CESTNICK

TAX MATTERS

Canadians are taxed on illusory capital gains

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In just a few days it will be 24 years since I got married. Carolyn and I travelled to southern England for our honeymoon, and I remember stopping at a local bookstore where I picked up a book on U.K. taxation. I read the chapter on capital gains taxes, and was impressed to see that, at the time, the U.K. adjusted capital gains for inflation.

I do recall that Carolyn was not impressed that residents of the U.K. had a more sensible tax law around capital gains than Canadians. She was even less impressed that I cared to read about it on our honeymoon. But I digress.

Last week I wrote about inflation as being a tax on Canadians. And if we're going to talk about inflation, we need to talk about capital gains taxes. As it stands today, we are taxed in Canada on "illusory gains." That is, we pay tax on so-called "gains" that don't actually result in additional real wealth or purchasing power.

THE HISTORY

It was in 1972 that taxes on capital gains were introduced in Canada, following the recommendations of the Royal Commission on Taxation, otherwise known as the Carter Commission, named after Kenneth Carter, who chaired the commission.

The taxable portion of capital gains in 1972 was 50 per cent. This is the same inclusion rate we have today, although that rate was as high as 75 per cent throughout most of the 1990s. One could make an argument that capital gains should be adjusted for inflation so that investors are not taxed on inflationary gains, but only on gains over and above inflation – or real gains – since there is no true economic benefit to the extent gains just keep up with inflation.

Proponents of our current system might suggest that capital gains are not fully taxable today so as to account for inflation. But this was not the original intention of Parliament. The Carter Commission had rejected any

adjustment for inflation on the basis that it was an "overemphasized argument."

Further, debates in the House of Commons on the proposals for tax reform at that time don't support the proposition that inflation protection was one of the reasons for the 50-per-cent inclusion rate. Rather, a response in Parliament by Robert Kaplan, the former Liberal MP, shed light on the fact that the inclusion rate was set at 50 per cent to ensure Canadian capital gains tax rates were competitive with those in the United States.

THE REALITY

Does our current capital gains taxation, and the 50-per-cent inclusion rate, accommodate for inflation? Let's consider an example. Suppose we have two investors: A and B. Each investor makes a $1,000 investment this year. At the end of 10 years, let's assume each investment has grown to be worth $3,000, for a capital gain of $2,000. This represents an annual pre-tax return of 11.6 per cent for both of them. (More detailed calculations are included with this column online.)

Let's also assume that both investors are subject to a marginal tax rate of 45 per cent (which, in any province or territory, represents a realistic tax rate for a high-income earner who is not quite in the highest tax bracket).

Now, let's assume that Investor A is entitled to today's 50-per-cent inclusion rate on capital gains. This investor would face taxes on just $1,000 of his capital gains, and the tax bill would amount to $450. This represents an after-tax return of 9.8 per cent.

What about Investor B? Assume that she is subject to a 100-per-cent inclusion rate. That is, she's fully taxed on her capital gains. Her tax bill would be $900, which represents an after-tax return of 7.7 per cent.

But what if we take inflation into account? Let's assume a world where Investor A faces inflation at 2 per cent annually, and Investor B faces no inflation at all. Investor A would have a real capital gain that is no longer $2,000, but just $1,781 (I have revised the numbers so that only real capital gains, after inflation, are taxed). Investor A in this scenario, who pays taxes of $450, achieves a reduced net after-tax return of just 7.7 per cent a year.

Did you catch that? After inflation, Investor A (who is entitled to the 50-per-cent inclusion rate) has the same after-tax rate of return as Investor B (who was fully taxed on her capital gains and faces no inflation).

THE MORAL

What does all of this mean? There are a lot of conclusions that can be drawn here, and I won't do it justice this week, so I'll finish the conversation next time. But I will say this: If the government is going to increase the capital gains inclusion rate as many expect, they had better make note of the impact when combined with their target levels of inflation.

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			Rate of Inflation			
			2.00%	3.00%	4.00%	5.00%
Facts						
	Investment in year 1		1,000	1,000	1,000	1,000
	Number of years for growth		10	10	10	10
	Proceeds of disposition end of last year		3,000	3,000	3,000	3,000
	Capital gain		2,000	2,000	2,000	2,000
	Pretax return on investment		**11.6%**	**11.6%**	**11.6%**	**11.6%**
Full Taxation of Capital Gains						
	Taxes at	45.00%	900	900	900	900
	Net after-tax gain		1,100	1,100	1,100	1,100
	Effective tax rate		45.00%	45.00%	45.00%	45.00%
	After-tax return on investment		**7.7%**	**7.7%**	**7.7%**	**7.7%**
Partial Taxation of Capital Gains						
	Inclusion rate	50.0%				
	Taxable capital gain		1,000	1,000	1,000	1,000
	Taxes at	45.00%	450	450	450	450
	Net after-tax gain		1,550	1,550	1,550	1,550
	Effective tax rate		22.5%	22.5%	22.5%	22.5%
	After-tax return on investment		**9.8%**	**9.8%**	**9.8%**	**9.8%**
Adjustment for Inflation						
	Investment adjusted for inflation		1,219	1,344	1,480	1,629
	Capital gain adjusted for inflation		1,781	1,656	1,520	1,371
Full taxation:	Net after-tax gain: full taxation		881	756	620	471
	Tax rate: full taxation		50.5%	54.3%	59.2%	65.6%
	After-tax return on investment		**5.6%**	**4.6%**	**3.6%**	**2.6%**
Partial taxation:	Net after-tax gain: partial taxation		1,331	1,206	1,070	921
	Tax rate: partial taxation		25.3%	27.2%	29.6%	32.8%
	After-tax return on investment		**7.7%**	**6.6%**	**5.6%**	**4.6%**

Derived from a table in the Canadian ax Journal, 2002, Vol. 50, No. 5, Frank Lochan, page 1837