TAXING CAPITAL GAINS ON AN ACCRUAL BASIS

Capital Gains Tax Reform Roundtable

Brian J. Arnold
Canadian Tax Foundation
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”
TAXING CAPITAL GAINS ON AN ACCRUAL BASIS

• 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?