson Foundation for supporting this research. We also appreciate many comments received on earlier versions of this paper from Jim Baillie, Jim Davies, John Dobson, Don Huggett, Kari Norman, Steve Richardson, and Munir Sheikh.

Should We Tax Capital Gains?

The normative argument for taxing capital gains is based on the principle that individuals should be taxed according to their ability to pay.[1] The economic well-being of individuals, goes the argument, reflects the amount of resources — or income received from all sources — that each can use for personal consumption or net accretion of wealth. Since capital gains reflect increases in the value of assets that individuals hold and can use to improve their economic position, such gains should be fully taxed.

Logically, this approach means that capital gains should be taxed *as they accrue*. (Accrual taxation implies that capital gains are subject to tax when an asset increases in value even if the owner has not disposed of it.) This timing contrasts with that of most tax systems today, which tax capital gains only when they are realized — that is, when the asset is disposed of.

The normative argument for taxing accrued capital gains has been challenged in two ways.

The taxation of capital income, including capital gains, is unfair to those who accumulate wealth for future consumption.

The Consumption Tax Argument. The first challenge is to reconsider the argument that accrued income is the appropriate base for the taxation of individuals. As pointed out in the literature,[2] the taxation of capital income, including capital gains, is unfair to those who accumulate wealth for future consumption. A person who earns income and consumes it immediately pays tax on that income only once. Another who has the same taxable earnings but postpones consumption pays tax twice: once on the earnings and a second time on the capital income earned on savings. In other words, under an income tax, future consumption is taxed more heavily than current consumption.

This argument suggests that consumption would be a better tax base than income. Under such a regime, consumers and savers would be treated similarly — a person would pay tax on earnings only once, regardless of whether they were consumed today or in the future. The proponents of income taxes argue, however, for the desirability of taxing capital income, including capital gains, on the grounds that wealth itself provides economic power over and above the ability to consume. Whether this rationale implies that the tax rate applied to capital income (including capital gains) should be the same as the rate applied to other income is a debatable point. Thus, even if capital income, including capital gains, is to be taxed as part of income, it is by no means clear that it should be taxed at the same rate as other sources of income.

1 This is referred to as the Haig-Simon approach to income taxation, with *income* defined as consumption plus the change in net worth.

2 See United States (1977); Institute of Fiscal Studies (1978); and Bradford 1984. Similar arguments are made by Boadway, Bruce, and Mintz (1987) and, recently, Kesselman (1999).

If income from property is already subject to taxation, there is no reason to subject capital gains themselves to taxation.

The Double Tax Argument. Another challenge rests on recognizing the source of capital gains. A well-founded principle is that they reflect the anticipation of increased income from property. If that income is already subject to taxation, there is no reason to subject capital gains themselves to taxation (since such income has already been taxed in another way).

This argument suggests that corporate and personal income taxes on dividends, rents, and other forms of income are already reflected in asset values. Therefore, capital gains arising from changes in after-tax property income should not be subject to another layer of tax (see Mintz and Richardson 1955; Chant 1999). This logic is also a basis for integrating business and individual taxes on income. The exclusion of capital gains from taxation is roughly appropriate when income earned at the business level is subject to a 20 percent tax rate and the PIT rate on high incomes is 50 percent. The higher the corporate income tax (CIT) rate, the greater the exclusion rate for capital gains should be to preserve the integration of corporate and personal income taxes. (For a description of the CIT in Canada, see Box 1.)

Can We Fully Tax Capital Gains?

Even if it is correct in principle to tax accrued capital gains, it is not possible to do so in practice. The taxation of accrued capital gains would often force individuals to sell assets in order to meet their tax obligations. Further, it is impossible to value the prices of all assets during a tax period since some (such as private company shares, real estate, and personal property) are infrequently traded.

Thus, pragmatic tax authorities tax capital gains only when assets are disposed of (on a “realization basis”).[3] However, such timing confers an advantage on those individuals who defer the payment of income taxes by postponing the sale of their assets.[4] As discussed below, the incentive so provided tends to lock in investments: investors may hold on to poor investments in order to avoid paying taxes on their disposal.[5]

Given these practicalities, one must question whether capital gains can be fully taxed.

By How Much Should Capital Gains Be Taxed?

The taxation of capital gains, even if desirable as part of an income tax system, raises several other difficult issues.

3 A measure to tax capital gains on an accrued basis after adjusting for inflation was made available to investors in Canada in the early 1980s through indexed security investment plans. Few individuals invested in these special plans.

4 See Davies and Glenday (1990) for estimates of accrual-equivalent capital gains tax rates based on the personal tax system after 1987.

5 One could impose an additional level of tax on capital gains according to the number of years that an asset is held to eliminate the deferral advantage. See Auerbach (1991); Helliwell (1969).

Box 1: *The Corporate Income Tax in Canada*

The taxation of corporate income varies according to the type of business activity, its location (province), and the organization of the corporation. The general federal rate levied on corporate income is 28 percent plus a surtax of 1.12 percent (4 percent of the general rate). Provincial rates average about 14 percent.

Manufacturing and processing income is taxed at lower rates than other types of business income at the federal level and by some provinces. The first $200,000 of income earned by Canadian-controlled private corporations is also taxed at favorable rates so long as the corporation has less than $15 million in taxable capital (as defined under the large corporations tax).

The accompanying table shows the various tax rates, with provincial rates and combined federal-provincial rates rounded to the nearest integer.

Current CIT Rates in Canada

	General	Manufacturing and Processing Income	Canadian-Controlled Private Corporations
		(percent)	
Federal rate including surtax	29.12	22.12	13.12
Average provincial rate	14	13	8
Combined tax rate	43	35	21

With the lock-in effect, investors may be reluctant to sell assets to restructure investments or businesses if the sales will trigger capital gains taxes.

The Lock-In Effect. The lock-in effect, described above, can act as a barrier to capital market and business efficiency in that investors may be reluctant to sell assets to restructure investments or businesses if the sales will trigger capital gains taxes. This effect is, in part, ameliorated by provisions that allow for the tax-free rollover of assets (as in the case of share-for-share exchanges, amalgamations, and liquidations, as long as certain qualifications are met). However, the lock-in effect can still impose significant economic costs if individuals hold assets longer than they should to better rebalance their portfolios or improve the management of their assets.[6]

Treatment of Losses. Under most tax systems, net capital losses (capital losses minus capital gains) are carried forward at a zero implicit interest rate and applied only to future net capital gains. Thus, governments fully share the

6 See Zodrow (1999). The lock-in effect is estimated to have an important impact on economic costs in the United States. That country does not, however, have deemed realization of capital gains at death, and many individuals do not need to pay estate tax. Canada has no estate tax, but it does have deemed realization of capital gains at death. Thus, Canadians cannot avoid capital gains altogether, and there is less incentive in Canada than in the United States to defer gains by not selling assets.

Since losses are not fully used, capital gains taxes can impose substantial burdens on risk taking.

gains but not the losses, which are only partly deductible in equivalent value. Since losses are not fully used, capital gains taxes can impose substantial burdens on risk taking.[7]

One could, therefore, argue that governments should provide for the full offsetting of capital losses by, for example, indexing capital loss carryforwards at a rate of interest or allowing such losses to reduce other income for tax purposes. Full loss-offsetting is fraught with difficulties, however. It could encourage tax evasion — say, by measuring asset values incorrectly to increase the size of the loss. And in the presence of crossborder capital flows, it could result in the dumping of losses into Canada should other countries not provide a similar treatment of losses.

Yet the lack of full loss-offsetting can result in effective tax rates' being much higher on risky investments than on those that are risk free. For example, suppose an asset with a certain 10 percent before-tax rate of return yields 5 percent after taxes. The effective tax rate is 50 percent. But if the asset is risky and losses are not shared by the government, the effective tax rate can be much higher. Suppose, for example, an asset with an uncertain rate of return has an expected before-tax rate of return of 10 percent — the average of 30 percent in a "good" state of weather and –10 percent in a "bad" one, each state with an equal chance of probability. Given a 50 percent tax rate and assuming the government does not share any value of the loss, the after-tax rate of return in the good state is 15 percent, but in the "bad" state it remains –10 percent. The net-of-tax expected rate of return is therefore only 2.5 percent (= [15 % + –10 %] H 50 %), which implies an effective tax rate of 75 percent![8] Risky assets can be highly penalized under a tax system in which losses are not fully shared with the tax authority.

The inability to fully write off losses is a significant barrier to risk taking and entrepreneurship. As shown in Table 1, the capital losses on shares not written off have been about 35 percent of net gains for individuals with incomes of less than $100,000. For taxpayers with incomes of more than $100,000, however, net losses have been about 7 percent of gains.[9]

Inflation. Like other forms of capital income, capital gains are not indexed for inflation under the Canadian tax regime. One result is excessively high taxes on capital gains. In the presence of inflation, the purchasing power of capital declines (see Box 2). Even at a low inflation rate of about 2 percent

7 Accumulated capital losses can shelter current gains from taxation, thereby lowering the effective tax rate on current investments. However, to accumulate such losses, risky investments in the past had to be penalized since capital losses could not be fully used at that time.

8 If the government fully shared the loss, the rate of return on capital in the bad state would be –5 percent and the expected rate of return would be 5 percent = (= [15% + –5%] H 50%). The effective tax rate would be 50 percent, identical to that of the riskless investment.

9 Since realized capital gains are included in income, measured income overstates true income for individuals who have realized substantial capital gains during the taxation year.

Table 1: ***Investors' Annual Average Net Capital Gains and Losses on Shares***

Income Class	Annual Average during Period		
	Net Gains	Net Losses	Net Losses as a Ratio of Net Gains
	($ millions)		*(percent)*
< $100,000			
1984–88	1,712	487	28.5
1989–96	1,541	607	39.3
1984–96	1,610	561	34.8
$100,000 or more			
1984–88	2,510	340	13.5
1989–96	6,122	319	5.2
1984–96	4,733	327	6.9

Notes: The data include gains and losses on small business shares; "net gains" are gains net of losses, "net losses" are losses net of gains.

Source: Canada, Department of National Revenue, *Taxation Statistics*, various years.

annually (the midpoint of the Bank of Canada's target range for inflation), the value of assets held for 20 years will decline by one-third in real terms.

The importance of this distortion varies with the holding period, being larger for longer periods. Under the current low inflation, therefore, the absence of indexation represents a significant increase in the effective tax rate on a typical real capital gain.

Under low inflation, the absence of indexation represents a significant increase in the effective tax rate on a typical real capital gain.

The deductibility of borrowing costs that are unadjusted for inflation can offset the effect of taxation on nominal capital gains. Thus, even if capital values were indexed for inflation to determine capital gains taxes, further adjustments would be necessary to avoid giving advantages to investments that are debt financed.

Given these three issues — addressing the problems of the lock-in effect, loss offsetting, and inflation indexation — one can argue that capital gains should generally be taxed less highly than other sources of income.

Can We Cut Capital Gains Taxes without Other Adjustments?

Several important structural issues make it impossible to look at capital gains taxation in isolation from other fundamental parts of the tax system. These issues include the difficulties caused by differential taxation of various kinds of capital income and the desirability of integrating corporate and personal taxes as closely as possible. Different countries choose different ways of solving these problems.

Taxing Various Kinds of Capital Income

If capital gains, dividends, and other forms of capital income are taxed differently, investors and businesses will try to structure their affairs to avoid the highest-taxed forms of capital income. This can create inefficiency. It can also mean unfairness in the tax system since some individuals are in a better position than others to plan for the most advantageous treatment.

An important system issue is to maintain a similar tax on dividends and capital gains.

An important system issue, especially for financial planning, estate planning, employee compensation, and corporate reorganizations, is to maintain a similar tax on dividends and capital gains. If the capital gains tax rate is lower than the dividend rate, investors will seek opportunities to convert dividends into capital gains, a technique called “surplus stripping.” The reverse — “capital gains stripping” — occurs if the capital gains tax rate is higher than the rate on dividends. This problem exists at the corporate level in Canada since dividends paid from one corporation to another are tax exempt, and the capital gains on shares held by one corporation in another are taxable.

It is worth noting that, since 1972, Canada has tried to maintain a close relationship between the tax on dividends and the tax on capital gains in order to minimize incentives for surplus stripping. When the rates have diverged, as in the late 1970s and since 1985, surplus stripping and similar devices have become quite common. One result has been the introduction of complex tax measures to forestall transactions aimed primarily at avoiding payment of tax.

Countries may also try to maintain a similar tax rate on real estate and share gains. If the real estate capital gains tax rate is higher than the rate on capital gains from selling shares, individuals have an incentive to hold real estate assets in corporate form, rather than directly. The investor who disposes of shares held in the corporation rather than the real estate as a person can achieve the lower rate of tax. Thus, for practical reasons, real estate and share gains are often taxed at similar rates. A similar argument applies to capital gains realized on the sale of any asset of an unincorporated business. Therefore, it is appropriate that a reduction in capital gain taxes apply to all assets, rather than be limited to corporate shares.

Integrating CITs and PITs

In large part, the appropriate taxation of capital gains depends on the jurisdiction’s degree of integration of corporate and personal taxes.[10] Because firms’ profits are subject to corporate taxation, the income derived

10 Integration of corporate and personal taxes is restricted to Canadian-resident shareholders. In an open economy such as Canada, integration measures at the personal level for resident owners (such as the dividend tax credit and the partial capital gains exclusion) are ineffective to the extent that corporations obtain equity financing from international markets. However, most studies show that the availability of Canadian savings does lower corporations’ cost of equity finance to some extent. (See McKenzie and Thompson 1996.) Moreover, integration measures are important for tax planning in many situations.

Box 2: ***The Pernicious Effect of Inflation***

Inflation, even at 2 percent, can substantially reduce the returns earned on investments. When the tax system does not provide for inflation adjustments, taxes on capital income can be quite high.

Take, for example a bond with a yield of 5 percent. Suppose the investor's marginal tax rate is 40 percent (common for individuals who earn income in the $30,000–$60,000 range, ignoring any clawback of benefits). The after-tax yield on the investment is 3 percent (= 5% x 60%) so long as we ignore inflation.

But part of the nominal interest paid on the bond is meant to compensate the investor for inflations' erosion of the purchasing power of capital. Taking inflation into account, the investor obtains an after-tax return on the investment of only 1 percent. In other words, 2 percentage points of the yield go to recovering the loss of purchasing power and 2 more points go to paying taxes to the government. The effective tax rate on savings in bonds is the amount of taxes paid relative to the inflation-adjusted yield on the asset. Therefore, the effective tax rate is a whopping 66.66 percent (2% divided by 3%), an amount much greater than the 40 percent marginal tax rate.

The same can be said about the taxation of capital gains. Taxes are paid on the nominal difference between the price at which the asset is sold and its original cost when purchased. If the asset was purchased years ago, calculating the actual yield means adjusting the original cost upward — sometimes far upward — to recognize the effects of inflation. [*Box continues.*]

Some countries exempt dividends and capital gains altogether if the profits have already been subject to corporate income tax at rates similar to the top personal rate.

from holding shares (capital gains and dividends) could be taxed a second time at the personal level. Some countries exempt dividends and capital gains altogether if the profits have already been subject to corporate income tax at rates similar to the top personal rate. Alternatively, investors may be given a tax credit (usually for dividends) or a partial exemption at the personal level (usually for gains) if the corporate income tax rate is below the personal tax rate.

The latter approach is effectively the one used in Canada (as described in Box 3), where the dividend tax credit and the exclusion of one-quarter of capital gains from the tax calculation roughly integrate the corporate and personal income tax for small business. The result is that tax rates on equity income are relatively close to those on interest from bonds and on salary payments (although the current tax rate on dividends, net of the credit, is somewhat lower that the effective capital gains tax rate — assuming no deferral of gains — in several provinces[11]).

The United States, in comparison to Canada, has a classical form of corporate income tax in that there is no integration of corporate and personal income taxes on corporate income distributed to shareholders. Its tax rate on capital gains has bounced around over the years, but in 1998 it

11 Recent reductions in provincial CIT rates for small businesses in several provinces suggest that the dividend tax credit may be greater in value than the amount of corporate tax withheld at the small business level.

Box 2 - continued

Even though capital gains taxes are deferred until the asset is sold, the effect of inflation, even at 2 percent, can largely offset the deferral advantage. Consider the following example. A share worth $100 is held for eight years with a typical nominal gain of 9 percent and a real gain of 7 percent. The asset is therefore sold at $199.25. Without indexation, the capital gain is $99.25 (= $199.25 minus the original cost of $100.00). Assuming the typical rate of 37.5 percent, the tax paid is $37.22, leaving only $62.03 as net-of-tax income.

If, however, the investor had to pay tax on accrued capital gains each year but the cost of shares was indexed for inflation, then the net-of-taxes income would be computed as follows. The real gain is 7 percent per year. The after-tax yield at a 37.5 percent tax rate is 4.375 percent. Assuming the reinvestment of the income, the value of the original investment would rise by 6.375 percent, which is equal to the after-tax real yield plus the inflation rate. At the end of eight years, the cumulative value of the investment after tax would be $163.95. Net of the original cost of $100.00, the total gain would be $63.95. Thus, the lack of indexation for inflation erodes the deferral value of paying tax on gains with an eight-year holding period.

The above calculations, based on a typical case, could vary substantially depending on the yield, the holding period for shares, and the tax rate. At least on average, however, the lack of indexation for inflation largely offsets the deferral advantage given to investors when assets are taxed on a realization basis.

went down to 20 percent on assets held for more than 18 months (see Box 4). This reduction makes some sense in that country since it reduces the difference between the taxation of shareholder income and that of other forms of income that are deductible expenses at the corporate level (such as interest expenses on bonds).

One result, however, is that the United States' long-term capital gains tax rate is now significantly below its PIT rate on dividends. This situation encourages US taxpayers to convert corporate earnings paid as dividends into capital gains. Tax administrators will need to introduce complex rules to cope with this form of tax arbitrage.

Taxing Capital Gains: Different Approaches

Some countries partially exempt capital gains to better integrate corporate and personal income taxes.

If one examines capital gains tax policies across countries, it is clear that there is no single philosophy as to how capital gains should be taxed. Some countries partially exempt capital gains to better integrate corporate and personal income taxes (the approach used in Canada and proposed in Australia). Some jurisdictions (Hong Kong, Singapore, and Thailand[12]) generally exempt both dividends and capital gains since the corporate

12 All three impose a special tax on dividends to ensure that the income is taxed at the corporate level prior to distribution.

Box 3: ***Taxes on Capital Gains, Dividends, and Other Income***

Canadian taxes on capital gains and dividends are fairly complicated. The total tax paid depends on the rates imposed by the federal and provincial governments and also on the capital gains exclusion and dividend tax credit that are provided as offsets for corporate income taxes paid prior to the investor's receiving the income.

The calculation of the tax due on capital gains starts with the calculation of the amount to be included in taxable income. Currently, 25 percent of the nominal gain is excluded.

The total federal-provincial tax rate applied to the remaining 75 percent depends, for high-income earners, on both the applicable basic rates and the surtaxes. In 1999, the top basic federal rate was 29 percent, and the federal high-income surtax was 6.5 percent, which combined to 30.89 percent (29% + [29% H 6.5%]). In Ontario, the basic rate was 39.5 percent of the basic federal tax. The effective Ontario rate was, therefore, 11.45 percent (= 39.5% H 29%). The Ontario surtax was 56 percent of the provincial tax, or 6.41 percent for the top rate. In total, the top personal tax rate was 48.75 percent (= 30.89% + 11.45% + 6.41%).

The top tax rate on capital gains was three-quarters of the top tax rate on income: 36.56 percent (= 75% of 48.75%).

The tax on dividends is calculated as follows. Each dollar of dividends is grossed up by a factor of 1.25 to determine taxable dividends for federal and provincial purposes. Personal income taxes are assessed on this value of taxable dividends. A federal tax credit of 16.67 percent of taxable dividends is given to reduce both the federal basic tax and the surtax. (Ontario, therefore, effectively provided a credit since its tax was 39.57 percent of the federal tax net of the dividend tax credit.) The total tax rate on dividends for high-income earners in 1999 was, therefore, the following:

Federal tax (29% H 1.25)	36.35%
Federal dividend tax credit (16.67%)	–16.67%
Basic federal tax, net of the credit	19.68%
Federal surtax (6.5%)	1.27%
Ontario tax (39.5% of basic federal tax)	7.73%
Ontario surtax (56% of Ontario tax)	4.33%
Dividend tax rate	33.01%

At 1999 rates, the dividend tax rate was less than the capital gains tax rate.

Suppose an investor received the dividend, capital gain, or other income from a Canadian-controlled private corporation taxed at the rate of 20 percent. Other income, such as salary or interest, paid out was a deductible expense for the corporation, reducing its income but distributed and undistributed profits were not deductible expenses ($1 of undistributed profits giving rise to $1 of capital gains).

Overall, the tax treatment of income for a Canadian-controlled private corporation varies with the form in which it is paid out (see the table at the end of this box). [*Box continues.*]

Box 3 - continued:

As shown in the table below, income earned in Ontario from a small Canadian-controlled private corporation that comes in the form of capital gains was more highly taxed (combined corporate and personal tax rate of about 49 percent) than salary or interest (personal tax rate of about 49 percent) or dividends (combined corporate and personal tax rate of about 46 percent). Currently, it is most favorable to pay out dividends to investors in Ontario.

If the paying corporation was larger and thus taxed at a higher rate (say, 44 percent), the combined corporate and personal tax on dividends of about 62 percent and capital gains of 65 percent would exceed the tax on salary or interest. In this case, despite the seemingly more favorable tax treatment of dividends and capital gains at the personal level, such income is subject to higher total taxes, including the corporate tax, than other forms of income paid out by the corporation.

Further, for corporations that are not paying taxes (say, because of carryforward losses), only personal taxes apply to income, so that the tax system favors the distribution of dividends over other forms of income that the investor might receive.

After-Tax Income Received from a Canadian-Controlled Private Corporation in Ontario

	Dividend	Capital Gain	Salary or Interest
		(dollars)	
Corporate profit	100	100	100
Corporate tax paid (21% rate)	21	21	0
After-tax profit	79	79	100
Personal tax (Ontario rate)	26	29	49
Income net of tax	54	50	51

Note: Tax rates are rounded to the nearest integer.

income tax rate is already close to the top personal rate. Some (Canada, the United States, and the United Kingdom) tax real estate and share gains similarly to remove any bias toward holding real estate assets either in a corporation or personally. Japan fully taxes gains and imposes a surtax on assets held for longer periods. Capital gains are indexed for inflation in some countries (Australia[13] and the United Kingdom, although both are abandoning

13 Australia recently announced a reduction in capital gains taxes from full to half inclusion. In implementing lower rates, however, that country has removed averaging of gains and indexing of the cost basis for inflation. The capital gains tax rate will also be close to the personal tax on dividends, reflecting a new form of integrating corporate and personal taxes in Australia. These changes are part of a overall reform, along with lower CIT and a new method of integrating corporate and personal taxes. At the time of writing this paper, the legislation had not received Senate approval.

Box 4: ***Recent Changes in the US Taxation of Capital Gains***

Before 1986, the United States taxed capital gains and losses on assets that had been held long term (more than a year) effectively at half the full rate levied on short-term gains or losses. As a result of this distinction between short-term and long-term gains, investors were able to use financial derivatives that enabled them to eliminate or reduce capital gains taxes by incurring short-term losses (fully included in income) against long-term losses (half included in income).* With tax reform in 1986, the United States eliminated the short-term/long-term distinction. Capital gains, like dividends, were fully taxed at a rate of 28 percent, which was comparable to the top PIT levied at that time. Corporate capital gains were taxed at 35 percent. By 1993, PIT rates were increased to almost 40 percent, but capital gains continued to be taxed at the more favorable rate of 28 percent.

In 1998, however, the United States reverted to its previous policy of distinguishing between long- and short-term capital gains. The federal tax rate on gains on assets held for more than 18 months net of short-term losses is 20 percent. Capital gains on assets held for one year but less than 18 months are taxed at 28 percent, and gains on assets held for less than one year are taxed at the federal PIT rate (about 40 percent). In addition, the federal government taxes capital gains on collectibles at 28 percent, on the sale of depreciable assets at 25 percent (to the extent of previously deducted depreciation), and on the sale of qualified small business shares owned for more than five years at 14 percent. The first $250,000 ($500,000 for taxpayers who file jointly) of capital gain on the sale of a principal residence is exempt from taxation.

The first $3,000 of capital losses that exceed gains can be used to reduce gains dollar for dollar. Unused capital losses can be carried forward indefinitely.

Capital gains are also subject to state taxation. Even allowing for the deductibility of state income taxes from federal income tax, the state rate can be as high as 7 percent.

* For further discussion, see Zodrow (1995). Evidence in the United States suggests, however, that many investors did not undertake transactions that would fully eliminate capital gains taxes.

indexation). Italy, Germany, the United States, and France provide lower rates of tax on long-term capital gains.

As a general principle, however, most countries choose corporate income, dividend, and capital gains tax rates in a manner that reduces the scope for complex transactions and tax avoidance.

Pressures for Improving Capital Gains Taxation in Canada

In Canada, realized capital gains are subject to federal income tax at a reduced rate (currently, three-quarters of the rate on ordinary income).

Some situations alleviate that bite. For example, rollover treatment, so that capital gains taxes are deferred, is given to qualifying share-for-share exchanges, liquidations of subsidiaries, amalgamations, replacement of property involuntarily disposed of, and farm property transferred to children. Capital gains on principal residences are wholly exempt, and there is a special lifetime $500,000 exemption for capital gains realized on the sale of farms and shares of qualified Canadian-controlled private corporations (CCPCs).

In this section, we discuss the pressures affecting the current level of capital gains taxes in Canada.

Imbalance between Taxation of Capital Gains and Taxation of Other Income

As discussed above, the existing effective rates of tax on capital gains are lower than on ordinary income for two reasons: the three-quarter inclusion rate for realized gains, and the deferral of tax on the accrual of capital gains. The latter advantage varies, of course, with the length of time the asset is held. For assets with sufficiently long holding periods, the tax deferral advantage is greater than the 25 percent reduction in the amount included in taxable income.

Some may argue that the lower effective rate of tax on capital gains constitutes a tax expenditure that reduces government revenues and distorts investment incentives. There are, however, good reasons to believe that a lower rate of tax on capital gains is appropriate on efficiency and equity grounds.

A lower rate of tax on capital gains is appropriate on efficiency and equity grounds.

- For most common shares, the integration of the Canadian CIT and PIT is inadequate. The resulting double taxation of corporate-source income is greatest for large taxpaying[14] corporations outside the manufacturing sector and is higher for undistributed income than for dividend income. One can argue that the dividend tax credit and the partial inclusion rate provide a partial, though incomplete, offset to this double taxation. But integration could be improved further, as we discuss below.
- Asset values are not indexed for inflation, as discussed above. Thus, the inflation component of realized gains, which does not represent true income, is subject to tax.
- With the lack of loss-offsetting, capital gains taxes penalize risk taking and entrepreneurship, as discussed below.

14 Some companies may pay no taxes. This happens when they carry forward past losses or take advantage of corporate tax incentives that reduce their taxable income. In these situations, the company is paying too little corporate income tax, and the dividend tax credit and capital gains exclusion more than offset the amount of corporate tax paid.

- Current Canadian tax law has no general provision for averaging income or capital gains over time.[15] Marginal tax rates vary considerably when capital gains are a significant component of particular taxpayers' income. The absence of averaging also exacerbates the distortion for risky assets.

The existing three-quarters inclusion rate is an inadequate offset for capital gains realized on equities of public corporations.

These issues create a strong case for reducing capital gains tax rates further. Indeed, the existing three-quarters inclusion rate appears to provide an inadequate offset, particularly for capital gains realized on equities of public corporations. And the lack of indexation, even given current low inflation, typically offsets the advantages of deferral.

Tax Disincentives for Risky Capital and Entrepreneurship

Capital gains taxes can particularly discourage investments in risky venture capital and in entrepreneurship, two key factors for economic growth today. This distortion is particularly important for high-risk assets and for situations in which an individual makes a substantial commitment to a venture.

The lack of full loss-offsetting makes risky investment less attractive. Capital losses may be deducted only against capital gains, with a limited carryback period but an indefinite carryforward. This asymmetrical treatment of gains and losses, coupled with the absence of averaging provisions, discriminates against investments in risky assets. This plight is particularly difficult for many entrepreneurs, who are typically credit rationed in the capital markets and consequently have to convert all or most of their resources to financing a new venture.[16] The winnings are fully taxed on realization, whereas the losses are not shared since they may never be fully used to reduce taxes on other income.

Venture capital providers, who represent the other source of funding for startup projects, are also affected by the asymmetrical treatment of gains and losses. Although most venture capitalists will be able to use a capital loss in the future, its deferral reduces its value. As a result, they require a higher expected return on startup projects to compensate them for the tax asymmetries in addition to normal business risk factors.

15 Although farmers and fishermen are permitted to use five-year block averaging of their income. Also, limited averaging of capital gains of certain assets may be effected over a five-year period if the seller of the asset is paid in installments; for farm properties, this period may be extended to ten years.

16 See Brown, Mintz, and Wilson (forthcoming) for a comparison of US and Canadian law. Using a model that incorporates the decision to go public, they find a bias in the Canadian tax system that encourages owners to keep their firms from going public, thereby giving up profitable investment opportunities. The lock-in effect may contribute to the lack of equity financing available to new businesses.

The negative effect on entrepreneurial ventures is a critical issue in capital gains taxation.

We view these negative effects on entrepreneurial ventures as a critical issue in capital gains taxation. Some analysts justify the $500,000 exemption for shares of CCPCs as providing an offset to the negative effects of capital gains taxation on entrepreneurial activities. The CCPC exemption does indeed reduce the capital gains tax disincentive for small startup ventures, but it is poorly targeted and insufficient. Since the exemption applies to *any* CCPC, including *large* ones, established firms benefit from the provision. Indeed, there is anecdotal evidence that some large public corporations have been restructured into private corporations so as to maximize capital gains exemption benefits for their new owners.

Thus, government should either make more fundamental reforms or provide special provisions targeting new businesses.

International Competitiveness

As already noted, US tax rates for long-term capital gains are substantially less than Canadian rates. Given the mobility of entrepreneurs, the high level of taxes on capital gains and other income is a significant concern in terms of the competitiveness of certain industries, especially information technology.

It may also influence the migration of individuals between Canada and the United States. Of course, crossborder migration depends on a host of factors.[17] For ordinary investors, the level of taxation of capital gains *per se* should not significantly affect location decisions. The *average* tax burden net of government benefits probably plays a large role. Potential migrants presumably assess the whole fiscal system, not just one part of it. Canada, unlike the United States, tries to integrate corporate and personal income taxes at the small business level. Moreover, Canadian taxation of small business is relatively generous (typically 21 percent on active business income), while the United States provides only a special regime that results in the full integration of corporate and personal taxes for qualifying corporations — “sub-chapter S corporate status” — but treats income as distributed to its owners and taxes it fully as personal income, whether actually distributed or not. Canada also provides a $500,000 lifetime capital gains exemption for investments in CCPCs of any size; the United States has a different incentive for small business owners, providing lower capital gains taxes for investors in shares of small businesses (less than $50 million in assets) so long as those shares are held for five years.

For entrepreneurs and venture capitalists, however, capital gains represent the lion’s share of their expected future income, and Canada’s more favorable treatment of small business is less relevant. For these

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17 Including fiscal benefits received from public programs and taxes paid to all levels of government and the limits imposed by governments, such as immigration quotas and entrepreneurship incentive programs. Recent studies show an increased flow of migrants to the United States since the early 1990s, although the number of migrants relative to the total population is relatively small (see Helliwell 1999; DeVoretz and Laryea 1998).

individuals, the level of taxation could play a significant role in influencing location decisions. In this context, the general statutory rates of tax, the treatment of losses, averaging provisions, and special exemptions or incentives for entrepreneurs are all important considerations.

Should Canada's Tax Rates on Capital Gains Be Lowered Anyway?

Taxing capital gains must be considered in relation to the overall tax system. Tax policy is generally based on three principles, which sometimes conflict with each other but are important nonetheless: reducing inefficiency, which harms the competitiveness of the economy; making the tax system fair; and minimizing compliance and administrative costs, which is desirable for taxpayers and tax collectors alike. The choice of the capital gains tax rate is largely based on a tradeoff among these competing objectives. Our proposals (below) are based on our assessment of how to make the Canadian tax system more efficient, fairer, and less costly to operate.

The aim of the proposals is to make the Canadian tax system more efficient, fairer, and less costly to operate.

Overall, we find a strong policy case for lowering capital gains taxes in Canada. We offer two arguments, one economic and the other structural, based on sound objectives for good tax policy.

Capital gains taxes have an impact on risky investments, as argued above. They also create significant economic distortions by encouarging investors to lock in their investments, making it difficult for new businesses to obtain financing. Anyone seeking to encourage economic growth and investment in risky opportunities can make the case that the effective tax rate on capital gains from risky investments is too high. The nominal rate of 37 percent should be lowered to bring the effective tax rate down.

The second argument is a structural one. If the main intent is to tax income, regardless of type, at a similar rate, the current provisions for integrating corporate and personal taxes on capital gains are inadequate, especially for income taxed at the corporate level at more than 20 percent.

Some people argue that the integration of corporate and personal taxes in an open economy is unnecessary since companies can raise funds from international markets for their investments. This view ignores two important issues. First, capital gains are a reward for entrepreneurship, not necessarily a reward for investment in capital. Second, the inadequate treatment of integration discourages some kinds of transactions, such as the use of stock options as employee compensation (a matter further discussed below).

The One-Quarter Capital Gains Exclusion

A significant reduction in capital gains taxes, although appropriate, would be difficult to accomplish without structural changes to the rest of the tax system. Reducing capital gains tax rates significantly below those on dividends would create incentives for individuals to convert dividend

income into capital gains, thereby creating a less efficient and more complex tax system.

As shown in Box 3, however, in 1999 the effective tax rate on capital gains was more than 36 percent for high-income taxpayers in Ontario, who faced a marginal tax rate on ordinary income of 48 percent (rates vary among provinces). The dividend tax rate was almost 33 percent. Thus, at present, the capital gains tax rate is somewhat higher than the rate on dividends for high-income individuals and substantially higher for moderate- and low-income individuals. There is, therefore, room for reducing the rate of tax on capital gains, with the added bonus of removing the current incentives to shift capital gains income into dividends. If the capital gains inclusion rate were reduced to two-thirds, the effective tax rates on capital gains would be close to those on dividends for individuals subject to the highest marginal rates in most provinces.

Recommendation 1: Given the existing tax system, the general capital gains exclusion should be increased from one-quarter to one-third.

Such a change would also improve the integration of corporate and personal taxes for firms paying CIT at a rate of 20 percent. On the other hand, we would still lack full integration of corporate and personal taxes for businesses taxed at higher rates.

Nevertheless, if this recommendation were adopted, the corporate tax rate on capital gains for firms paying CIT at 44 percent would fall from about 33 percent to somewhat more than 29 percent.

Comprehensive Tax Reform and Tax Cuts

Recommendation 1 would result in a typical effective tax rate on capital gains of about 32 percent — disappointingly high in terms of economic costs imposed by capital gains taxation on entrepreneurship, savings, and growth. What we are seeing is a reflection of the fact that Canada imposes high CIT and PIT rates on investments and savings in general.

The primary policy issue is Canada's taxation of income from savings in general, not just capital gains. Without indexation for inflation, tax rates on savings can be excessive (look back at Box 2). The lack of proper integration of corporate and personal taxes and the absence of full loss-offsetting result in excessively high taxes on equity income earned as capital gains and dividends. There is, therefore, a need to lower the PIT on savings in general, including capital gains income. One might be concerned that such actions would make the tax system less fair. On the contrary, excessively high taxes on capital income create an unfairness for many taxpayers who receive this form of income relative to those who receive other earnings. Fairness is best achieved by ensuring that the tax base is appropriately defined and measured prior to applying a graduated rate schedule.

There is a need to lower the PIT on savings in general, including capital gains income.

Capital gains tax rates could be reduced further than 32 percent if general tax rates were reduced. Given the current fiscal positions of the federal and provincial governments, major cuts in personal taxes will not be immediate. Actions at both levels of government suggest, however, that it will not be long before the top personal tax rate is lowered to less than 45 percent. For example, Alberta is proposing a flat tax of 11 percent, so that the combined federal-provincial rate for high-income earners would be 42 percent. This level would imply a capital gains tax rate of 28 percent with a two-thirds inclusion rate. So some movement is possible.

Further cuts to capital gains taxes could take place if there was an overall reform of the tax system.

Further cuts to capital gains taxes could take place if there was an overall reform of the tax system. Two potential reforms are possible. The first is changes to both corporate and personal tax systems that broadened tax bases, removed distortions, and lowered rates. The second is a new method of taxing individuals.

Integrating CITs and PITs

The first approach would be to better integrate corporate and personal taxes for shares of all businesses. If the dividend tax credit was increased to a level that reflected the high corporate income tax (currently more than 43 percent for nonmanufacturing income), the capital gains exclusion could logically be increased too. However, for small businesses, facing a combined federal-provincial CIT rate of about 20 percent on their active business income, the dividend tax credit and the capital gains exclusion would then be too rich. They would also be unfairly rich for large manufacturers, which typically have a combined CIT rate of 35 percent. Thus, it would be necessary to have three different dividend tax credit and capital gains exclusion rates: one for dividends paid from the active business income of and capital gains from shares held by smaller firms, another for those held by large manufacturing firms, and another for those held by other large firms. This regime would be exceedingly complex since the dividends and capital gains of large firms paid through small firms would need to be segregated in different pools.

A simpler and hence better way to improve the integration of corporate and personal taxes would be to reduce the difference between small and large firms' CIT rates at the federal and provincial levels. For example, the complete elimination of differences in rates could be achieved by having a single CIT rate of 25 percent.[18] The elimination of multiple rates for firms from different industries and of different sizes would be a significant

18 The Technical Committee on Business Taxation (Canada 1998, ch. 1) shows that, with some base-broadening proposals, the CIT rate for large corporations could be reduced to 33 percent with no loss in federal or provincial revenues. Assuming the elimination of the small business deduction, which applies to about one-third of corporate taxable income, and some loss in business tax revenue with corporate rate cuts, a combined federal-provincial corporate income tax rate much less than 33 percent would be feasible over the medium term. We use 25 percent for illustrative purposes.

The elimination of multiple rates for firms from different industries and of different sizes would significantly improve the current system.

general improvement to the current system since such differential rates are highly distortionary, given the relative ease businesses have in shifting reported income from high- to low-tax sources.

Given a more uniform CIT rate for Canada, the combined federal-provincial dividend tax credit could be increased from the current reference CIT rate of 20 percent (a one-quarter gross-up of dividends and a tax credit of 20 percent on the grossed-up amount) to a level reflecting a reference rate of 25 percent (a one-third gross-up of dividends and a tax credit of 25 percent on the grossed-up amount). At a PIT rate of 42 percent, the effective tax rate on dividends would be about 22.5 percent; the capital gains exclusion could, therefore, be close to one-half without significantly affecting the balance between dividend and capital gains tax rates. The latter would then be close to 21 percent, not much different from the effective US tax rate on long-term capital gains.

This move to a single corporate tax rate would, of course, raise the rate for small businesses from 20 percent to 25 percent. Although one could say that the higher dividend tax credit and capital gains exclusion would provide a reasonable offset, some might argue for a lower corporate income tax rate to encourage small firms to accumulate retained earnings for investment. If this goal was judged a constraint, governments could set a lower CIT rate for small business but maintain the advantages of the scheme by increasing the dividend tax credit and capital gains exclusion and imposing, for all companies, a dividend distribution tax credit to be applied against CITs presumed to be levied at a rate of 25 percent.[19]

Recommendation 2: Assuming a more comprehensive reform of corporate and personal incomes taxes with lower marginal rates, the capital gains exclusion rate should be increased from the existing one-quarter rate to one-half. The dividend tax credit should also be increased; dividends should be grossed up by one-third, instead of one-quarter, and the combined federal-provincial dividend credit on grossed-up dividends should be set at 25 percent, instead of roughly 20 percent.

Moving to an Expenditure Tax Base

The second approach to changing the tax system would be a braver reform of shifting from income taxation to an expenditure tax base. Under such a base, individuals would be taxed on the difference between their earnings and their contributions to registered savings plans. Income earned by the plans would be tax exempt, and withdrawals would be fully taxed. Thus, there would be no capital gains tax, but asset disposals would be fully taxed.

19 A dividend distribution tax credit was proposed by the Technical Committee on Business Taxation (Canada 1998, ch. 7) to improve the integration of corporate and personal taxes.

Canada's current tax system already has expenditure-type treatment of registered pension plans (RPPs) and registered retirement savings plans (RRSPs). Such treatment is also effectively available for owner-occupied housing and other consumer durables: no deduction is given for investments in consumer durables, such as housing and automobiles, but there is also no tax on the sale of principal residences or automobiles or on the imputed rental income from owner-occupied housing. Thus, for a significant portion of savings, especially for low- and middle-income households, Canadians receive expenditure-tax treatment. That treatment could be extended by eliminating the constraints on amounts of savings that can be contributed to registered plans and extending the tax-exempt status for income earned from other investments.

This approach to tax policy raises a host of other issues that go beyond the scope of this paper.

Targeted Capital Gains Incentives for Entrepreneurs and Venture Capital

The existing tax system provides special incentives for entrepreneurs and certain venture capital investments. Some of these treatments could be improved. There are also other issues related to capital gains taxation, such as the tax treatment of stock option benefits.

Capital Gains Exemption for Entrepreneurs

As discussed above, the $500,000 capital gains exemption for investments in farm property and qualifying shares of CCPCs has been ineffective and wasteful. Our view is that this exemption is, in part, offered as an offset to the limits on retirement savings incentives for the owners of small businesses and farmers. Thus, we endorse the recommendation of the Technical Committee on Business Taxation to replace the existing lifetime capital gains exemption with generous rollovers of realized capital gains into RRSPs for farmers and small business owners (Canada 1998, ch. 7).

A different type of tax incentive could encourage the growth of small and medium-sized companies that sell their shares to the public. The United States, for example, provides a rollover treatment that allows investors to pay reduced capital gains taxes on shares of small businesses purchased in an initial public offering if those shares are held for at least five years. This type of policy provides an incentive for firms to grow large enough to go public. In contrast, Canada's lifetime capital gains exemption encourages businesses to remain private. Canada could replace its exemption with an incentive similar to that of the United States.

Canada's lifetime capital gains exemption encourages businesses to remain private.

This measure would, however, be less desirable than a general reduction in capital gains taxes along the lines suggested in recommendation 2. A special incentive distorts capital markets by encouraging low-quality firms

to issue shares that could result in the underpricing of shares of high-quality firms (see Mintz 1997).

Venture Capital Incentives

Another existing incentive is for venture capital. A tax credit of 15 percent is provided by the federal government (provinces may add their own credits) to individuals for up to $5,000 invested in labor-sponsored venture capital corporations that, in turn, invest in shares of venture capital firms. The income earned from the investments is taxed like other income.

The justification for the credit is that venture capital is highly risky and markets tend to underprice such investments, given potential investors' lack of information about the attributes of the projects. If the goal is governments' sharing risk with investors, then the credit is an inappropriate mechanism. It would be better for governments to directly share the cost of the investment, as well as the gains and losses. If the problem is underpricing of shares because of informational difficulties, then the credit is also inappropriate. An investment tax credit would be better than a financing credit since the latter encourages too many inefficient firms to operate in the market.

If the goal is governments' sharing risk with investors, then the venture capital tax credit is an inappropriate mechanism.

The current treatment of venture capital in Canada has encountered two difficulties. The first is finding sufficiently good investments that qualify for venture capital status. Before 1996, the federal credit was 20 percent, but venture capital firms, flush with savings, had difficulty meeting rules that required them to invest the funds in venture capital firms (instead they have held treasury bills). Moreover, some qualified investments have been poor ones — the return on average for venture capital funds has been significantly below stock market returns.[20]

The second problem has been that many entrepreneurs in Canada have little incentive to take their firms public (see Amit, Brander, and Zott 1997). The small business deduction and the capital gains exemption are provided only for private firms,[21] discouraging firms from going public.

Thus, we propose an alternative new savings instrument that would provide significant risk-sharing benefits to investors in venture capital firms but with less distortion of markets. Instead of obtaining a tax credit for investments in labor-sponsored venture capital funds, individuals would be able to hold new registered venture capital plans that would operate like RRSPs. Qualifying venture capital investments would be deductible from income, subject to an overall contribution limit. Withdrawals from the plans would be fully included in income and subject to tax; the income earned

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20 See Osborne and Sandler (1998) for a survey of studies. They also show the average annual pre-tax rate of return on labor-sponsored venture capital corporation funds for three years was only 3.7 percent, well below the small- to mid-cap equity fund average of 21.0 percent over the same period.

21 The capital gains exemption is available for shares held by the owner if realized when the firm goes public.

within the funds would be tax exempt. Individuals would not be able to deduct borrowing costs to finance investments in these assets.

The advantage of this proposal would be twofold. It would provide additional tax expenditure tax treatment for assets invested in venture capital. Also, because the original investments would be fully deductible from income and sales would be fully taxable, the government would fully share the gains and losses with the private investors. Thus, risky investments in venture would not penalized relative to safer investments. No special credit would be needed.

Recommendation 3: Ottawa should replace the labor-sponsored venture capital corporation credit with opportunities to invest in registered venture capital asset funds that operate like RRSPs. Such funds would provide additional incentives to save for retirement purposes without affecting current limits for RRSPs.

Stock Options

The Canadian tax treatment discourages the use of stock options rather than salary compensation.

A third issue is the tax treatment of stock options used in the compensation of employees. Stock options, which allow individuals to buy shares of a firm at a later time, are important instruments for improving productivity in businesses (because employees receive them relative to the firm's performance). The Canadian tax treatment, however, discourages the use of stock options rather than salary compensation. Stock option benefits are generally not deductible from the profits of the firm,[22] but are taxable as capital gains income for the employee at the time of exercise.[23] For businesses with CIT rates of more than 20 percent, the nondeductibility of stock options at the corporate level and the three-quarter inclusion of income as capital gains are less favorable than a cash payment that is deductible and fully taxable at the personal level.[24] A better system, like that of the United States and some other countries, would be having the stock option benefits deductible at the corporate level and taxable in the hands of the employee. In this way, the tax system would treat salary income and stock options alike.

A second-best alternative would be to disallow the deduction of the cost of stock options from the corporate tax base, as under the current system, but to exempt stock option gains at the time of exercise (as is done under the

22 Under certain circumstances, a company may be able to deduct for tax purposes the difference between the exercise value and the grant value of the stock option. The income received by the employee is taxed, with one-quarter excluded.

23 For CCPC stock options, the recipient pays capital gains tax not at the time of exercise but when he or she subsequently disposes of the shares.

24 If the CIT rate is 43 percent, the effective tax rate on income for the stock option is 43 percent plus 37 percent of net-of-corporate-tax income, which is approximately equal to 64 percent.

US stock option incentive provisions). This second approach would, however, create incentives to issue stock options and not pay salary income to employees or vice versa, depending on the relevant CIT and PIT rates.

Some analysts propose that stock option benefits awarded high-technology workers should be exempt from capital gains taxes. One could perhaps argue that the exemption of stock options from capital gains taxes would be fair, given that these benefits are not deductible from the employer's income. However, this targeted incentive would make little policy sense. Setting aside the problem of even defining a "hi-tech" worker, we cannot see why only one type of worker should be so favored. For example, why should an engineer in a high-tech company get more favorable tax treatment than one who contributes to the productivity of a manufacturing enterprise?

Why should an engineer in a high-tech company get more favorable tax treatment than one who contributes to the productivity of a manufacturing enterprise?

Recommendation 4: Ottawa should remove the tax penalty on stock option benefits. Their tax treatment should be similar to that of compensation in the form of salary. The benefits should be deductible for the employer and taxable for the employee. No special regimes should be provided for any particular type of employee.

Revenue Effects of Cuts to Capital Gains Taxes

A common argument made by those who favor cutting capital gains tax rates is that governments would not lose revenue. The basic notion is that a cut in the rate would result in greater realizations by reducing the lock-in effect as discussed above — so much so that overall revenues would not decline. Past studies,[25] especially those in the United States, suggest that temporary realizations are quite sensitive to cuts in capital gains tax rates — indeed, several show that the effect of such a cut is to increase government revenues, at least in the short run. For permanent realizations, however, most studies show that, after the initial effect, anticipated cuts reduce revenues in the longer run.

Canadian studies are fewer. The most recent on the revenue effects of the lifetime capital gains exemption (Mintz and Wilson 1995; updated in Mintz and Wilson forthcoming) estimates the tax expenditure cost of this provision. We then calculate the "cash flow cost" of the exemption as its immediate tax expenditure cost net of revenue obtained from realizations. The final calculation is the net present value of the capital gains tax cost, which takes into account both short- and long-run effects of the capital gains exemption.

25 The most important study in recent years, based on individual investor data, is Burman and Randolph (1994). Zodrow (1999) suggests that a cut in the tax rate from 28 percent to 20 percent would increase permanent realizations by 10 percent. For further review, see Milligan, Mintz, and Wilson (1999).

In our 1995 study, we conclude that the lifetime capital gains exemption had a strong impact on realizations over the 1985–93 period. Because of the stimulus to realizations, the tax expenditure estimates of this measure seriously overstate its true cost. On a cash flow basis over the period, our calculations reduce by 76 percent the federal and provincial revenue losses under the tax expenditure accounts, from a cumulative amount of $14.1 billion[26] to $3.4 billion. When account is taken of the *future* revenues lost as a result of fewer realizations in the future, it is clear that the net revenue loss was larger than the cash cost (although still much smaller than the tax expenditure estimate). Over the 1985–93 period, the net present value of this revenue loss was an estimated $6.0 billion, which is only 43 percent of the cumulative tax expenditure cost of the capital gains exemption.

None of the above estimates, however, takes into account the impact of capital gains tax cuts on investment and asset values, which would further reduce the revenue effect of any cut. Neither do the estimates take into account the incentive for investors to convert high-taxed dividend income into low-taxed capital gains. The latter consideration would increase the revenue cost if the reduced capital gains tax rate cut was below the dividend tax rate.

These proposals for cuts to capital gains taxes would not have large effects on the fiscal positions of the federal or provincial governments.

We expect that our proposals for cuts to capital gains taxes would not have large effects on the fiscal positions of the federal or provincial governments. Reducing the inclusion rate from three-quarters to two-thirds would have only a small annual effect (about $200 million[27]) on federal revenue. Many of our other recommendations would be part of an overall reform that would improve the tax system and facilitate much lower capital gains taxes. The revenue effect associated with the capital gains tax cuts would be relatively small compared with the overall revenue effects of the reform package.

Conclusions

Our conclusions can be summarized in two categories: those concerning general measures and those concerning particular, targeted measures.

General Measures

Under an income tax system, the case for rates of tax on capital gains that are lower than those on ordinary income rests on the following factors:

- Without indexing of asset values, some portion of capital gains reflects inflation, rather than increased real resources. Even low rates of inflation

26 This estimate differs slightly from the Finance Department's own estimates in the Tax Expenditure accounts.

27 The Department of Finance tax expenditure estimate would be about $300 million. We reduce this amount by realizations to arrive at our figure.

increase the effective tax rates on real capital gains. A lower rate of tax can offset this distortion.

- The lock-in effect arising from capital gains taxes on realizations results in investors' holding stocks that could be replaced by investments with better returns (including the returns on venture capital).
- Without full loss-offsetting, capital gains taxation discriminates against investments in risky assets. A lower rate of tax can mitigate this effect.
- For corporate equities, it is important to maintain a balance between effective tax rates on dividends and capital gains, particularly for top-bracket taxpayers. The need to maintain these rates at the same level sets a lower limit to the capital gains tax rate. Currently, Canada's dividend tax rates are below its capital gains tax rates, so there is some room to reduce the latter.

The general exclusion rate for capital gains should be immediately increased from one-quarter to one-third.

We therefore recommend that the general exclusion rate for capital gains be immediately increased from one-quarter to one-third, making capital gains and dividend tax rates approximately equal for top-bracket taxpayers.

Additional reductions in capital gains taxes could be achieved if dividend integration was increased or if corporate or personal tax rates were reduced. If general corporate rates were reduced to 25 percent, personal rates to 40 percent, and the dividend gross-up and credit formula adjusted accordingly, the general capital gains exclusion could be increased to one-half.

Special Measures

The existing $500,000 capital gains exemption for farm properties and shares of Canadian-controlled private corporations should be replaced by special RRSP provisions for farmers and small business owners. The existing credit for investing through labor-sponsored venture capital corporations should be replaced by an augmented RRSP deduction for investments in venture capital projects.

The existing tax treatment of employee stock options, which discriminates against their use, should be replaced by a more neutral system. The value of options should be deductible to the company granting the options to employees.

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