TAXING CAPITAL GAINS ON AN ACCRUAL BASIS

Capital Gains Tax Reform Roundtable

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TAXING CAPITAL GAINS ON AN ACCRUAL BASIS

- Basic rule for gains and losses from the disposition of capital property is realization (the statutory concept of “disposition”)
- However, there are several exceptions
- Most business and property income is taxable on an accrual basis; mark-to-market for securities of financial institutions; and imputed income from interests in “offshore investment fund property”

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- Proposal: gains and losses on publicly traded securities should be taxed on accrual basis
- Recently surfaced in the United States but restricted to the super-rich
- Carter Commission recommended taxing gains and losses on publicly traded securities every 5 years
- Accepted by 1969 White Paper but then dropped

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- Justification for accrual taxation of publicly traded securities as an exception to realization is convincing
- Accrued gains (losses) increase (decrease) wealth and economic power
- Realization often defended on the basis of problems of valuation, liquidity and impact on investment
- Publicly traded securities are readily valued and, if necessary, taxpayers can sell shares to get funds to pay the tax
- Effect on investment?

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- Proposal is independent of the inclusion rate for capital gains
- Accrual taxation limits the need for relief from inflation and eliminates the lock-in effect of realization, and therefore should improve the efficiency of capital markets

DESIGN ISSUES

- Should apply to all taxpayers (individuals and corporations) and all publicly traded securities
- De minimis threshold exemption for individuals
- Annual accrual, although a longer period may be more acceptable
- Accrued losses should offset accrued and realized gains, with any excess losses carried over in accordance with the existing rules

DESIGN ISSUES

- Relief measures may be necessary for special circumstances
  - for example, publicly traded securities that are thinly traded
  - substantial holdings
  - impact on companies going public
  - transitional relief for the year of implementation
- Anti-avoidance rules will be necessary to prevent avoidance transactions
  - for example, multiplication of the de minimis threshold exemption, the use of derivatives, hybrid securities

CONCLUSION

- Proposal is based on the government’s need for additional revenue to pay for pandemic relief and recovery
- Basic policy question is: what is the best way to raise tax revenue with respect to capital gains?
- Basic political question is: what is the most politically acceptable way to raise revenue?