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TAX MATTERS

Increasing taxes on capital gains would be stifling for Canadian investors

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It was the finance minister of Louis XIV, Jean-Baptiste Colbert, who said that "the art of taxation consists in so plucking the goose as to obtain the largest possible number of feathers with the smallest possible amount of hissing." If the government moves to increase taxes on capital gains, as many expect, there's going to be a lot of hissing from Canadian taxpayers. And for good reason.

THE OBSERVATIONS

Last week I shared an observation about two investors: A and B. Both investors had invested $1,000 and, 10 years later, saw their investments grow to $3,000 – an 11.6-per-cent annual rate of return. I assumed that both investors were in the same tax bracket, with a marginal tax rate of 45 per cent. In the story, Investor A faced a capital gains inclusion rate of 50 per cent, while Investor B was taxed on 100 per cent of her capital gains.

You would expect Investor B to be worse off than Investor A after taxes – which is true if you ignore inflation. But if Investor A faced inflation of 2 per cent annually over the 10 years, while Investor B faced no inflation, Investor A would face tax on "illusory gains" (not real economic gains). As I wrote in another column two weeks ago, inflation itself is a tax. After income taxes and the "inflation tax," Investor A ends up with a 7.7-per-cent return – the same return as Investor B who was taxed on 100 per cent of her capital gains.

That is, while you might think our government is being generous by taxing just 50 per cent of capital gains, the reality is that there's no generosity there at all. After inflation of just 2 per cent, Investor A in my example is no better off with the 50-per-cent inclusion rate than Investor B who faced full taxation of her capital gains and no inflation. Economically, they're equivalent.

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When you look at the math, the after-tax, after-inflation rate of return varies depending on the level of inflation, the capital gains inclusion rate and a person's marginal tax rate (I shared the detailed math in the online version of last week's column).

Investor A and B in my example are relatively high-income earners with a marginal tax rate of 45 per cent. How does the math look when someone has a lower level of income? It's interesting to note that, the lower your level of income, the worse off you are on an after-tax, after-inflation basis when it comes to taxation of capital gains. Why? Because inflation, unlike income taxes, is a tax that is not scaled back when your income level is lower.

If our two investors instead had a marginal tax rate of 30 per cent (the average rate in Canada for someone earning about $50,000 annually), Investor A would no longer have the same after-tax, after-inflation rate of return as Investor B, but rather would have a return that is 0.9 per cent lower than Investor B.

What if the level of inflation rose above 2 per cent? At an inflation rate of 2.5 per cent or higher, Investor A would be worse off than Investor B when looking at after-tax, after-inflation returns – regardless of their level of income or marginal tax rates.

THE CONCLUSIONS

One could argue that the current 50-per-cent inclusion rate somewhat mitigates the effects of inflation, provided inflation remains at about 2 per cent or lower – although I showed last week that mitigating inflation was not the intention of Parliament when the capital gains tax, and a 50-per-cent inclusion rate, was introduced in 1972. The intention was to set capital gains tax rates at a level consistent with those in the United States.

If I was a betting man, I'd put money on the likelihood that the current government, if it wins the next election, will push to increase tax rates on capital gains by increasing the inclusion rate. Don't be surprised if the government applies a different tax rate on capital gains for those with income over a certain level (since this is what the Biden administration south of the border has proposed; and heaven forbid our government should come up with its own policy around capital gains taxes).

If our government wants to provide an incentive for Canadians to invest in businesses and other riskier assets, it should not make a change to the inclusion rate. What is clear is that the current 50-per-cent inclusion rate isn't sufficient as it is to both mitigate inflation and, in addition, provide an incentive for Canadians to invest in risk assets such as businesses, which are so critical to our economic well-being as a country.

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