It's time to raise capital gains taxes in Canada

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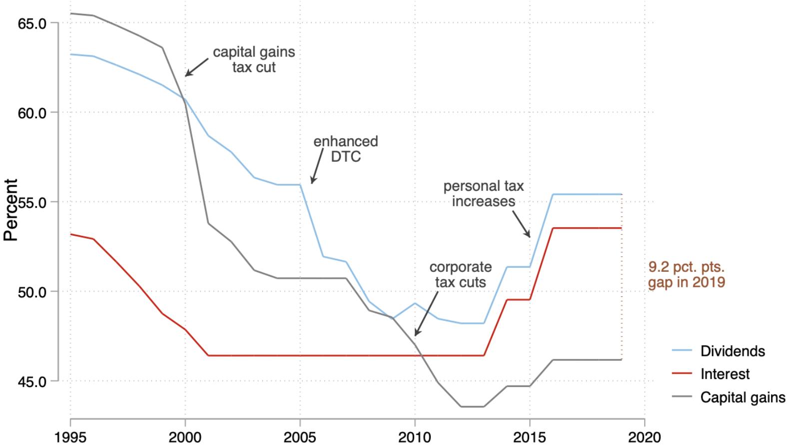
Introduction

- The neutrality principle requires that capital income from interest, dividends, and capital gains to face the same effective tax rate
- Since the 2000 reform, capital gains tax rates too low for neutrality
- Economic consequences:
  - \$17 billion annual revenue loss – or 5% of all income tax revenues
  - base erosion due to share buybacks (up 350% on TSX in real terms since 2000)
  - surplus stripping incentives for CCPCs – stronger since Bill C-208
- To achieve neutrality, capital gains inclusion rate should rise from 50 to 80%
  - a sensible piecemeal reform – even as we consider more fundamental changes to the system

Following corporate tax cuts and personal tax increases, capital gains have been undertaxed since 2010

Figure 1 Effective tax rates, large corporations, Ontario



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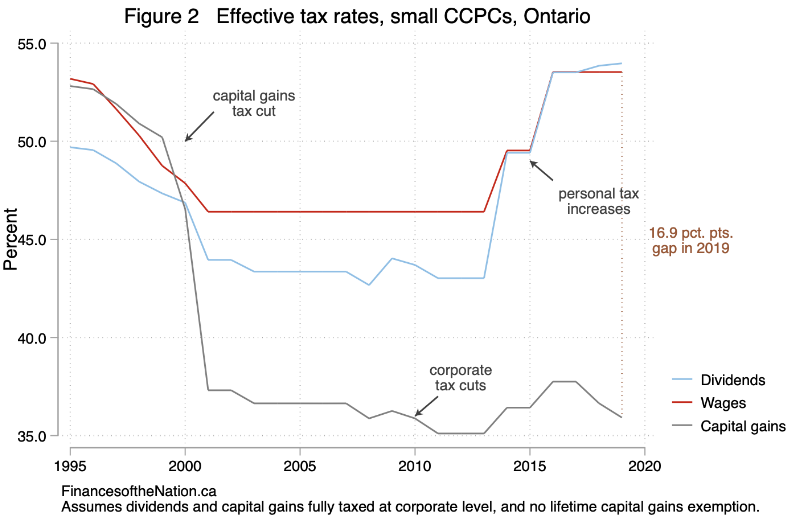
Assumes dividends and capital gains fully taxed at corporate level, and no lifetime capital gains exemption.

For small CCPCs, the tax gap is wider



Debunking Myths

Myth 1: Capital gains income goes to the middle class

- Capital gains realization happens infrequently for most taxpayers, raising income temporarily
- Annual statistics may therefore overstate inequality in capital gains on a lifetime income basis
- But are "capital gains are widely enjoyed, not just by top earners"?
  - Smart and Hasan Jafry (2022) examine distribution of capital gains income by five-year average family income (a proxy for lifetime income)

Myth 1: Capital gains income goes to the middle class

Table 1: Distribution of capital gains income, annual vs. long-term perspectives, 2014-18

	Taxpayers ranked by annual income		Taxpayers ranked by five-year average income	
	Average capital gains ($)	Cumulative share of gains (%)	Average capital gains ($)	Cumulative share of gains (%)
Top 0.01%	5,918,580	11	3,447,440	6
Next 0.09%	1,020,260	29	790,300	18
Next 0.9%	168,740	57	153,980	41
Next 9%	14,320	82	20,880	72
Bottom 90%	1,058	100	1,873	100

Note: Annual capital gains of taxpayers ranked by annual or by five-year average family income.
Source: Smart and Hasan Jafry (2022) using Longitudinal Administrative Databank.

Myth 2: The burden of capital gains tax reform would be widespread

- Even within income bins, capital gains income is highly unequally distributed – many taxpayers with little or no CGs, a few with a lot
- This raises horizontal as well as vertical equity issues
- To demonstrate, we simulate a new annual exemption for taxable capital gains
  - What fraction of taxpayers would face a new tax on annual gains above $0, $1,000, $10,000, …?
  - What fraction of gains would be taxed?

Myth 2: The burden of capital gains tax reform would be widespread

Table 2: Simulated effect of annual capital gains tax exemptions

	Annual exemption level:			
	Zero	$1K	$10K	$20K
Share of taxpayers taxable	17.0	11.2	4.7	3.1
Share of those in top 10% of incomes	24.5	28.0	38.7	45.1
Share of total capital gains taxable	100.1	99.8	95.6	91.9

Note: Simulation based on average capital gains realizations, 2014-18. Taxpayers ranked by quantiles of five-year average family income (including capital gains) over the years 2014-2018.
Source: Longitudinal Administrative Databank 2010-2018, and calculations in Smart and Hasan Jafry (2022).

Myth 3: The “lock-in effect” limits revenue gains from tax increases

- Lock-in effect: investors are discouraged by taxes from realizing gains
- But:
  - Tax benefit of deferred realization is small, when interest rates are low
  - Deemed realization at death in Canada makes deferral only temporary
  - Deferral only delays revenue gains not eliminates them – irrelevant when interest rates are low (Sarin, Summers, Zidar, and Zwick, 2021)
  - Empirical evidence suggests to me that response in realizations to capital gains tax changes is very short-run within a year or two of reform (e.g., Agersnap and Zidar, 2020; Lavecchia and Tazhitidinova, 2021)

Myth 4: Capital gains are partly compensation for inflation, so should be taxed lightly

- Vaillancourt and Kerkhoff (2019): “those paying the tax on realised gains are paying taxes on an increased value owing partially or entirely to inflation and not to an increase in the real value of the asset”
- …but we tax nominal returns to other assets too (bonds, dividend stocks)
- …and the tax on realized nominal gains simply recaptures the deferral advantage shareholders receive under our realization-based tax
- Simple calculations suggest that – with annual inflation rates of 2-4% – inclusion rates of 70-90% deliver approximately full and fair taxation of real returns on a retrospective basis