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Pathways to Reform of Capital Gains Taxation in Canada

Abstract: Recent calls for increased taxation of capital gains in Canada culminated in the 2022 federal budget's announcement of a forthcoming proposal to revise the alternative minimum tax (AMT). This is a timely juncture to review the concentration of capital gains and related forms of investment income among top earners, their concessionary tax treatment, and alternative ways of addressing top-end income inequality. This paper assesses the arguments and claims that have been made both favouring and opposing increased taxation of capital gains and subjects them to conceptual query and empirical evidence. It then investigates a wide range of issues including the equity and efficiency/growth impacts of existing and prospective increases in the capital gains tax inclusion rate. Considerable empirical literature documenting the various channels by which capital gains taxation may affect the efficiency and growth of the economy—diverting savings and capital from productive business investment—has been neglected by both the supporters and the opponents of reform. Moreover, it is essential to consider the corresponding capital gains tax provisions in the US, both to maintain Canada's competitive status and to gain insights into potentially useful reforms.

The key findings of the paper are that: 1) increased taxation of capital gains and related forms of investment income could play an important role in reducing top-end income inequality; 2) the reform should be targeted on high incomes and/or large gains rather than a general increase in the tax inclusion rate; 3) such targeting would relieve large numbers of tax filers with smaller and infrequent gains; and 4) various mitigating reforms should also be adopted to reduce some of the adverse economic impacts and facilitate political and public acceptance. The paper then assesses various structures for targeting the capital gains tax increases using thresholds based on the size of gains and/or income levels of the tax filer. Also considered are AMT reform and a surtax method along the lines of the US Net Investment Income Tax. Among other reforms, the restoration of income averaging for tax could be a useful companion for reasons of equity, efficiency, and public acceptance. The paper concludes that AMT reform may not pose the best approach and that careful further study of the various threshold methods might yield the best prospects for equity and efficiency while effectively reducing top-end inequality.

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Executive Summary

Motivation for the report

In Canada today, only 50 per cent of net capital gains are taxable income. This favourable tax treatment of capital gains is a key contributor to top-tail income inequality, and it can facilitate tax avoidance by high-income taxpayers. For many years, public finance and tax policy experts have proposed various reforms to capital gains taxation, with some calling for lower and others for higher tax rates. Recent publications of the Canadian Tax Foundation have included articles with arguments and evidence on both sides of the debate, with a majority of them advocating an increase in the gains tax inclusion rate, typically to 75 per cent. This report assesses the positions taken in these articles and in the broader literature, finding that both proponents and opponents of reform have missed much of the relevant evidence and that neither side has considered the other conditions needed to make increased taxation of gains possible. I find that a variety of mitigation measures should accompany such reforms to blunt any adverse economic impacts. Targeting the tax increases at those with the largest capital gains would best address top-tail inequalities, while facilitating public acceptance and political palatability.

Recent calls for increased taxation of capital gains in Canada culminated in the 2022 federal budget's announcement of a forthcoming proposal to revise the alternative minimum tax (AMT). The AMT has not been significantly reformed since its introduction in 1986. It now affects fewer than 50,000 taxpayers per year with an average liability of less than $7,000. The AMT is a complex overlay to the ordinary income tax system and — unless radically tightened and simplified — would seem a weak basis for addressing top-end concentration of incomes. This report reviews the arguments and evidence related to increased taxation of capital gains (and other forms of investment income) and presents alternative reform pathways that would be simpler and more effective than AMT reform and more targeted than a broad increase in capital gains taxes. It also addresses both the economic and political barriers to reform.

Capital gains and inequality

Some arguments about a potential increase in taxation of capital gains revolve around fairness or equity. Proponents of a general increase in the inclusion rate for gains argue that all sources of income should be taxed more equally for all taxpayers. Yet, moderate- and middle-income earners already have many vehicles — such as RRSPs, RPPs and TFSAs — for limited amounts of their income to be taxed on a preferential basis, without evoking charges of inequity. Rather, it is the unbounded scope for tax-favoured capital gains accessible to high-earners and wealth-holders that would seem most objectionable. Capital gains are highly concentrated among top earners, as has been shown in annual

statistical data for many years. Opponents of increased taxation of capital gains have argued that much of these gains are received by taxpayers with moderate incomes and irregularly, so that the impact of higher gains taxation if applied across-the-board would be borne widely. Thus, a key question is how concentrated are receipts of capital gains, which requires analysis of longitudinal data to obtain a clear picture.

Recent analyses of longitudinal data confirm that the bulk of capital gains is received recurrently and in very large amounts overwhelmingly by persons at upper and very high incomes. Several examples of the extreme concentration of capital gains at high income levels in Canada can be drawn from this report and elsewhere. As shown in Table 1 (near the end of the report), which covers the ten-year period 2009–18, just 19 per cent of filers reported a taxable capital gain (TCG) of any size in at least one year, and this figure falls to 14 per cent if we exclude only trivial gains (TCGs less than $500 in any year). Thus, nearly one out of five filers reported at least occasional gains over the 10 years, though most received only small and infrequent gains. But they still would have been affected by a general increase in the inclusion rate. Those reporting TCGs in just one or two years constituted nearly 60 per cent of all TCG filers, but they accounted for just one-third of total TCGs. Moreover, total TCGs that filers reported over the 10 years rise from an average of $26,800 for those with gains in a single year by more than 12-fold to $328,000 for those with gains in all years. Those reporting TCGs in four or more of the years accounted for more than 56 per cent of all TCGs over the period.

If we consider shorter time intervals or annual data, the extreme concentration of TCGs and hence of the tax benefits of the partial inclusion provision are even more striking. Michael Smart has estimated that in 2017 alone, of individual filers with incomes under $100,000, nine per cent reported some gains, with an average savings in tax of $1,179 or 16 per cent of the total tax savings, contrasted with those having incomes of $250,000 and up, of whom 52 per cent reported gains, with an average tax savings of $64,063 or 61 per cent of the total tax savings. Using longitudinal data on family incomes for the five-year period 2014-18, Smart and Sobia Jafry estimated that the top one per cent of income groups garnered 41 per cent of the total tax benefits from preferential tax on gains, while the top 10 per cent by income reaped 72 per cent of the total savings. The top one per cent had average annual incomes of $1.5 million or higher and average annual TCGs exceeding $800,000.

The preceding figures illustrate the high concentration of TCGs among relatively few taxpayers and at very high incomes. Targeting an increased tax inclusion rate on gains received in large amounts or by filers with very high incomes would sharply reduce the affected numbers of filers, easing both administration and compliance as well as public acceptance. Nevertheless, the “bunching” of capital

gains received by some filers – through the infrequent sales of assets or in decedent estates – suggests the advisability of companion measures such as allowing carryover of gains for tax purposes relative to the use of an annual threshold (whether based on total income or total TCGs in the year) or else the restoration of income tax averaging provisions. The latter approach would also benefit many self-employed, small businesses and workers in volatile sectors so as to enhance equitable treatment and bolster support for the measure. AMTs in both Canada and the United States offer carryover provisions to address a similar issue.

Capital gains and economic efficiency

Other arguments about increased taxation of capital gains revolve around the potential impact on the economy's efficiency and long-run growth. Opponents of increased taxes have cited several studies suggesting adverse outcomes, while proponents have tended to minimize these findings or discount them entirely. This report provides an extensive review of studies on the estimated or likely impact in areas such as venture capital, startups, tax evasion and avoidance, tax-favoured accounts, lock-in of asset holdings, and diversion of capital or savings via housing investment, corporate activities and donation of appreciated shares. The overall impact of existing and increased capital gains taxes on the economy's efficiency and growth are mixed and not easily quantified. However, contrary to common claims, some of these impacts would be economically favourable, while others that might be economically adverse could be mitigated through appropriate concomitant reforms.

Several examples illustrate the potential positive and negative economic impacts of increased taxation of capital gains. Narrowing the gap between the effective tax rate on gains and that on ordinary income should reduce both the incentive and the incidence of tax avoidance activities. This will improve the efficient allocation of resources while also reducing the waste of time and skills on tax and financial planning. Limiting the extent of avoidance through use of the principal-residence exemption from capital gains tax would reduce the diversion of capital and savings from productive business investment. On the other hand, an increased gains inclusion rate would increase the extent of inefficient lock-in of real properties from their sale for more productive alternative uses and the diversion of appreciated assets from productive investment to charitable contributions. Relatively simple reforms to other provisions (such as the charitable contributions tax credit for top-bracket donors) could neutralize those impacts. Similarly, targeted carve-outs for venture capital and business startups could offset adverse impacts that might arise in those areas.

Competitiveness issues

Remaining competitive with the U.S. is important for Canada because of our extensive business, financial, trade and labour ties. In general, effective tax rates

on capital gains are lower for most taxpayers in most of the U.S. Despite some blatant deficiencies of the capital gains tax system in the U.S., Canada can still learn from American provisions in the areas of like-kind exchanges, limits on deductibility of investment expenses, venture capital and startups, and tax on gains from the sale of principal residences. While the AMT format has been critiqued in both countries as complex and ineffective, the U.S. net investment income tax (NIIT) could serve as a possible model for a Canadian surtax on large capital gains and dividend incomes. Both countries abolished income averaging when income tax rates were flattened in the 1980s and capital gains became taxed more like ordinary income. But a restoration of averaging could be justified with an increased inclusion rate, given the rise in Canada's top marginal tax rates in recent years. This would also widen the appeal of the overall package of tax reforms.

If the tax inclusion rate for capital gains were to be increased on a targeted basis, several alternatives would be feasible. The report first considers a threshold for the higher rate based on the total amount of TCGs reported by the filer in a given year. This approach (like the others to be cited) could be combined with various types of carrybacks or carryforwards or a more general averaging provision. An option would be to allow couples to combine or transfer their threshold amounts, given that the Canadian tax system already offers various channels by which spouses are readily able to split their capital gains and investment incomes (such as interspousal loans). Next considered is a threshold linked to the filer's income; i.e., only capital gains (and possibly dividends) on the portion of income above that threshold would be subjected to the higher tax inclusion rate. This approach is analogous to the surtax format of the US NIIT. A third approach would be an inflation-indexed threshold based on lifetime cumulative gains. Even with a very high threshold, top recipients of capital gains would quickly exceed it and be subject to the increased inclusion rate on all subsequent TCGs received.

A viable pathway

As much as the design and choice of good tax policy should satisfy the criteria of good economics, it is equally vital that it meet the requisites of public acceptance and sound politics. Using a relatively high threshold for the application of an increased tax inclusion rate – thus insulating the great majority of gains recipients from its impact – only modestly reduces the revenue yield while focusing the change on taxpayers perceived as not "paying their fair share." Combined with carryover provisions and the various mitigating provisions, the pathway proposed here should satisfy the needs of broad public acceptance. In fact, Canada's AMT was originally motivated by perceptions (and realities) that some high-income taxpayers were paying relatively little tax through extensive use of tax preferences, including capital gains. The same concern was invoked in the 2022 budget presaging a rework of the AMT. Yet, a complaint against the existing AMT

is that it was crafted to create the political optics that all high-earners were paying some minimum amount, without substantively raising the liabilities of very high-earners.

Both federal and provincial governments have increased their top marginal rates for filers with high incomes but have done comparatively little to tighten up the tax base. Further increases in already high top marginal tax rates – above 50 per cent for taxpayers in most of the country – will be limited in their ability to extract more revenue from high-earners who extensively rely on capital gains, dividends and various strategies that often rely on capital gains. With such a porous tax base, increasing tax rates on high earners will mainly stimulate greater efforts and resources in avoidance strategies. For nearly a decade commencing in 1990, the inclusion rate for capital gains was raised to 75 per cent, without creating discernable adverse impacts on economic performance. Any assessment of the Finance Canada proposals for AMT reform will need to await their release. Only then will we be able to determine whether it is merely polishing up the optics or whether it is a serious attempt to reduce high rates of top-tail income inequality. That will enable us to assess whether proposals of the kinds sketched in this report (summarized in Box 1 at the end of the report) would constitute a superior pathway.

Pathways to Reform of Capital Gains Taxation in Canada

> "There is no ideal capital gains tax. There never has been and there never will be. One hundred years from now, the question of what is the ideal capital gains tax will be debated in this Chamber. There is no ideal income tax because all tax law involves a compromise between competing values. Those competing values carry different weight amongst different members of the population and legislators, and at different times in our history." [Professor Vern Krishna testifying before a Senate Committee of Parliament, 1999][1]

Introduction

Capital gains tax reform has been frequently discussed in recent years and recurrently rumoured in runups to Canadian federal budgets.[2] Typical discourse has focused on an increase in the tax inclusion rate from its existing 50%. Financial and tax advisors have even proffered advice on how taxpayers might prepare for a prospective increase in capital gains tax.[3] Advocacy groups have touted higher capital gains taxes as a way to finance their favoured schemes.[4] In the 2021 election the New Democratic Party of Canada pledged to raise the inclusion rate to 75%,[5] and in the electoral aftermath the NDP lent support to the Liberal government in a supply-and-confidence agreement. Next the 2022 federal budget proposed to stiffen the alternative minimum tax (AMT), illustrated with figures showing the low tax rates paid by some very higher earners when 100% of their realized capital gains and the cash value of dividends were included in income. The government promised to release details on a proposed AMT reform in the Fall economic update, which further delayed the release date to the 2023 budget.[6]

Amidst the cited developments, in late 2021 the Canadian Tax Foundation (CTF) added grist to the dialogue on this topic with 11 pieces in two of its

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[1] From transcript of the Standing Senate Committee on Banking, Trade and Commerce, Ottawa, November 25, 1999; reproduced in Grubel (2000, 132). The following year Canada initiated a two-stage cut to the capital gains inclusion rate from 75% to restore its original 50% value.

[2] The Québec Taxation Review Committee (2015, 258) had recommended 100% tax inclusion for capital gains, with indexation of cost basis for assets held more than one year, to be coordinated with parallel changes by all other taxing jurisdictions in Canada.

[3] For examples, see Golombek (2021) and Ewens et al. (2022).

[4] In one example, the Basic Income Canada Network (2020) advocated raising the tax inclusion rate to 100% as one of many tax increases needed to finance a poverty-level basic income.

[5] New Democratic Party of Canada (2021, 39).

[6] Canada Department of Finance (2022b, 206–07; 2022c, 40).

journals.[7] Most of the authors argued in favour of increasing the tax inclusion rate, while a minority cautioned against raising the tax burden on capital gains. Since these authors include several of Canada's leading tax policy scholars, their evidence and arguments on both sides of the debate provide fertile ground for in-depth policy assessment. I assess the desirability and feasibility of reforms in two main dimensions: 1) the economic impacts in terms of both distribution and economic efficiency/growth; and 2) the public and political acceptance in terms of how many and which taxpayers would be affected. I seek ways of mitigating any adverse economic impacts of increased taxation of capital gains while simultaneously making the reforms more targeted and thus more politically palatable.

My paper proceeds in the following way. I begin by summarizing key positions and claims by both advocates and opponents of higher capital gains taxation. I then assess the issues relating to horizontal and vertical equity. Next, I review the evidence on how capital gains taxes may affect the efficiency and growth of the economy, with a focus on the diversion of savings and capital from productive business investment through various causal channels. Much of the research literature has been neglected by both the advocates and the opponents of capital gains tax reform. I review key differences between Canadian and US tax treatment of capital gains, which is an essential prelude to identifying reforms that would be both desirable and feasible. I then consider long-standing issues for the design of capital gains taxes. With that background, I assess the comparative merits of a broad increase in the inclusion rate versus raising the inclusion rate only for gains above specified thresholds (based on total income or the size of gains). Other approaches that I consider are revisions to Canada's existing AMT (a form of which the US also operates) and the surtax structure of the US Net Investment Income Tax (NIIT). Finally, I assess issues of political and public acceptance related to the various reform approaches.

The essential findings and recommendations of this paper are: 1) that increased taxation of capital gains is warranted in Canada if one places priority on taming income inequality at the top; 2) that the higher burden should be

[7] Four full-length studies appeared in "Policy Forum: The Rate of Taxation on Capital Gains," *Canadian Tax Journal* 69(4):1151–1250 (2021), followed by seven shorter articles in *Perspectives on Tax Law & Policy* 2(3), (September 2021). Also see Arnold (2022).

targeted on taxpayers with large recurrent gains and high incomes; and 3) that the reforms should pay heed to mitigating tax measures both for minimizing adverse economic impacts in Canada and minding our economic competitiveness vis-à-vis the US. Attention to all these considerations will optimize the prospects of surmounting the economic and political hurdles to reform of capital gains tax treatment. This paper explores alternative pathways to reforming Canadian taxation of capital gains that would address the varied barriers to effective, efficient, and sustainable outcomes and sets the ground for further policy analysis.

Before proceeding, I offer two prefatory notes. First, one cannot talk sensibly about the reform of capital gains taxation without also addressing a variety of interlinked matters. These include, among others, dividend taxation, the deductibility of investment expenses, employee stock options, principal residences, and alternative minimum taxes. Second, I shall use the term "effective tax rate" on capital gains to mean the product of an individual's marginal tax rate on ordinary income multiplied by the gains inclusion rate. This represents the tax rate on assets sold or disposed of in a given year and is thus the rate on *realized* gains. However, it must be noted that this figure fails to account for the deferral of tax on assets held for longer than one year before being sold, which further reduces their *true* effective tax rate relative to an accrual-based income tax.[8]

The Opposing Positions

The economists and analysts advocating an increase in the tax inclusion rate, most typically to 75%,[9] present their arguments in terms of the following benefits:

- An improvement in horizontal equity, in the sense that dollars of gains would be taxed more on par with the full taxation of most other forms of income
- An improvement in vertical equity, to the extent that capital gains are received disproportionately by taxpayers at higher incomes

[8] This adjustment requires multiplying the effective tax rate by the proportion of accruals that are actually realized in the year, which is the measure introduced by Bailey (1969, 46–49) in his pioneering early study of capital gains taxation.

[9] Smart and Jafry (2021) alone among this group propose an inclusion rate of 80%.

- An increase in tax revenues that could be used for various purposes[10]
- Little adverse impacts on the efficiency or growth of the real economy
- Improved neutrality in the treatment of income from corporations
- Reduced effort at and resources wasted on tax avoidance activities

Little attention is paid to public acceptance of this prospective reform. Almost all the advocates support an across-the-board increase in the tax inclusion rate,[11] which would ensnare numerous taxpayers at lower and middle incomes as well as the wealthy.

The tax policy analysts arguing against any increased taxation of capital gains typically pose the following concerns:

- The vertical equity and redistributive impact would be reduced because much capital gains are received infrequently by persons whose other sources of income are moderate or low
- Horizontal equity would be further compromised on account of the high variability of a taxpayer's annual receipt of gains, given the lack of provision for income averaging with the progressive tax rate schedule
- Potentially significant adverse impacts on the efficiency and growth of the real economy would arise, and these effects are still poorly understood[12]
- Investors would feel increasingly "locked-in" to their existing holdings, thus inhibiting efficient exchanges and transfers of assets
- The resultant additional revenues generated would be reduced by taxpayer responses and would be limited sums relative to total tax revenues
- Capital gains tax in Canada cannot get far out of line with US rates and practices, given the high degree of economic and financial integration

This last point of concern raised by opponents of reform is paid scant heed by proponents of reform. Like the advocates for change, the opponents have little of

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[10] None of the cited advocates suggests that the increased revenues be utilized to reduce the tax burden on labour-type incomes, an approach that could enhance public acceptance.

[11] Among the cited papers, only Minas et al. (2021) propose the provision of relief for small capital gains receipts via a non-cumulative annual exempt amount, which they suggest could facilitate raising the gains inclusion rate to 100%.

[12] For example, Strawson (2021, 5) asserts that "There are relatively few studies on the economic implications of increasing the capital gains tax rate, particularly in the context of Canada."

substance to say about the public acceptance or political feasibility of increased tax on capital gains.

Equity Dimensions

Horizontal equity

One basis for advocacy of fuller taxation of capital gains is that the entire amount of any realized gain constitutes income and thus should be taxed like any other income.[13] That is, treating taxpayers fairly requires that we properly measure their comparative ability to pay, which in an income-based tax means that all income counts equally. Yet, the Canadian personal "income" tax system is in fact a messy mélange of income-type and consumption-type components. The latter include registered pensions plans (RPPs), Registered Retirement Savings Plans (RRSPs), and Tax-Free Savings Accounts (TFSAs). All those provisions are departures from an income base, but still they are widely used and accepted without complaint that they are "unfair." The reason for this may stem from their accessibility to all taxpayers, their linkage to earned income, and their dollar ceilings on contributions. In contrast, capital gains outside of registered accounts enjoy favourable tax treatment but without any ceiling on the amounts of investible funds that are allowed, thus enabling extremely large amounts to accumulate with deferral and then only half the gain becomes taxable. Given the acceptance of limited amounts of tax-preferred savings in RPPs, RRSPs, and TFSAs, one might imagine that limited amounts of tax-favoured capital gains would be deemed offensive only within a rigid view of horizontal equity.

The cited provisions allow for extensive tax sheltering of capital gains and other capital incomes relative to a comprehensive income base. Reportedly, 90% of Canadians could shelter all their capital income if they fully utilized existing provisions, and 70% of all capital income received by Canadians could be sheltered.[14] The Canada Department of Finance provides projections of the federal revenues lost in 2023 due to each of these provisions.[15] The largest by far are the revenue costs of RPPs and RRSPs, at $33.0 billion and $18.4 billion, respectively. As a relative newcomer, the TFSA has a projected federal revenue

[13] For now, I ignore the part of the gain that is purely inflation, an issue to which I later return.
[14] These figures are cited in Boadway (2019, 648), who draws on Milligan (2012) and others.
[15] Canada Department of Finance (2022a).

cost of $2.2 billion for 2023 but is the fastest growing in cost (more than doubling since 2019). In contrast, the partial inclusion of capital gains is projected to cost $10.8 billion for personal tax, closely followed by the full exemption from capital gains tax on the sale of principal residences (the PRE) at $10.1 billion.[16]

Another dimension of fair tax treatment of individuals with progressive tax rates relates to comparison of their incomes across time. If two persons have the same total income over a given period, one should not be penalized for having a more variable year-to-year pattern. Without a provision for income averaging, the one with more volatile income receipts will bear a higher tax liability. This outcome would be horizontally inequitable, and it also creates disincentives for entering riskier occupations and ventures. Because capital gains are the most variable and lumpy of income receipts, they are one of the largest contributors to the tax penalty from the absence of averaging in the Canadian tax.[17] The ability to carry back capital losses facilitates averaging to a modest degree but falls far short of full income averaging. In any prospective reform with a higher inclusion rate on gains above a specified threshold, horizontal equity would require carryover provisions. Otherwise, a more general income-averaging provision would be needed.

Vertical equity

Analysis of the vertical distribution of capital gains receipt and the associated tax benefits from partial inclusion has been undertaken in various ways. Annual data shows taxable capital gains to be the income component most extremely concentrated at the very highest income quantiles.[18] One method popular particularly with market-oriented analysts in Canada has been to compare annual data on capital gains receipts across incomes both including and

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[16] Note that the PRE's revenue costing is based on the differential between a 0% versus 100% inclusion, while the costing for capital gains on other assets is based on 50% versus 100%.

[17] Gordon and Wen (2017, 17) find that "Those who experienced capital gains are … predominant among the top percentile of [tax] penalty-payers" [due to the lack of averaging].

[18] For example, based on 2011 individual tax data the shares of total net capital gains going to the top 1% and 0.01% by income were 61.8% and 13.4%, respectively, and their respective shares of the total benefit from partial inclusion were 70.8% and 15.5%. The top 1% garnered $2.55 billion of tax savings from the tax preference for capital gains and an additional $1.73 billion (nearly half the total) in tax benefits from the tax treatment of corporate dividends. The top 1% also garnered 80% of the total tax benefits for the LCGE on small business and 100% for the employee stock options deduction. Murphy et al. (2015, 668) and corrections graciously provided by Mike Veall.

excluding the capital gains.[19] This approach finds that taxpayers with lower and middle incomes when classified excluding their capital gains are assigned a higher proportion of total gains than when they are classified by their total incomes including gains. However, this method is misleading in assuming that non-gains income is a good measure of usual or permanent income. For example, a high wealth retiree or active investor with little non-gains income could have large ongoing gains income; they would be misclassified with the low-income group. Longitudinal data are needed to resolve this matter, as has been done in several recent studies. Their findings confirm the very high concentration of recurrent gains at top incomes as well as the large numbers at lower incomes receiving much smaller gains infrequently.[20]

Those opposed to a general increase in the tax inclusion rate for capital gains have noted that large numbers of taxpayers who receive gains only infrequently and in limited amounts would be impacted. Table 1 offers analysis of longitudinal data for the ten-year period 2009–2018 that assists in assessing that matter and also in explicating its full implications for policy reform.[21] Of the 33.5 million distinct tax filers covered in this period, 80.7% never reported a taxable capital gain (TCG), and if those reporting only trivial gains (less than $500 in any of those years) are excluded the rate rises to 85.9%. Thus, nearly one out of five tax filers reported at least occasional gains over this period, though many reported only very small gains, and excluding those who never reported a gain over $500 in any year, the incidence is still one out of seven.

Despite the many taxpayers reporting infrequent capital gains, most TCGs are concentrated among filers at higher incomes, who report them repeatedly and in much larger amounts.[22] As shown in Table 1, the average total income for

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[19] An early example of this method is Grubel (2000, 36–39), who noted the need for longitudinal data to resolve the matter. Despite the availability of the Longitudinal Administrative Databank for certified researchers for more than a decade, use of the outdated method persists, as in studies by Thivierge and Laurin (2017), Whalen and Clemens (2021), and Laurin (2021).

[20] See the five-year average gains patterns by average family income in Smart and Jafry (2021, 1160, 1163) and the ten-year average patterns in Gagné-Dubé et al. (2021, 1189, 1192).

[21] This table was constructed from special extractions provided by the authors of Gagné-Dubé et al. (2021) and is a corrected/extended version of their original Table 4A; see my table for details.

[22] Milligan (2022) reports on the large role of capital gains and dividends in top-end incomes. Roine, and Waldenström (2012) similarly find that recurrent receipt of capital gains are a major contributor to top-end inequality in Sweden but are not significant at lower incomes. Corlett et al. (2020) report that taxable capital gains are an important and increasing part of UK top incomes.

those reporting no (or trivial) TCGs is $32,500 versus $85,900 for those with more than non-trivial TCGs in any of those years. The average income of $62,800 for those with TCGs in a single year more than triples to $228,500 for those with TCGs in all ten years. Those reporting TCGs in one or two years constituted nearly 60% of all TCG filers, but they accounted for just one-third of aggregate TCGs. Moreover, the total TCGs that filers reported over the ten years rises from an average $26,800 for those with a single year by more than 12-fold to $328,300 for those with gains in all years. Those reporting TCGs in four or more years accounted for more than half (56.4%) of all TCGs over the entire period.

These findings support the view that large numbers of taxpayers receive TCGs, albeit for most of them it is an infrequent event and in limited amounts. Thus, a general increase in the tax inclusion rate would affect many taxpayers in occasional years. But this does not constitute an argument against increased taxation of capital gains received with greater regularity and in larger amounts by taxpayers at much higher incomes. Applying an increased inclusion rate to capital gains but only above a threshold (based on total income or capital gains) would be effective in reducing top-end inequality while sparing the great majority of TCG recipients from any additional burdens. It would also capture most of the potential additional revenue given the concentration of gains among higher-income taxpayers in upper tax brackets. This approach could deal with issues of public acceptance, political feasibility, and sustainability of reform. Alternative designs for the structure of such a targeted tax increase on gains are explored later in this study.

Economic Efficiency and Growth Impacts

How adequate is existing evidence?

I earlier noted our limited understanding of the broader and long-run impacts of higher capital gains taxation on the Canadian economy, cited in ominous but vague terms by opponents of such reforms. Yet, empirical research cited in the papers by proponents of higher gains taxation also misses or minimizes many channels for potential economic impacts. For example, much study has been devoted to measuring the responsiveness of gains realizations to the tax rate, which is useful in projecting the short-run revenue impacts. However,

far less effort has been devoted to assessing the long-run impacts of higher capital gains taxes on the diversion of capital from productive investment.[23] Those effects will exert far more important impacts on economic growth—and hence on the total resultant long-run revenue impacts arising through all types of taxes. Similarly, the finding of little aggregate savings responsiveness to the net-of-tax rate of return on capital tells us nothing about impacts on the savings, financing sources, and incentives pertinent to startup and innovative enterprises. One contributor to the CTF studies who supports increased capital gains taxation surmises after reviewing the literature:[24]

> [T]he evidence base is still rather underdeveloped, and for now there is not enough breadth of evidence for strong conclusions to be drawn. I would therefore not support the view that the evidence is settled and that there are few negative consequences to taxing gains at a higher rate.

Many questions about the long-run economic impacts of heavier tax on capital gains remain unanswered—and often unasked. For example, how would it affect Canada as an attractive place for high-tech business startups, venture capital, and generally growing a business? How would it affect Canada's ability to attract skilled immigrants as well as our ability to retain top talent in the entrepreneurial, managerial, technical, inventive, professional, and creative realms? How would higher capital gains taxes affect the siting in Canada of head offices and the related R&D, marketing activities, and employment? Would there be added inflationary impacts on housing if capital gains tax were raised on financial assets but the gains on principal residences were to remain tax exempt? And how would that affect Canada's appeal for immigrants, head offices, and urban growth centres? What are the impacts on domestic versus foreign siting of branch expansions and of the taxable venue of intellectual property? The list of unanswered questions goes on and on.[25] Here I review the research literature and posit some further behavioural issues, with a focus on how increased capital gains tax might divert savings and capital from productive investment in the

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[23] See Globerman and Emes (2021) for documentation about Canada's low rates of gross fixed capital formation as a share of GDP since 2010, particularly in the critical areas of machinery, equipment, and intellectual property, relative to the US and other countries.

[24] Advani (2021, 1242–43).

[25] Grubel (2000) and Mintz and Wilson (2000) posited some of the behavioural impacts of capital gains taxation in Canada prior to the reduction in the gains tax inclusion rate in 2000.

business sector.

Startups, venture capital, employee stock options

The creation and success of startup firms with innovative products, processes, and/or business models is critical to an economy's long-run growth and the generation of higher-paying jobs.[26] Capital gains taxation plays an important role at all three points in the process of initiating, financing (including seed capital and second- and third-round funding), and nurturing startups. First, potential entrepreneurs with an innovation will be motivated by the returns to their exit strategy, either by selling their enterprise or through an initial public offering. The rate of capital gains tax affects these prospective returns and thus the decision of whether to launch a firm and, if so, the performance incentives. Second, given the paucity of conventional funding sources for startups, they are highly dependent on venture capital (VC) firms, which provide not only funding but also monitoring, industry and personal connections, and managerial expertise. The supply of venture capital and the quality of oversight by VC partners is similarly influenced by capital gains taxes. Third, the ability of a startup to attract and retain highly skilled and specialized talent depends on drawing them from employment with mature firms, and this is typically assisted by the provision of stock options that benefit from capital gains tax treatment. Theoretical economic analysis confirms the adverse effects of higher capital gains taxes on these behaviours and on the creation and success of startup enterprises.[27]

Empirical and quantitative analysis of the impacts of capital gains taxation on startups and venture capital confirms the theoretical predictions and adds interesting twists.[28] An early study of the relation between capital gains tax and startups observed that the multi-year deferral to the entrepreneur's cashing out attenuates the present value of the tax bite. It also observed that the supply of funds from VC firms is affected mainly by corporate taxation and less so by

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[26] See Baumol et al. (2007) for the concept of "entrepreneurial capitalism" and the salience of innovative new enterprises to an economy's vitality and long-run growth.

[27] Keuschnigg and Nielsen (2014a; 2014b). These analyses find that reduced tax on capital gains is more effective than subsidies to startups, since only the former improves incentives for entrepreneurial effort and VC involvement.

[28] It is noteworthy that of all the CTF papers only Advani (2021) refers even obliquely to the potential impact of higher capital gains taxes on startup enterprises or venture capital funding.

capital gains tax at the individual level.[29] A panel study of 14 European countries for 1988–2001 found that a lower corporate capital gains tax rate increased the "innovation ratio"—the share of VC investment in early-stage high-tech enterprises.[30] Perhaps most revealing, a study of data from 32 countries focused on the decisions of individual venture capitalists to test their ability to assess the success of prospective investments. It found that a higher capital gains tax rate reduced their total number of investments but that the ultimate success rate for supported ventures increased, which confirmed that their decreased outlays focused on the best prospects. That study suggested that a decrease of five percentage points in the capital gains tax in the US would be associated with a 16.4% increase in the number of startups.[31]

Capital diversion to housing

For the majority of Canadians who are homeowners, a strong tax advantage to investing savings in their home stems from the principal residence exemption (PRE).[32] Combined with the absence of capital gains tax, the high leverage from mortgage finance at low secured rates (relative to other investments or margin loans), the untaxed savings on rent for accommodation, and the secular appreciation of home values, these factors pose a powerful incentive for home ownership. For all the cited reasons, most families find their owned residence to be the largest part of their total wealth apart from any pension entitlements, and this is often the case even well up the income scale.[33] For all these reasons, Canada devotes an unusually large share of all capital formation to housing, likely diverting savings from productive business investment.[34] With an unchanged PRE, an increase in the tax inclusion rate for

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[29] Poterba (1989). Subsequent empirical studies based on US experience include Gentry (2016) and Edwards and Todtenhaupt (2020), which find adverse impacts from capital gains taxation, and Weisbach (2017), which finds adverse impacts via feedbacks to corporate investment.

[30] Da Rin et al. (2006).

[31] Bock and Watzinger (2019).

[32] The Carter Commission had recommended that owner-occupied homes be subject to full tax on gains beyond a lifetime exemption of $20,000 per person (about $190,000 in current dollars), but this proposal was rejected in the following White Paper and the actual reform legislation.

[33] In the US, the estimated share of total housing wealth was most concentrated in the top 98% to 99.9% of individuals by income in 2016 (Smith et al. 2021, 69, Figure 12E).

[34] Globerman and Emes (2021, 8 and 11). They also remark, "It is possible that the relatively favourable treatment of capital gains on owner-occupied dwellings compared to the treatment of

unsheltered capital gains would further divert savings from productive capital into the excessive purchase, renovation, and resale of homes, which in turn would reduce the revenues from capital gains tax.[35]

One might anticipate a further round of impacts from increasing the relative tax attraction for individuals and families to put incremental savings into spending on their principal residence rather than investing in businesses either directly or through public equity markets. As noted, such a change would add to pressures for escalation of home prices and therefore purchasers' needs to finance them. The added demand for mortgage borrowing would be readily accommodated by financial institutions, for whom this holds attractions on account of the high collateral value of dwellings and the insurability of mortgages. In the process, this will further constrain lenders' ability and inclination to finance much riskier business startups and expansion of early-stage businesses, which have little ability to tap equity markets and are highly dependent on bank borrowing.

Capital diversion to tax-favoured accounts

Raising the tax inclusion rate for realized capital gains can be expected to induce some individuals to divert more of their financial investments to tax-favoured accounts that either leave gains fully untaxed (TFSAs) or provide potentially very long tax deferral (RRSPs and RPPs). The aggregate amounts of unutilized contribution room for these types of accounts is very large, and an across-the board increase in the capital gains tax rate would induce some shift of funds from taxable accounts to tax-favoured ones. However, the taxpayers who would be most affected by a targeted increase in capital gains tax are at higher income and wealth levels, and they are the ones who already more fully exploit their contribution limits to tax-favoured accounts. Moreover, holdings in TFSA, RPPs, and RRSPs are generally restricted to securities traded on public markets, so that the funds will flow to domestic and foreign corporate coffers similar to non-sheltered savings. Thus, this channel would seem unlikely to divert much incremental funds away from productive investment in Canadian industry.

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capital gains on business-related investments is contributing to the changing distribution of investment across asset categories." (14)

[35] Woolley (2021) addresses possible reforms to the PRE, and other CTF studies refer to the issue, but none of them notes the increased distortions if the PRE is not also reformed.

Capital diversion via tax evasion

Capital gains are among several types of income (along with self-employment) that are significantly underreported to the tax authorities.[36] The incentive and proclivity to evade income tax is directly related to the relevant tax rate, so any hike to the effective rate on capital gains would be expected to increase evasion. A substantial response of capital gains evasion to tax rates has been estimated using US data, with a finding of major problem areas including securities and real estate.[37] However, in recent years both Canada and the United States have tightened the requirements for financial and other institutions to report the proceeds and cost bases for sales of securities and real property, thus mitigating these problem areas.

In contrast, there remains little or no information reporting on the sales of other assets generating capital gains, and the tax authorities are very limited in their ability to detect, monitor, or assess these gains. Prime examples include private sales of fine art, precious metals, antiques, collectibles, and foreign real estate (which can serve as a repository for the preceding items). Even securities holdings and foreign business activities can be concealed with the assistance of tax havens. Wealthy persons subject to an increased inclusion rate on taxable gains would have an incentive to shift more resources into these magnets for evasion, thereby diverting capital from productive investment in Canadian industry. Higher tax rates on capital gains from domestic securities could also result in greater wealth shifts to foreign tax havens.

Capital gains and tax avoidance

While increased taxation of capital gains will tend to increase evasion, it is at the same time likely to dampen legal tax avoidance and yield generally salutary economic results. Many current complex and roundabout schemes exploit the tax savings from the 50% inclusion rate for gains (along with tax deferral on accruing gains). Raising the inclusion rate to 75%, for example, would reduce the tax savings from this type of avoidance by half, and this dampened

[36] The US Internal Revenue Service (2019, 20) estimated that 23% of capital gains incomes were non-reported versus only about 1% for wages, salaries, and tips and 51% of rents and royalties; comparable estimates for Canada are not available.

[37] Poterba (1987a; 1987b), who reported that 40.7% of realized gains went unreported in the US in 1981. This figure inevitably undercounted gains on tangible items of the kinds listed in the text.

incentive would be expected to reduce the use of various legal tax avoidance practices. That, in turn would yield real savings from the reduction in resources now devoted to tax planning via tax accountants, tax lawyers, and financial advisors. Moreover, many of these avoidance manoeuvres further divert real resources to particular industries, subsectors, uses, and financial structures that reduce the efficient allocation of the economy's capital, and these economic losses would be reduced. In short, there exist some channels whereby increased gains taxation would yield economic benefits, though the magnitude of this effect is completely unknown.

Lock-in of asset holdings

The "lock-in" of asset holdings on account of taxing capital gains only when they are realized is cited in several of the CTF papers and is a classic argument by opponents of increased tax rates. Some proposals for reforming capital gains tax have suggested remedies such as annual accrual taxation or taxing at realization with a penalty rate applied to offset the benefits of deferral.[38] Without resorting to those complexities, I would suggest a different perspective. The inefficiency of lock-in for individual investors holding financial assets arises when their portfolios become unbalanced due to a few holdings that have risen sharply but are retained despite the existence of more promising alternatives. However, with an active market for securities, this does not constitute inefficiency for the real economy, since each security will be valued in the market by all investors. Moreover, corporate shares represent capital assets that are already fixed and not malleable. Nevertheless lock-in for lumpy tangible assets such as a business, building, or plot of land for which a prospective buyer could make more productive use does pose true economic inefficiency. In those cases, the provision of a tax rollover (tax deferral) for like-kind exchanges makes sense, which Canada now permits only in limited areas.

Capital diversion to charitable giving

Capital gains on appreciated publicly listed securities are granted a zero inclusion rate if they are donated to charities and meet certain conditions.[39] Moreover, such gifts qualify for federal credits at a 33% rate for donors who are in

[38] See Helliwell (1969), Auerbach (1991), and Arnold (2022).

[39] For details on the tax treatment of charitable contributions (including donations of appreciated assets), see Canada Revenue Agency, "Gifts and Income Tax 2021," P113(E) Rev. 21.

the top tax bracket, and many such donors have wealth in the form of appreciated assets. This group is also a focus of policy interest because they constitute the group making the largest donations. An estimated 35% of the total 2011 federal tax benefits from the zero inclusion rate went to the top 1% of filers by income.[40] Charitable donations also qualify for provincial tax credits at rates that vary by province but rise above 20% for several provinces.[41] In short, donating appreciated securities benefits donors both by tax exemption on the embedded gains and by receipt of the federal and provincial tax credits. Together these provisions pose a strong incentive for donating appreciated properties, and increasing the inclusion rate for realized capital gains on non-donated property would augment this incentive and thereby reduce federal and provincial revenues. It would also likely divert capital away from productive investments in the business sector.

To assess how an increased inclusion rate for capital gains would affect the net incentive for donating (versus selling and paying tax on) appreciated assets, illustrative calculations are informative. Here I assume that the donor is in the top tax bracket for federal plus provincial taxes, at a rate of 53% that prevails in the three most populous provinces. I take the credit rate of 20% for top-bracket donors found in some provinces, yielding a total credit rate also equal to 53%. Table 2 presents the calculated net cost to such a donor for making tax-eligible donations of appreciated assets. The table shows results for inclusion rates ranging from the current 50% to 75% or 100% and for various ratios of asset value to cost basis (X). With the 50% inclusion rate, the net cost ranges from 33.8% to 20.5% hinging on how much of the asset value is accrued gain. Next considering an asset with X = 10, the table shows that the net cost of donating is currently about 23 cents on the dollar but falls by more than half to 11 cents if the inclusion rate were increased to 75%.[42] Clearly, raising the inclusion rate could sharply increase incentives for donating highly appreciated assets, cutting into

[40] Murphy et al. (2015, 676).

[41] The provincial credit rates are tabulated in http://www.taxtips.ca/filing/donations/tax-credit-rates-2021.htm. Alberta, British Columbia, Nova Scotia, and Quebec all have top credit rates exceeding 20%. There are also limits on donations eligible for the credits, such as 75% of donor's net income for the year, but these limits do not constrain the zero inclusion rate for capital gains.

[42] With an inclusion rate of 100%, the net cost of donating highly appreciated assets would turn negative—the donor would actually be better off by donating than selling the asset.

revenues. This finding is not an argument *per se* against raising the inclusion rate for wealthy taxpayers, but it could be a reason to simultaneously reduce the top federal charitable tax credit rate.

Distortions and avoidance via corporations

One critique of current tax provisions is that they bias how corporations reward their shareholders, in ways that unduly favour those with high wealth who own the most corporate equity. The Canadian dividend tax credit (DTC) provision was intended to integrate the corporate and personal tax systems such that tax paid at the corporate level and embedded in dividends did not bear tax again in the shareholders' hands. However, the provisions have fallen out of balance such that shareholders at higher income levels will typically prefer that the company retain earnings and use them either to buy back shares or to reinvest the funds, so that shareholders can reap their returns via tax-favoured capital gains. Moreover, Canadian Controlled Private Corporation (CCPC) owners have been able to use surplus stripping to access the Lifetime Capital Gains Exemption to obtain further tax relief for themselves and related persons who are shareholders.[43] Some analysts have cited this bias as a primary reason to increase the capital gains inclusion rate and calibrated the proposed requisite rate to offset the existing bias.[44]

Overall impact on the economy

The overall impact of existing and increased capital gains taxes on the economy's efficiency and growth are mixed and not easily quantified. When the gains inclusion rate was raised to 75% in 1990 for nearly a decade, adverse economic impacts were not observed, though this is at best weak evidence. Contrary to common claims about higher taxes on gains, some impacts would be economically favourable, and others that might be adverse could be mitigated through appropriate concomitant reforms. For example, narrowing the gap between the effective tax rate on gains and that on ordinary income should reduce the incentive and incidence of tax avoidance activities. This will improve the efficient allocation of resources while also reducing the waste of time and skills on tax and financial planning. Setting an upper limit on access to the PRE

[43] See Lanthier (2021b; 2021c).

[44] For examples, see Smart (2021) and Smart and Jafry (2021).

would reduce the diversion of capital and savings from productive business investment. On the other hand, an increased gains inclusion rate would increase the extent of inefficient lock-in of real properties from their sale for more productive alternative uses and the diversion of appreciated assets from productive investment to charitable contributions. Relatively simple reforms to other provisions could neutralize those impacts.

Estimating potential revenue gains

Estimates have been made for the revenue gains from raising the capital gains inclusion rate for personal and corporate income taxes. Static estimates of the additional revenues for 2017 assuming no response to a shift to a 75% inclusion rate are clearly substantial at $7.8 billion for federal plus provincial personal taxes plus another $8 billion for federal plus provincial corporate taxes for an annual total of $15.8 billion, or 4.7% of total federal plus provincial income tax revenues.[45] However, based on various empirical studies of how the realization of gains is influenced by the tax rate, these static estimates are almost certainly overstated. Using a range of estimates of the elasticities of response, one study finds that raising the inclusion rate for personal tax on capital gains in Canada to 75% could reduce the forecast revenue gains by as much as two-thirds of the static model forecasts though likely less.[46] Estimates for the response of capital gains realizations to a higher tax inclusion rate applied to corporations are not available.

Estimating the slippage of revenue forecasts from the naïve modeling does not end with an analysis based on elasticity estimates, which do not embody many responses that would be expected to emerge over the longer run. I have cited a variety of potential responses, each of which could further reduce revenue yields: greater diversion of personal savings into principal residences; greater charitable donations of appreciated assets; and reduced investment in startups. On top of all this would be heightened incentives for personal investments in artworks, other tangibles, and overseas real estate and assets that are particularly difficult for the tax authorities to detect and pursue. Moreover, to the extent that higher taxation of capital gains evokes the effects adverse to

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[45] Smart (2021b, 8).

[46] Laurin (2021).

economic growth canvassed earlier, the feedbacks reducing tax revenues of all kinds could be significant. In short, a great deal of uncertainty attaches to any estimate of the long-run revenue impacts, and it is possible that the net revenue impact would even be negative unless appropriate mitigating measures were to accompany the reform.

Comparative US-Canada Policies

Given the high degree of business and financial integration, as well as the cross-border mobility of skilled labour, capital, and intellectual property, Canada must pay close heed to US policies in undertaking capital gains tax reform. Moreover, we should be open to points on which American tax policy has innately positive features from which Canadian policy can usefully learn.[47] An abbreviated summary and comparison of capital gains tax policies in the two countries is not merely a useful, but an essential foundation for assessing the path forward for Canadian reforms.[48]

Capital gains tax precedents

The US has included capital gains in taxable income since inception of its federal income tax in 1913. Realized gains were fully taxable with no preference until 1921, when a distinction was drawn between short-term gains (which remained fully taxable) and long-term gains (which were taxed at lower rates). Over its history, the dividing line between short- and long-term gains has altered, and the method of advantaging long-term gains has shifted among a lower flat rate, percentage exclusion rates (sometimes based on the holding period), and schedular rates based on the taxpayer's ordinary tax rate bracket. For a period following the Tax Reform Act of 1986, with its sharp reduction in the top federal tax rate, the holding-period distinction was eliminated and all gains became fully taxable. From the tax's outset, accrued gains on assets held at death escaped all tax by a "basis step-up" provision, a major omission that remains in place to this date. The US does apply estate or inheritance taxes at the federal level and in 17 states.

Canada was a comparative latecomer to taxing capital gains (aside from

[47] For commentary on desirable reforms of US capital gains tax policies based on elements of Canadian tax policy, see Kesselman (2005a; 2005b).

[48] For a more detailed comparative chronology of capital gains and related tax policy evolution in the US and Canada, and references to source materials, see Kesselman (2022).

gains on trade in business), with no such tax from inception in 1917 until the sweeping tax reform of 1972. Based on various political and economic considerations, including the US gains rate at the time, the initial treatment was a 50% tax inclusion rate for gains with no distinction based on holding periods. A crucial component in the 1972 reform was the use of a valuation date for assets, whereby previous accrued gains were exempt from tax. Another concession was abolition of the federal estate tax, a field that the provinces also soon vacated. The tax inclusion rate for capital gains has remained at 50% for most of the subsequent period except for 1988 to 2000 when it was raised to as high as 75% before reverting to 50%. The increased inclusion rate following 1988 was partially offset by a flattening of the ordinary tax rate schedule similar to what had occurred in the US. Thus, Canada has always used a proportionate inclusion rate and never applied a distinction based on asset holding periods. Canada also deems accrued gains to be realized and taxable when an individual emigrates and loses their Canadian tax residence status.[49]

Current effective tax rates on gains

Since 1997 the US federal tax on long-term capital gains has applied a separate rate schedule tied to a taxpayer's ordinary rate bracket. The rates on long-term gains for 2023 are 0%, 15%, and 20%, which apply for taxable income up to US$89,250, up to US$553,850, and above US$553,850, respectively, for married joint filers (and smaller income ranges for single filers).[50] Each of these rates is lower than that on ordinary income, which top out at 37%. To qualify for long-term tax treatment, an asset must be held for more than one year; otherwise, it is taxed as ordinary income. In addition, most states also tax capital gains but at full rates regardless of holding period; a few states have top rates between 10% and 13%; most are 5% or less; nine states tax long-term gains at concessionary rates; and eight states impose no income tax. Beginning in 2013 the US also instituted a Net Investment Income Tax (NIIT), which is a surtax at a flat rate of 3.8%. NIIT applies fully to both short- and long-term capital gains, dividends, interest, and rental incomes to the extent that they exceed a

[49] In contrast, the US continues to tax its citizens on their world income, which ends only if they relinquish their US citizenship, in which case part of their accrued gains may become taxable.

[50] Between mid-1998 and 2007, the schedule of long-term gains rates for those in the 15% tax bracket had additional 5% and 10% steps before these rates were reduced to 0% in 2008.

US$250,000 income threshold for married joint filers (US$200,000 for single filers).[51] Thus, the total top tax rate on long-term gains is the federal 23.8% plus any applicable state-level tax.

The Canadian tax treatment of realized capital gains is a relatively simple 50% inclusion rate relative to ordinary income, with no distinction based on asset holding period. In 2023 the top bracket rate for federal tax on ordinary incomes is 33% for taxable incomes above $235,675, and adding the top provincial tax rates in the three most populous provinces the total top rate is 53.5%. Thus, the top effective tax rate on capital gains is 26.75%, which applies to a minority of gains recipients but applies to a large share of aggregate capital gains given their concentration. Canada has no equivalent to the 0% and 15% rates applicable to long-term gains for US earners up to very high incomes, and accrued gains on assets held at death are deemed to be realized for tax.[52] Most Canadians receiving gains are taxed at higher effective rates than most Americans except for those whose gains are mainly short-term and residing in higher-tax states.

Although comparison of Canada's top capital gains tax rate with that of the US is most relevant, comparisons with those in the other 36 OECD countries are revealing.[53] Nine of those countries have a zero rate of tax on capital gains.[54] The mean top rate for this group is 19.1% and the median is 20.3% (for Japan), which Canada already substantially exceeds. The maximum top rates are in Chile (at 40.00%) and Denmark (at 42.00%). If Canada's gains tax inclusion rate were raised to the 75% or 80% as mooted by some advocates,[55] the effective top rate would rise to 40.1% or 42.8%, respectively. The former figure is just above the Chilean top rate, and the latter would place Canada above the top rate in any other OECD country, namely high-taxing Denmark. Canada's top rate on gains would also be twice the mean and median values for the OECD.

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[51] The NIIT was instituted to help finance the Obama medicare expansion; for Canada-US dual citizens who are tax-resident in Canada, the NIIT is not eligible for the foreign tax credit as it was legislated outside the US income tax act and is not covered by the countries' tax treaty.

[52] Despite the taxation of accrued gains at death (apart from rollovers to a surviving spouse), a variety of tax manoeuvres such as estate freezes, trusts, and other devices can blunt the impact.

[53] Source of the data is Bunn and Asen (2021, 9); the present writer undertook calculations for the mean and median rates using their data.

[54] See the studies in Grubel (2001) on several countries that impose no capital gains taxes.

[55] The 75% rate is suggested in Smart (2021b) and is characterized by Boadway (2021, 4) as a "reasonable compromise," while the 80% rate is proposed by Smart and Jafry (2021).

Tax smoothing for capital gains

The lumpy and irregular pattern of capital gains received by many taxpayers means that they may be unfairly treated under a progressive income tax, since they can be elevated into higher tax rate brackets in some years. That is, horizontal equity will be diminished and could be worsened if the gains inclusion rate were increased. This problem can be addressed by various provisions to smooth the measure of capital gains, such as income averaging.[56] However, both the US and Canada eliminated their existing provisions for income averaging in the 1980s, on the premise that averaging was less needed following their flattening of tax rate schedules (albeit while also raising their gains inclusion rates).[57] Formal provisions for income averaging remain only for farmers and fishers in the US and not at all in Canada.

The US federal structure of taxing long-term gains provides a mechanism that reduces the tax penalty from unusual hikes in receipts, as the applicable rate is based on a schedule tied to the filer's income taxed at ordinary rates.[58] Since short-term gains are taxed at ordinary rates, they can affect the filer's tax rate on long-term gains by bumping up their ordinary income. A variety of other means for selective averaging of capital gains income are available in limited circumstances in each country, such as installment sales, like-kind exchanges, and the asset holder's discretion about when to realize the gain through sales. When a capital property is sold at a profit but the proceeds are paid only over a period, Canada allows a capital gains reserve with tax on the rest of the proceeds spread up to five years. However, these methods are most accessible to wealthier taxpayers, who hold portfolios that are larger and more diversified and also more amenable to tax-loss "harvesting."

A taxpayer experiencing *net* capital losses in a year also has options for tax smoothing. Canada's provisions for applying net capital losses are relatively flexible, allowing the taxpayer to selectively apply them against gains in any of the previous three tax years or carrying them forward indefinitely against gains in

[56] The tax penalties due to income fluctuations including capital gains were the principal concerns motivating economist William Vickrey's (1939) development of schemes for income averaging.

[57] Canada abolished provisions for general forward income averaging in 1988; in earlier years it had allowed for block averaging and general income averaging (see Gordon and Wen 1917).

[58] More long-term gains may push the filer into a federal higher gains tax bracket (0%, 15%, or 20%), but they will not affect their federal tax bracket for ordinary income.

future years. The US system provides no option for carryback of net capital losses but allows up to US$3,000 to offset ordinary taxable income in the current year, with any excess available to offset gains in future years. The issue of averaging or tax-smoothing also arises for any tax on gains that has a threshold or multiple rates such as those that I consider later.

Alternative minimum taxes and NIIT

Both countries also apply an alternative minimum tax (AMT) to taxpayers who make relatively large claim for various tax breaks and preferences. AMT is calculated on the basis of the filer's regular tax base adding certain items deductible for regular tax and subtracting other items included for regular tax. The AMT allows an exempt amount and applies a different set of tax rates than the regular tax rate schedule. AMT is due when it exceeds the filer's regular tax liability, and the difference can be claimed in future years (no limit in the US and up to seven in Canada) as a credit against regular tax when that exceeds their calculated AMT. The US AMT applies tax at rates that include the special rates for long-term gains, so that their receipt does not directly bear AMT. In contrast, the base for Canadian AMT adds in the excluded 50% of capital gains, so that a hike in the gains inclusion rate would reduce any incremental AMT. Contrary to the tax smoothing provided by the AMT credit carryover provision, the US NIIT applies on a year-by-year basis for filers with investment income above its threshold and therefore offers no such relief for those whose investment income subsequently falls below the threshold.

Corporate dividends and capital gains

The coordination of personal income tax rates with corporate rates has been an ongoing issue for dividends, since dividends (unlike interest) are paid without a deduction for the company, and the two countries have used different approaches. Dividends need to be considered alongside capital gains also because of their high concentration at top incomes.[59] For many years, the US taxed the receipt of corporate dividends as ordinary income (with a very small annual exempt amount for each recipient). In 2003 the US extended the same schedular rates as were (and are still) used for long-term capital gains to

[59] Dividends in Canada are a form of income highly concentrated in the top income quantiles, not far behind the concentration of capital gains, and those groups also garner the lion's share of DTC benefits. See Murphy et al. (2015, 668).

"qualified" dividends.[60] Thus, the two sources of returns for corporate shareholders are equalized and at preferential rates relative to those applied to ordinary income. This equivalence means that regardless of whether the corporation distributes or retains its net income for share repurchases, the shareholder should (in principle) be indifferent, so that there should be no bias. Certain types of dividends are deemed to be "nonqualified" are taxable to the shareholder at the rates applicable to ordinary income.

Canada uses a gross-up and credit system in an attempt to integrate the tax treatment of corporate dividends. In principle, this compensates the shareholder for the corporate tax that has already been paid and is embedded in the distributed dividends. Because corporations are taxed at two different rates, the dividend tax credits (DTCs) are also differentiated by the type of company. "Eligible" dividends paid by large firms receive the larger DTC, while "ineligible" dividends paid by most small corporate businesses that bear a lower corporate tax rate receive a lower DTC. At lower taxable incomes, the filer actually gets a reduction in tax liability. However, the DTC has fallen out of balance relative to capital gains tax rates, so that shareholders at higher income levels will typically prefer that the company retain net earnings and use them either to buy back shares or reinvest the funds. Some analysts have cited this bias as a primary reason to increase the capital gains inclusion rate to achieve a better balance.[61]

Small incorporated businesses have presented Canada with challenges beyond the smooth integration with personal taxation for dividends and capital gains. Over the years various provisions have been introduced both to liberalize and constrain their tax benefits. In1985 the government implemented a Lifetime Capital Gains Exemption (LCGE) of $100,000 for individuals and $500,000 for major shareholders in small businesses set up as CCPCs.[62] Since the exemption applies on top of the non-taxed 50% portion of a gain, it would more correctly be labelled as an exemption of half the stated amount–$50,000 for the individual LCGE, for example. The LCGE remained for individuals until its repeal in 1994.

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[60] Under US tax treatment, "qualified dividends" include the shares of many large Canadian corporations. In contrast, to count as "eligible" dividends for the preferential DTCs in Canada, the issuing company must be Canadian and taxed at the full corporate rate.

[61] See, for example, Smart (2021) and Smart and Jafry (2021).

[62] The LCGE replaced the short-lived Indexed Securities Investment Plan, which I describe later.

Over time, the LCGE has been indexed for small business corporations (reaching $971,190 in 2023) and extended to farming and fishing corporations ($1 million in 2023 but not indexed).[63] Abuses of the LCGE and "dividend sprinkling" to increase the number of persons able to access these provisions have been the target of measures in recent years, which I will not recount here.

Dual income tax vs current provisions

Several seasoned tax policy analysts have mooted a shift of the Canadian personal income tax toward a dual income tax (DIT), similar to tax systems in Nordic countries.[64] In the archetypal DIT, capital gain and investment incomes are taxed at a relatively low, flat rate, while employment and labour-type incomes are taxed at progressive rates. The US tax system represents an interesting twist on the DIT approach, with its separate schedular lower rates for capital gains and dividends. However, the US schedule employs three rates ranging from 0% to 20% and then subjects gains and dividends to additional rates for high earners via the NIIT, rendering the entire structure progressive. Canada instead adheres to the use of a common progressive rate schedule for all forms of income, with concessionary provisions for gains and dividends.

A key challenge to a pure DIT is distinguishing between capital and labour incomes, given the incentive for individuals to recharacterize their incomes as the lower-taxed capital-type. While methods have been developed to address that issue, in fact labour and personal attributes are inextricable components in achieving superior returns on capital, whether they be in portfolio investments, business activities, or real estate development.[65] Another concern about a shift toward a DIT in Canada would be the significantly adverse distributional impact, with capital incomes relegated to lower flat tax rates, relative to the existing system and particularly relative to progressive reforms.

Startups, venture capital, and employee stock options

As explained earlier, the tax treatment of startup enterprises, venture capital, and employee stock options is important to economic growth and

[63] See the 1995 Supplementary issue of *Canadian Public Policy* for articles assessing the LCGE, especially the contribution by Hogg (1995).

[64] For examples, see Mintz (2006), Sørensen (2007), and Milligan (2014).

[65] Kesselman (2017b) raises this objection to the DIT proposal, given that top earners are often combining their labour, human capital, and personal skills with financial or tangible capital.

innovation, and capital gains tax plays an essential role. In 1993 the US introduced a 50% exclusion from the then-applicable 28% tax rate on capital gains for Qualified Small Business Stock (QSBS), yielding a 14% net tax rate. The QSBS provision was motivated as an incentive for early-stage investment in innovative startups. Among other restrictions, QSBS shares must be held at least five years to benefit from the tax preference, must be used only for eligible types of business, and are subject to limits on the tax savings available (currently the greater of US$10 million or 10 times the initial investment). In the years following its introduction, the QSBS exclusion has been periodically increased relative to the already concessionary rates on long-term gains; in 2010 the tax exclusion rate was raised to 100% where it remains today.[66] Canada has no direct counterpart to the US QSBS exclusion, and it warrants consideration as a means to spur innovative business sectors.

Employee stock options are one way to incentive work performance, typically granted to key higher-level employees. The US distinguishes between "incentive" stock options and non-qualified stock options, with different rules on taxability and how they can access capital gains tax treatment. Canada recently amended its tax treatment of employee stock options, which were previously granted a 50% deduction from tax in the hands of the employee, similar to the 50% inclusion for capital gains. Beginning in mid-2021 the policy instituted a limit of $200,000 on the options vested in an employee each year that qualified for the 50% deduction, applicable only to large corporate employers. Employers that are CCPCs or deemed to be smaller employers (with annual gross revenues under $500 million) are exempt from this new restriction. This policy is notable as a marker of the government's concern not to overburden upper-level employees and their employers in the high-tech sector relative to their tax treatment under counterpart US tax provisions. This complex policy area warrants review as to its cost and efficacy.

Like-kind exchanges

As noted earlier, the incentive to "lock-in" asset holdings due to the taxation of gains only when realized may generate real economic inefficiencies

[66] For a brief chronology of the QSBS rate reductions, see: https://www.qsbsexpert.com/history-of-qualified-small-business-stock-qsbs-section-1202/

with respect to tangible assets. Any increase in the effective tax rate on capital gains would exacerbate this inefficiency. Section 1031 of the US Internal Revenue Code permits tax-deferred like-kind exchanges of certain types of property other than principal residences. Canada's Income Tax Act Section 44 permits tax-deferred like-kind exchange in more restricted circumstances—only if the original property had been stolen, destroyed, or publicly expropriated, and/or used to generate business income other than rentals. Provisions to unlock the potential efficiency gains from the shift of a wider range of assets to more productive owners or applications are worth scrutiny, despite the complexities they would add to practical tax administration.

Investment expense deductions

The US income tax permits deductions of interest expense incurred to carry financial investments with certain limitations. The taxpayer must opt to use itemized deductions (and thus forgo the standard deduction), and the amount of interest deductible is capped at their receipt of net investment income taxed at ordinary rates in that year. That excludes investment income taxed at favourable rates such as long-term gains, qualifying dividends, and tax-free bond interest. Any excess amount of interest expense is eligible for carryover to a future year for potential deduction. Quebec income tax also imposes a cap on investment expense deductions somewhat along those lines. In contrast, Canadian federal income tax permits the deduction of investment interest expense (along with investment advice and management fees) without any of those kinds of limitations. Although in principle the deduction is limited to the cost of holding assets that produce or are expected to produce income (such as future dividends), this appears to be minimally enforced in practice. Thus, equities such as growth stocks that produce their expected returns as tax-favoured capital gains can get a full write-off of their financing costs.

Taxation of carried interest

Managers with partnership interests in private equity and hedge funds can have their profits structured in such a way as to be taxed at favourable long-term capital gains rates. The 2017 US tax act extended the requisite holding period for the relevant assets from at one year to three years for the managers to benefit from the lower tax rates on this "carried interest." Canadian taxation of managers

of private equity and hedge funds can also access capital gains tax treatment on carried interest if properly structured,[67] and like with other capital gains there is no minimum holding period. Favourable tax treatment of carried interest has been repeatedly but unsuccessfully challenged in both countries as a form of return to the skill and effort of managers that should be taxed as ordinary income.

Gains on principal residences

The application of capital gains tax on principal residences under US law is also relevant in comparisons with Canada. Prior to 1997 US homeowners could defer capital gains tax when selling their home under a rollover provision, which required the purchase of another home within a specified period with a deferral of their gain based on their new purchase price to the extent it equaled or exceeded the proceeds from their home sale. If they subsequently sold that home and did not qualify for further rollover, the deferred gain became taxable. After the 1997 tax act, the rollover provision was converted to an exempt amount of capital gain on the home sale—US$250,000 for a single tax filer and US$500,000 for a couple filing a joint tax return. This exemption could be claimed repeatedly on subsequent sales but only after a specified period of residence between claims. Both the previous and current provisions allowed for adjusting the cost basis for the expense of major home improvements and repairs during ownership or prior to sale.

From its inception the Canadian income tax fully exempted capital gains on the sale of owner-occupied homes under widely applicable conditions. As noted earlier, the federal revenue loss from this principal residence exemption (PRE) is approaching the revenue cost of partial exclusion on all other capital gains. Changes in the PRE since 1972 have restricted it to one dwelling per couple at a time and in 2016 instituted a requirement to report all sales. Apart from some restrictions to curb tax avoidance (such as serial home renovators), the PRE allows repeated tax-free gains on home sales with no limit on each exempt gain, be it $50,000 or $5 million. Thus, unlike the tax-favoured accounts, the PRE is a channel for almost unbounded tax-free gains.[68] While its benefits

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[67] Blanchet et al. (2014).

[68] This extreme tax distortion and associated inequities has evoked calls for taxing such gains. See Kesselman (2017a) and Lanthier (2021a) and as well as the proposal of the Québec Taxation Review Committee (2015, 259) to subject the PRE to an indexed lifetime limit of $1 million.

are widely dispersed, they are concentrated in certain cities, cohorts, and wealth levels.

Investments in residential housing unless occupied by the owner does not qualify for the Canadian PRE. That typically means such properties are treated as a capital gain for tax purposes upon disposition, with the general 50% tax inclusion for the net amount of gain. However, the 2022 federal budget proposed a new rule to discourage the short-term flipping of residential properties.[69] The anti-flipping provision went into effect at the start of 2023 for the disposition of such properties that had been held for less than one year by taxing the net gains with a 100% inclusion rate—the same rates as for other types of property gains that are deemed to be in the nature of business income.

Preliminary Policy Design Issues

Before launching into alternative options for targeted hikes to the tax inclusion rate for capital gains, I review several preliminary issues that could interact with any of those primary reforms. All of these issues have been closely investigated by researchers over many years, mainly in the context of US tax policy but with strong relevance to Canadian tax analysis.[70] Thus, some of these features might be regarded as possible add-ons to the more fundamental choices for how broadly to increase capital gains taxation.

Use of a valuation date: rebasing

When Canada introduced taxation of realized capital gains with its 1972 tax reform, it allowed for a “rebasing” of all asset cost bases for tax purposes to the date of implementation. This approach relinquished all future revenues from gains that had accrued by that date, but it served several important purposes. It eased public acceptance of the reform, and it avoided the difficult challenge of documenting the cost bases for assets that had been held for many years, well before investors would have anticipated the need to keep such records for tax purposes. It further served to improve equity between individuals who had sold assets prior to the reform and otherwise similar individuals who would bear large

[69] Canada Department of Finance (2022b, 49); the legislation provides a few exclusions such as cases involving marital dissolution or death of the taxpayer.

[70] Important sources are Vickrey (1939), Seltzer et al. (1951), Bailey (1969), and Burman (1999).

tax liabilities by selling afterwards.[71] In contrast, the adoption of increased inclusion rates for gains that began in 1988 did not provide for a resetting of cost bases, which implied a form of retroactive taxation with expanded future revenue potential. Note that the change had been foreshadowed in the 1987 White Paper on tax reform and that record keeping for cost bases was no longer an issue.

If Canada were to increase its capital gains inclusion rate, this raises the question of whether it should be accompanied by rebasing for assets held at the implementation date—but only for those taxpayers and assets affected by the increased inclusion rate. That choice would effectively eliminate all future revenue stemming from gains accrued by that date.[72] However, with some complexity a new higher inclusion rate could apply only to cost bases reset to that date, with the preceding lower inclusion rate applied to the original cost bases. Given the precedent of the 1988 increase to inclusion rates as well as the desire for increased revenues, most likely such a reform would not allow any resetting of cost bases. Note should be made that the earlier cited forecasts of revenue gains from increasing the inclusion rate assumed no rebasing; otherwise, the revenue gain would be very small in the initial year and grow only over time.

Indexation, accrual, and inclusion rates

Devotees of the real accrued income concept as the proper basis for personal taxation would ideally endorse reforms of capital gains taxation with 100% inclusion, indexed cost bases,[73] and annual or frequent tax on accrued gains. Various contributors to the CTF papers endorse one or more of these features, though none explicitly advocates a full 100% inclusion rate. However, these features of an ideal income base face compromises when confronted with practical or political constraints. If indexation poses unacceptable complexity, or cannot be achieved equally for all types capital incomes, then should that shortcoming be compensated by setting the inclusion rate below 100%?[74] If

[71] In contrast, Advani (2021, 1248) argues that rebasing would be "horizontally inequitable because it benefits those who have not yet realized their gains but are otherwise similar to those who recently have."

[72] Boadway (2021, 4) argues that rebasing would be desirable "[t]o preclude retroactive taxation."

[73] For country experiences with indexation for capital gains, see the studies in Grubel (2001), Advani (2021), and Minas et al. (2021).

[74] If the inclusion rate is used as a rough offset for the lack of indexation, that rate should be set to decline with the asset holding period, which runs counter to the logic of an inclusion rate that is set to increase with the asset's holding period as an offset to the lack of accrual taxation of gains.

frequent application of the tax based on accruals, rather than realizations, is not practical[75]—because many asset types cannot be valued frequently or until sold—should the inclusion rate rise beyond 100% based on the holding period to reflect the time value of tax deferral? Alternatively, should inclusion or tax rates for capital gains decline with the holding period (as the US did in earlier years) to reduce the inefficiencies from lock-in and to reflect the absence of indexation for inflation?

The cited three features of the real accrued income base thus become entangled when one or more of them is not practically or politically feasible. And the desirability of implementing one or two of them without the other(s) requires nuanced balancing of factors related to both the equity and efficiency of the outcomes. Moreover, given the cautionary approach by most advocates of heavier taxation of capital gains toward 100% inclusion, they likely have unspoken concerns relating to the potential long-run economic impacts of either partial or complete congruity with their ideal base—or perhaps concerns over political viability. As noted previously, any reform needs to consider a wide range of economic responses given Canada's close financial, business, trade, and labour ties with the US and the relevance of counterpart American tax provisions.

Despite the forgoing considerations, a case could be made for introducing indexation in the measure of realized capital gains so that only the real component would be taxable.[76] Holders of investments with modest nominal returns can experience negative real returns even at moderate rates of inflation; this situation can lead to liability for capital gains tax on the sale of assets that have declined in real value. This perverse outcome is exacerbated for assets with long holding periods and even more so with higher inflation rates. Indexing the cost basis of financial assets to remove the inflation part of the measured gain over the holding period would be simple for fiduciary institutions to undertake and to report. Yet, consistency would also require indexation adjustments for other types of real and financial assets as well as for any interest cost deductions. For these reasons as well as the tendency for assets that are held for long periods

[75] Recent experimental research findings suggest that most participants do not support taxing gains on accrual but only when the gains are realized and consumed (Liscow and Fox 2022). Freedman (2021) cites various drawbacks associated with taxing gains only on realization.

[76] Spiro (2017) and McMillan (2021) have advocated cost-basis indexation for capital gains tax, the latter illustrating the extent to which inflation has increased the average gains tax burden. .

and thus benefit most from deferral to yield the largest gains,[77] the case for comprehensive indexation is less than persuasive.

Provision for tax averaging

Individuals holding assets with accrued gains (and accrued losses) have some discretion over how much is taxable and the timing. Based on their forecast of the future returns from holding onto a capital asset, the individual can choose to sell it at any given point—that is, realize the accrued gain or loss—or retain it for future disposition. The tax impacts of this choice also enter the calculation, such that they may prefer to realize gains in years that they are in a lower tax bracket than normally.[78] The investor also has discretion over when to sell assets with accrued losses and can thereby control their net taxable gains to some extent. Thus, the investor with accrued gains has some control over the averaging of taxes to minimize their long-run total tax liability. In each year, any capital losses must be offset against capital gains, and if that results in an overall net capital loss, Canadian provisions allow for net capital losses to be carried back up to three years or carried forward indefinitely to offset the net capital gains of other years.

While the cited provisions give the investor some flexibility to "self-average" for tax purposes, the degree of flex varies by circumstances. A wealthy investor with a large portfolio might be in the top tax bracket in most years and thus have little benefit from averaging. An investor with a more modest and less diversified portfolio might be holding lumpy assets that must be sold all-or-nothing or other assets that are peaking in value and most advantageously sold quickly. For the latter investor, infrequent discrete realizations of gains could cause their taxable income to fluctuate sharply, resulting in unduly high tax liabilities without an averaging provision.[79] When Canada flattened its tax rate schedule and reduced the gap between the top and bottom federal tax rates to 12 percentage

[77] US data on the relation between actual asset holding periods and the size of realized gains indicates this kind of pattern; see Wilson and Liddell (2016, 57–71).

[78] An investor can also choose to crystallize a gain (sell and immediately repurchase the asset) for tax averaging if they want to keep holding the asset. However, if they wish to realize a capital loss for tax purposes but want to retain an interest in that asset, they must not repurchase it for at least 30 days in order to avoid the "superficial loss" rule (which disqualifies a tax claim for the capital loss and sustains the original cost basis).

[79] Note that while net capital losses for a year can be carried back or forward, net capital gains realized in any year unavoidably enter taxable income for that year.

points in the 1988 reforms, it justified the abolition of averaging provisions as no longer needed for equitable treatment.[80] However, the top-to-bottom gap in federal rates has now widened to 18 percentage points and is further compounded by the provinces' widening rate gaps in recent years. This matter would be exacerbated by an increase in the capital gains inclusion rate, thus arguing for the restoration of formal tax averaging provisions for capital gains (and for all earners with variable incomes).

Indexed Security Investment Plan (ISIP)

Canada had a scheme for taxing capital gains that addressed all the issues of deferral, indexation, and averaging, called the Indexed Security Investment Plan. The ISIP was short-lived from October 1983 until it was supplanted by the LCGE in 1985; it is little documented and seems long forgotten.[81] Individuals could opt to transfer non-registered publicly traded securities into an ISIP, which would bring into tax (with the 50% inclusion rate) each year one-quarter of the plan's total indexed accrued gains since the preceding year. Given the relatively high inflation rates during that period, this option could be attractive for investors who anticipated modest real returns and/or short holding periods in their portfolios and were willing to trade-off reduced deferral of tax for the benefit of annual indexation on their account's cost basis. However, a deterrent to shifting securities into an ISIP was that their accrued gains would be deemed realized for tax purposes. Relatively few investors opted to use ISIPs, and accordingly, the annual federal revenue cost of the fully mature ISIP was estimated at just $300 million.

Corporate tax integration and capital gains

As noted earlier, one motivation cited for raising the capital gains inclusion rate is to remove the bias against corporate distribution of dividends versus ways of rewarding shareholders that exploit the capital gains preference. For large corporations with publicly traded shares, in a small open economy the justification for providing shareholders a DTC has been widely challenged on economic

[80] Wilson (1987, 28).

[81] See Boultbee (1983) and explanatory notes on the ISIP released with the 1983 federal budget (Canada Department of Finance 1983, 26–27).

grounds.[82] With mobile financial capital, these companies face the international rate of return on equity and should be little influenced by the tax treatment of domestic shareholders; only tax at the corporate level matters. Moreover, the assets for many resident shareholders do not even qualify for the DTC, and this includes pension funds, registered plans, investment funds, and other corporate entities.[83] As a result the rationale for providing a DTC for resident shareholders in large corporations rests on thin ice, and its abolition would save billions of dollars per year[84] with the bulk being losses to high income investors (equity interests of less wealthy persons are held mostly in vehicles not eligible for the DTC). Thus, at least with respect to large corporate equities, the choice of the optimal gains inclusion rate should hinge primarily on considerations other than balancing the DTC.

The economic analysis and policy issues for CCPCs differ sharply from those for large corporations. These smaller firms do not access public equity markets and need to raise capital through personal savings, informal channels, retained earnings, and bank loans from domestic sources. Since dividends paid by the firm are not deductible, the provision of a DTC is appropriate to balance the net return with payout via salary; this issue does not arise for large corporations since the shareholders are not active in the firm and are not on the payroll. However, raising the gains inclusion rate would increase the value of the LCGE, and a tightening of legislation related to surplus stripping and access to the LCGE would be in order. In fact, a review of the LCGE itself (along with the PRE and the employee stock option deduction) would be apposite either with or without any prospective changes to capital gains taxation more generally.

Options for Targeting Gains Tax Hikes

The CTF papers that support increased taxation of capital gains focus

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[82] Boadway and Bruce (1992), Spiro (2013; 2017), Kesselman and Spiro (2014), Boadway and Tremblay (2016), and Boadway (2019).

[83] Foreign shareholders (who predominate in the valuation of many large Canadian corporations) are not eligible for the Canadian DTC, so that further weakens the neutrality case for the DTC. Note that US resident shareholders face the same rate schedule for long-term gains and "qualified dividends" that include the shares of many large Canadian corporations. Also see Burman et al. (2017) for discussion of policy implications of the high proportion of US dividends received by non-taxable entities, which has likely implications for Canada as well.

[84] The forgone federal revenue from the DTC is forecast at $5 billion for 2022, with additional sums forgone by provinces via their DTC provisions.

almost exclusively on reforms that would raise "the" tax inclusion rate, overlooking the potential for reforms that are more targeted. Even those not supporting an increase in the inclusion rate for capital gains do not consider limited reforms.[85] A more comprehensive analysis needs to compare a general increase in the inclusion rate with rate increases targeted by various thresholds of income or capital gains and possibly over multi-year periods or even lifetimes. Given the high concentration of capital gains at very high incomes and the oft-cited concerns over income and wealth inequality, targeting higher taxes at those levels might be an appealing approach. In what follows I survey and assess the key design components in formulating any such reforms. My discussion assumes an increased inclusion rate of 75% for illustration, though the chosen rate could be higher or lower. The income and gains thresholds cited in my discussion are also purely illustrative.

Option 1: General inclusion rate hike

The broadest reform, seemingly endorsed by most of the CTF contributors who support a hike, would be an across-the-board increase in the capital gains inclusion rate without any exceptions. Such a reform would be the simplest to implement and to explain to the public. If the new inclusion rate were 75%, tax liabilities on capital gains would rise by half; they would increase even more for taxpayers who were pushed into higher marginal tax brackets on account of the added taxable income. This general hike in the inclusion rate would affect nearly 20% of all tax filers over a ten-year period, based on the evidence for 2009–2018 as in Table 1. This proposal also raises a host of policy issues, such as lock-in, averaging provisions, and various incentives for diversion of funds away from productive investment, not to mention public acceptance and policy sustainability. Table 1 also demonstrated that the great majority of the minority of tax filers who ever receive capital gains do so relatively infrequently, typically in smaller amounts, and are normally at moderate incomes. The bulk of capital gains are received by filers at much higher incomes and in much larger amounts, which suggests targeting the reforms on this group, particularly if a prime objective is to address income inequalities.

[85] An exception is Arnold (2022), who advocates annual accrual taxation of gains and opines that increasing the inclusion rate might be more politically difficult and damaging to markets.

A substantial increase in the inclusion rate affecting all recipients of capital gains would further exacerbate distortions relative to asset types or savings that are immunized from the capital gains tax. Increasing the differential will raise the incentives for shifting savings and capital into these tax-preferred forms, such as principal residences, employee stock options, charitable contributions, and tangible but readily concealed types of assets. Registered forms of savings already have limits on contributions, and the ability to shift more into them will be greatest for those with the most unused contribution room, who are mostly at lower and middle incomes. Those with the highest incomes and wealth already utilize their RRSP and TFSA allowable contribution limits to a greater degree than those with lesser resources, so this will not be a significant avoidance response to imposing a higher gains tax rate on this group.

Perhaps the most salient policy and equity issue arising with a general increase in the gains inclusion rate is the added impetus this will give for inefficient over-investment in principal residences with their unlimited tax-free status. More people will be incented to buy a home versus putting their savings into a private business or public equity markets; more will be inclined to renovate or enlarge their existing home with the prospect of resale at higher value; and more will be induced to purchase a larger home than suits their needs out of anticipation of a greater ultimate tax-free gain. When many are accruing hundreds of thousands or even millions on their principal residence on a tax-free basis, it will appear even more inequitable if others are made to pay higher taxes on modest gains from savings invested in the market or in a family business.

Option 2: Gains-linked threshold

Three alternative criteria could be used to target an increased capital gains tax inclusion rate on particular groups of taxpayers: either by the magnitude of their gains on a multi-year or cumulative lifetime basis or by their total annual incomes. These approaches are designed to insulate from the increased inclusion rate those filers with capital gains or total income below a specified threshold level. In this section I explore the approach where filers with capital gains above a specified threshold would face the higher inclusion rate but only on the portion of their gains above the threshold, regardless of their income level. Similarly, as I explore in the next section, the higher inclusion rate could be

imposed only on the portion of gains in assessed incomes that rise above a specified income threshold, regardless of the size of those gains. In a subsequent section I consider an indexed threshold based on cumulative lifetime capital gains. One could also consider more complex targeting methods that factored in both the size of the gain and the taxpayer's income, or a progressive rate schedule for gains above a threshold level, but for simplicity I do not pursue those types of policy reforms here.

For illustrative purposes, consider an exemption of up to $20,000 per year of gains from the 75% inclusion rate for each filer. Gains under that threshold would still be subject to the 50% inclusion rate, so they would not be tax-exempt, and unused room in the annual amount could be carried back or forward five years. Thus, over this period an individual could shield up to $100,000 from the newly imposed 75% inclusion rate. The maximum annual savings of federal-provincial tax for a top-bracket filer would then be $20,000 x (0.75 – 0.50) x 0.54 or $2,700 relative to full application of the 75% inclusion rate. A scheme of the proposed type would differ from systems that fully exempt all gains for low-bracket taxpayers (as in the US) or that fully exempt a specified annual amount of gains irrespective of the filer's income but that cannot be carried over to other years if unused (as in the UK and as proposed for Australia).[86]

The advantages of the proposed method of implementing a targeted increase in the inclusion rate are several relative to a full annual exemption without carryover of unused room. First, this method does not forgo any revenue from taxpayers on their gains that fall within the allowance. Second, the carryover feature does not penalize smaller recipients of gains who might not be able to realize the full annual allowance each year, while those who can regularly generate substantial gains do not benefit from the feature. Third, by allowing for an amount of gains to remain taxed at the lower inclusion rate every year or in every five-year period, it will incentivize higher wealth holders to realize at least that much of their accrued gains, thus accelerating their payment of tax on gains that might otherwise be deferred. Finally, even allowing $20,000 per year of gains

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[86] The UK system provides a fixed annual exemption on capital gains of £12,300 (just under $20,000 at recent exchange rates) which does not carry over if unused in the year, and an Australian proposal for a "non-cumulative annual exempt amount" is similar to the UK scheme (see Evans et al. 2015; Minas et al. 2021).

to retain the lower inclusion rate would benefit only a small portion of the capital gains realized by the highest wealth holders, and it would strike relatively few non-wealthy persons. For example, for the period 2014-2018, of the bottom 90% of families by income with any capital gains, only 1.9% reported an annual average amount of gains exceeding $20,000, while among families in the top 0.01% of incomes 62.1% reported annual capital gains exceeding $50,000.[87] Thus, a provision of this kind would capture the bulk of tax revenue on gains while relieving the great majority of taxpayers receiving gains from exposure to the higher inclusion rate.

One design issue for a scheme of the kind described here—which also arises for the scheme based on an income threshold described in the next section—is whether a couple should be able to split a doubled benefit. That is, if the threshold is $20,000 per year for an individual and with carryover, should a couple be able to share a total of $40,000 per year for capital gains at the lower inclusion rate? Given the relative ease with which couples are able to engineer income-splitting of investment-type incomes through various legal arrangements, this would appear to be the best approach.[88] Since couples with less expansive incomes and financial resources are less aware of or less able to exploit these splitting arrangements, equity would best be served by making splitting of the gains provision readily accessible, given certain precedents in Canada.[89]

Option 3: Income-linked threshold

An alternative threshold to use for targeting the higher capital gains inclusion rate is the filer's total income including the entire amount of gain. Only the portion of the capital gain that exceeded the specified threshold would be

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[87] Smart and Jafry (2021, 1164). Moreover, for the 2017 tax year, 52% of all tax filers with incomes of $250,000-plus reported capital gains, with an average taxable gain of $249,600, average tax savings of $64,100, and accounted for 55% of all taxable gains and 61% of the total tax benefits (Smart 2021b, 2).

[88] Among the many techniques that couples can utilize to split investment-type incomes for taxes, one of the simplest is an inter-spousal loan, with the current prescribed interest rate of just 2%.

[89] Between 1974 and 1988 the Canadian tax offered a $1,000 per filer annual exemption (not cumulative) on interest income and grossed-up dividends from Canadian corporations, which was extended to include the taxable half of capital gains on Canadian securities in 1977. Any unused portion of the exemption could be transferred to the filer's spouse. Some analysts might object to this approach as they have to pension splitting on grounds of gender equity (e.g., Woolley 2007), but unlike pension splitting the full tax liability would remain on the spouse earning the gains.

subject to the increased inclusion rate.[90] To illustrate this, assume that the chosen annual income threshold is $250,000, which corresponds to roughly the top 1% of tax filers in Canada. Now consider an individual whose taxable income *excluding capital gains* is $200,000 and whose *total* capital gain is $110,000 for a total income of $310,000 and a taxable income of $255,000 under current treatment. The first $50,000 of their capital gain brings their income up to the $250,000 threshold, so it remains subject to the 50% inclusion rate (adding $25,000 to taxable income), while the remaining $60,000 of capital gain takes their income above the threshold and is thus subject to the assumed 75% inclusion rate (adding $45,000 to taxable income), rendering their amended taxable income $270,000.

The use of an income-linked threshold for application of a higher inclusion rate raises issues similar to those arising with a threshold based on the amount of capital gains. Should some form of multi-year tax averaging be allowed for taxpayers with incomes varying above and below the threshold and with at least part of their income above the threshold in some years comprised of capital gains? (Alternatively, this could be handled via credit carryback and carryforward provisions.) Given the choice of a high threshold, this might affect few persons but could still be a concern in cases where an isolated large capital gain subjected a taxpayer to the increased inclusion rate. And should the provision allow for splitting of capital gains for couples? In my example this would become a $500,000 annual combined income threshold for application of the higher rate on capital gains that could be shared between the partners. One consideration is that many couples at such high incomes already engage in splitting of investment incomes.

Option 4: Lifetime gains threshold

An alternative threshold to use for targeting a higher capital gains inclusion rate would be a cumulative lifetime amount per individual. The threshold would be indexed annually for inflation (like the LCGE for CCPCs), and it also could be shareable between spouses based on the reasons cited earlier. For example, a

[90] As described earlier, the US NIIT is a surtax on capital gains and dividends for earners above an income threshold, somewhat analogous to the option described here. A US proposal in 2021, which failed to pass in Congress, would have taxed at full rates long-term capital gains for taxpayers with annual incomes above US$1 million.

lifetime capital gains threshold (LCGT) set at $1 million[91] would mean that an individual's cumulative capital gains up to that amount (indexed for inflation) would face the current 50% inclusion rate; any gains exceeding that threshold would face the new higher inclusion rate. Like in all the other threshold options, no filer would bear any lower capital gains tax liability than at present. Recall that the Québec Taxation Review Committee had recommended the introduction of an indexed lifetime exemption of $1 million as a limit to the PRE benefit on gains from the sale of principal residences.

The CRA could keep track of how much of their LCGT a filer had exhausted, and at a figure of $1 million very few taxpayers would ever need to concern themselves with this reform. In contrast, those in the very highest income quantiles who regularly report large amounts of gains would quickly exhaust their lifetime threshold allowance and then become subject to the higher inclusion rate on all subsequent capital gains. The top 0.01% of taxpayers by family income reported an average of $6,112,000 in gains in 2014-2018; the top 0.1% to 0.01% reported $1,054,000, and the top 1% to 0.1% reported $174,000,[92] and all of the cited figures most likely have risen since then. Clearly, the top recipients of capital gains would quickly exceed a LCGT even as high as $1 million.

Option 5: Reform of the AMT

Canada's AMT was introduced in 1986, and the reforms presaged in the 2022 budget would be the first major changes since then. In the government's words, this "will go further towards ensuring that all wealthy Canadians pay their fair share of tax."[93] The additional burdens would target taxpayers who utilize tax preference items heavily and whose regular tax is deemed low relative to a more comprehensive measure of their total income. The current AMT applies a flat 15% rate—less than half the top federal tax rate of 33%—to its expanded base and provides an unindexed $40,000 exemption. The AMT yields relatively little revenues; for the 2019 tax year, it raised just $295 million out of $242 billion in federal personal income tax, or just one dollar out of 800.[94] This figure is far less

[91] $500,000 was the figure initially proposed for the LCGE for individuals in 1985, but it was never allowed to rise beyond $100,000. Note that that $500,000 today would represent less than $10,000 per year in real dollar terms over a lifetime for a person now attaining majority age.

[92] Smart and Jafry (2021, 1160).

[93] Canada Department of Finance (2022b, 207).

[94] Canada Revenue Agency (2022, Final Table 2); all figures in this paragraph relate to 2019.

than revenue forecasts for an increase in the inclusion rate even allowing for some slippage and targeting on larger gains recipients.[95] Filers with assessed incomes of $150,000 and higher accounted for over half of all AMT payers and 90% of all AMT. Just 42,040 filers were subject to the AMT with an average liability of only $7,024.[96] Computation of the AMT, imposed on many filers even if they find that they do not owe any AMT, involves a complex eight-page form (Schedule T691).[97]

The AMT might be questioned as posing the best basis for targeted additional taxation of capital gains for high earners in Canada. It fails to encompass tax filers with large amounts of gains if they have sufficient income of other, fully taxable forms, but does not relieve other similar filers lacking those incomes. It would further complicate an already complex tax, and it could ensnare many additional filers in compliance and possible tax liability. A leading US tax analyst recounted in a 2009 interview:[98]

> I had actually put forward the idea of using a surtax as a replacement for the alternative minimum tax. The idea was that the alternative minimum tax is an incredibly stupid tax with really undesirable policy consequences, and it's incredibly complicated. We can replace it with a slightly less stupid tax on AGI [adjusted gross income], which at very low rates might not do too much damage and would be simpler than the AMT.

Along these lines, a much simpler threshold-based surtax might be a superior approach to taxing large capital gains. This NIIT-like surtax could operate alongside a simplified, streamlined reform of the existing AMT or even allow for its complete elimination.

The AMT format suffers from additional deficiencies beyond complexity and compliance burdens. It affects in complex ways the effective marginal tax rates on various income and deduction items included in its computation, which

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[95] For example, Smart (2021b, 8) projects federal plus provincial revenue gains from personal tax of about $7.8 billion in 2017 with an inclusion rate of 75%.

[96] The author has also calculated the average AMT payable for the preceding five tax years and found a result of less than $6,600 per affected taxpayer. The numbers of AMT payers ranged between about 32,000 and 49,000. Canada Revenue Agency (2022 and various years).

[97] Most provinces also impose an AMT that piggybacks onto the federal AMT as a percentage of the federal liability (for example, Ontario at 33.3%, BC at 33.7%, Alberta at 35%, and Manitoba at 50%), while the Quebec AMT requires the completion of a six-page form (TP-1.D.B-V).

[98] The interviewee was Leonard Burman; see Young (2009, 327). Also see Burman (2007).

will obscure understanding of the net returns to various choices.[99] The result is that tax incentives for specific types of investment, such as film properties or resource flow-through resource shares, will be blunted. Might it be preferable to insert limitations in those tax preferences directly and thereby streamline the AMT? Often the ATM is justified as a feasible way to satisfy the political imperative for optics that persons at high wealth are paying sufficient tax. As another veteran US tax scholar has written:[100]

> [M]inimum taxes have serious drawbacks, and generally make sense (if at all) only if otherwise superior options must be ruled out for reasons of optics or political economy. … [A]ny such use should generally be contingent, reluctant, and based on understanding their structural deficiencies. … A broader takeaway is that optical effects on perceived tax burdens may tend to be inherently unstable and unpredictable. However, making the overall tax system more complex, and even less transparent than it might otherwise be, is not in general a formula for creating better outcomes …

With a surtax in the form of a higher inclusion rate for capital gains above a threshold, the taxpayer could simply and quickly assess whether they are affected.

Similar reservations about the potential value of an AMT were expressed by a leading Canadian tax economist in 1984 prior to the government's introduction of one:[101]

> [A]lthough the minimum tax sounds simple, it is in fact complex. Its introduction would be a move away from tax simplification. It would mean setting up a second personal income tax, with a separate set of rules, alongside the income tax that we now have. This duplication would necessarily make tax planning more complex. …[I]t is hard to be sanguine about the effects of a minimum tax. At worst, a minimum tax is ineffective, in which case it would increase the complexity of the tax system without any real change in equity.

With several years of operation of the federal and Quebec AMTs to observe, analysts offered this biting assessment in 1994: "[T]he AMT as structured in Canada is a tax that imposes genuine hardships on few of the taxpayers it targets. … If we are not willing to sharpen the tiger's teeth, we should have the

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[99] For METR computations in the context of the US AMT, see Feenberg and Poterba (2004).
[100] Shaviro (2021, 398 and 420).
[101] Bossons (1985, 917, 924).

political courage to dispatch it promptly."[102]

Complementary Tax Reform Options

Any serious review of capital gains tax policies in Canada motivated by concern over increased concentration of wealth would also assess the reform of other related tax provisions. Several potential areas for reform have been referenced earlier in this study, some referring to existing provisions in the US income tax. Here I cite candidates for reformed tax treatment either jointly with any reforms for capital gains taxation or in parallel measures. I describe the general nature of the inefficiency or inequity to be addressed and sketch possible approaches but do not prescribe the best approach. Each item warrants further in-depth economic, policy, and tax analysis.

Dividend taxation

Prominent on this list should be the dividend tax credit with its projected 2023 federal revenue cost of $5.8 billion and nearly half of the associated tax benefits captured by filers in the top 1% of incomes based on earlier estimates.[103] My previous discussion cited the finding of a weak justification for the DTC on shares of large publicly traded companies but the need to retain it for CCPCs. A reform could fully abolish the DTC (at the federal and provincial levels) on eligible dividends, but given the reliance of many seniors on these dividends to support their retirement needs, an annual cap on a filer's federal DTC for eligible dividends could make this reform more politically palatable. Alternatively, this could be addressed via an amended AMT or a new NIIT-type surtax.

Deductibility of investment expense

A second area warranting review is the deductibility of interest and carrying charges incurred to earn investment incomes. These charges are closely related to the receipt of investment income including capital gains and dividends. On elementary principles of taxation, a deduction would be justified as the necessary costs of earning an income but only if that income were fully taxable. However, given the favourable tax treatment of capital gains and dividends, deductions for the full cost of financing such assets is not justified. While

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[102] Larin and Jacques (1994, 842).

[103] The statistics do not allow partition between eligible and non-eligible dividends. The 47.8% figure for the top one percent is for the 2011 tax year, taken from Murphy et al. (2015, 671).

Canadian provisions nominally restrict this deductibility to the costs associated with the finance of assets that generate taxable income in the form of interest or dividends, they rarely in fact are used to deny deductions for the finance of equities that are held mainly or solely for capital gains.[104] The rules would be more effective if Canada were to mirror US and Quebec provisions that restrict deduction of such costs to the amount of taxable investment income received in the year (excluding, in the US, low-taxed long-term capital gains and "qualified" dividends), with any excess costs eligible to be carried forward. This approach would also reduce the need to trace the use of borrowed funds,[105] at least apart from areas such as unincorporated businesses and rental housing where the new rules would not be applicable.

Averaging for tax purposes

An increase in the effective tax rate on capital gains would exacerbate existing horizontal inequities for those facing large income fluctuations, such as many recipients of capital gains. This issue could be addressed to some degree by carryover provisions in a reform that raised the inclusion rate on gains above a threshold, or similarly for a reform of the AMT or a NIIT-like surtax. However, a restoration of more general tax averaging provisions along the lines of those abolished with the 1987 tax reforms would also be useful. This change would be more beneficial for persons realizing occasional lumpy gains than the wealthy who regularly report large gains and that put them in the top rate bracket. The reform would also be beneficial to many workers and self-employed persons who experience significant year-to-year fluctuations in their earnings.[106]

Tax relief for estates of singles

An increased inclusion rate on gains would be particularly onerous for persons who die while holding substantial assets with accrued gains and registered accounts but without a surviving spouse or common-law partner to

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[104] Officially, the requirement is that the investor has a "reasonable expectation" that dividends will be distributed in the future. Canada Revenue Agency, Income Tax Folio S3-F6-C1, "Interest Deductibility."

[105] The proposed approach would also circumscribe a manoeuvre often advised by investment counselors to render mortgage interest tax deductible: sell your investment portfolio, use the proceeds to reduce mortgage debt, and then borrow a like sum to repurchase your portfolio.

[106] Based on analysis of data from UK incorporated owner-managed businesses, Miller et al. (2021) find extensive ability to self-average personal taxes by the choice of earnings retention versus disbursement of dividends or salaries. Similar choices are available to CCPCs.

access rollover provisions. Even a liberal averaging provision is unlikely to provide adequate relief to the estates of many decedents.[107] In 2018 the returns for deceased taxpayers accounted for only 1.5% of all filers with capital gains but 15% of the value of all capital gains.[108] Many such estates will be sufficiently large as not to be well insulated by an averaging provision and any threshold in the higher gains tax rate. For both equity and political palatability, it might be apropos to provide a limited rollover provision for bequests made to other surviving relatives from accrued capital gains and RRIF, LIF, and TFSA balances.[109]

Like-kind exchanges

An increased gains tax inclusion rate for filers above the relevant threshold could exacerbate the existing lock-in inefficiencies on tangible assets. Broadening the coverage of gains tax rollovers for like-kind exchanges to more tangible assets to reduce inefficient lock-in, following US practice, could be a constructive reform. A somewhat liberalized rollover system for like-kind exchanges is worth exploring for Canada with due regard for administrative complexity and potential abuses. This reform could be facilitated by permitting deferral on only half of the gain, which would reduce the effective tax rate on gains from such sales even with an increased gains inclusion rate.[110]

Venture capital and startups

Innovative new firms that develop and nurture advanced products, processes, and services are the lifeblood of a productive modern economy that spawns high value-added output and well-paid jobs with wide spinoffs. The

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[107] Note that tax returns filed in the year of a taxpayer's death are not subject to the AMT.

[108] Gagné-Dubé, et al. (2021, 1185). They also note, "Taxpayers aged 55 and over with income of less than $50,000 excluding taxable capital gains account for almost a quarter (24.1%) of the total value of capital gains reported in 2018."

[109] The amounts of rollovers and the period of tax deferral should be limited, since the beneficiary might be much younger. Note that TFSA proceeds can already be transferred to any named beneficiary, but that person must have TFSA contribution room to shift the funds into their own TFSA; this limited right should extend to the naming of a TFSA successor which does not require that the recipient have TFSA room and is now limited to a spouse or common-law partner. These proposals are akin to policies recommended by the group Single Seniors for Tax Fairness.

[110] Burman (1999, 136–37) discusses some issues and problems related to US rollover provisions, which should be heeded in any counterpart Canadian reforms. Without any rollover, the effective tax rate is now 27% for a filer in a top 54% rate bracket. That lock-in effect would be reduced to 20.25% if the inclusion rate were hiked to 75% but with only half the gain granted a rollover.

United States is clearly the world leader in the domain of innovative start-ups, and the role of venture capital, employee stock options, and capital gains tax policies are important to understand better. Some of these advantages stem from agglomerations of successful firms, venture capital networks, and entrepreneurial culture that Canada will not easily emulate simply by imitating US capital gains tax policies. But US tax policy in this area warrants further careful analysis to assess Canadian tax treatment for potential reforms. This area poses undeniable tensions between more efficient incentives and attempts to reign in top-end inequalities.

Principal residences

An important area of potential capital gains tax reform relates to owner-occupied housing. The PRE diverts capital from productive business investment, and its tax expenditure is now approaching that of the 50% inclusion of gains in the personal tax. Any politically feasible reform in this area will need to tread carefully and likely draw on some of the following components:[111]

- Rebasing the home's cost to its market value at the reform's effective date
- Allowing indexation of the home's cost basis for inflation until the sale date
- Providing an exempt amount on the taxable gain, preferably (as proposed in the Quebec taxation review) on a cumulative indexed lifetime basis
- Allowing rollover of the gain when selling one home and buying another, with any shortfall being taxable; taxing the gain if no further purchase[112]

If an exemption is provided, it could be subsumed under a lifetime cumulative exemption (my Option 4), which could also be integrated with the LCGE for greater equity across home-owning taxpayers and those holding interests in CCPCs. Compromises of these kinds would sharply reduce revenue gains in the

[111] See Woolley (2021) for similar proposals and recall that the US has utilized versions of the third and fourth cited approaches at different times.

[112] Burman (1999, 137 and 187 note 7) attributes the US shift to an exempt amount of gain from a rollover provision to the latter's complexity, inducement for the purchase of excessive housing, and inefficiency as a revenue generator.

initial years but would set the path for longer-term improved interpersonal equity, economic efficiency, and revenue growth.

Charitable contributions

My earlier analysis of the impact from a higher gains inclusion rate on tax-based incentives for gifting highly appreciated assets found that this could divert more capital away from productive investment. Whether this constitutes desirable public policy would hinge on values outside the scope of my analysis. However, in my example the effective cost for a donor in the top tax bracket of gifting a highly appreciated asset would be cut in half if the inclusion rate were raised from 50% to 75%. If this change were deemed to be excessive, a reduction in the charitable contribution tax credit rate would be needed.

Public and Political Acceptance

Even if any efficiency and equity downsides to increased taxation of capital gains can be avoided or mitigated through measures of the kinds covered above, there remain the likely barriers to implementation from public and political acceptance. Some of the advocates of higher gains tax have cautioned that "… opposition to capital gains tax increases among affected taxpayers is likely to be vociferous."[113] It is notable that the only episodes in both the US and Canada when the gains inclusion rates were increased arose jointly with flattening of tax rate schedules and sharp reductions in top-bracket rates. These were the 1986 Reagan tax reform, which rendered long-term gains fully taxable (a 100% inclusion rate) and the 1987 Canadian White Paper on tax reform (which raised the gains inclusion rate to 66⅔% and 75% in the following years). As an astute observer of US tax policy noted, "the higher tax rate on capital gains was offered [in the US Senate finance committee] in part as a compromise in order to obtain support for generally lower tax rates on the incomes of high-income taxpayers."

Since increased capital gains taxation would disproportionately strike taxpayers at the highest incomes, any effective political strategy would need to build support from a wide set of other taxpayers and the general public. To begin, it could appeal to current widespread opinion that top-end concentration of income has become excessive and that the "rich" benefit unduly from tax concessions. Next, it would be important to avoid increased taxation on the many

[113] Smart and Jafry (2021, 1164).

taxpayers who occasionally report modest amounts of capital gains. As shown in my earlier discussion (and Table 1), a general across-the-board hike to the inclusion rate could affect up to one-fifth of all tax filers over a ten-year period. By targeting the capital gains increase on recipients with large gains and/or high incomes, the numbers impacted could be sharply reduced. Targeting of higher capital gains taxation could be achieved by any of the structural options reviewed here—a gains threshold, an income threshold, a reformed AMT, or a separate NIIT-like surtax. Moreover, well-designed carryover or averaging provisions would address critics' concerns about undue burden on infrequent recipients of limited amounts of gains. It appears that the Canadian public is already strongly supportive of reforms to close tax "loopholes" that primarily benefit the wealthy, such as the capital gains provisions.[114]

In addition to the public appeal of addressing the extreme top-end concentration of incomes, this reform could effectively be presented as a package of items that might be attractive to varied constituencies. Some of these items are readily justified as mitigating certain adverse effects of higher gains taxation as presented earlier; others could go a few steps further. Here is a compendium of potential reform "sweeteners":

- Restoration of general averaging provisions, which would be beneficial not only for recipients of occasional gains but also for many self-employed workers, employees in volatile industries, and unincorporated proprietors
- Expansion of the assets and circumstances eligible for deferral of accrued gains on like-kind exchanges
- Review of tax treatment for innovative startups and venture capital with possible adoption of some features in the US tax system
- Provision of a limited gains rollover for the estates of decedents who lack a surviving spouse but wish to provide bequests to other relatives, which could appeal to single seniors who lack the tax benefits of senior couples
- Reduce the salience and impact of a reformed PRE for homeowners by

[114] The Broadbent Institute (2021) reports on a survey of 1500 Canadian adults finding that 60% "strongly support" and another 33% "support" "closing tax loopholes used primarily by the wealthy to lower their overall income tax rate."

rebasing and/or indexation of the home's cost base or via a lifetime gains exemption level
- Use a portion of the incremental revenues for tax relief on labour earnings, thus reducing the tax differential between earned incomes and capital incomes

Conclusion

The proper tax treatment of capital gains has been a matter of enduring debate and was described more than half a century ago as "one of the most controversial facets of the tax structure."[115] A major aspect of that debate has been, as stated at the outset of this paper, "a compromise between competing values … [that] carry different weight amongst different members of the population and legislators, and at different times in our history."[116] In contemporary Canada, a salient value held by many is restraint on rising concentration of incomes at the top end, and calls have come from various quarters to address that concern through higher taxation of capital gains, which play a large role in top-end inequality. Yet advocates of policies to achieve that goal have neglected both the economic and political requisites; and opponents of such reforms have cited adverse outcomes in vague terms but not examined how they might be avoided or mitigated. In this paper I have sought to uncover the kinds of reforms that could address the obstacles on both the economic and political fronts to achieve the stated goal.

On the economic front a variety of behavioural channels could cause an increased effective tax rate on capital gains to divert savings and capital from productive business investment—and thus adversely affect both economic growth and long-run tax revenues. These effects could arise via startup enterprises, venture capital, asset lock-ins, CCPC tax avoidance, housing investment, and charitable contributions of highly appreciated assets. The oft-mooted increase of the capital gains inclusion rate to 75%would raise Canada's effective tax rate on the affected top-bracket gains recipients above 40%, approaching only high-taxed Denmark. Moreover, most gains recipients at upper incomes in Canada already face higher effective tax rates than almost all of their US counterparts,

[115] Bailey (1969, 11).
[116] Vern Krishna, see the first footnote.

and an increased inclusion rate would only exacerbate the differential.[117] Tax policy in Canada cannot be unmindful of this matter in view of the vital linkages between the two countries via business, investment, finance, trade, and skilled labour. Box 1 summarizes several measures proposed in this paper to mitigate or minimize these adverse impacts.

Equally critical is overcoming the political and public acceptance barriers to increasing capital gains taxation in Canada. The most important element is targeting the new tax on the largest and most recurrent recipients of capital gains, who are clustered at the highest incomes. In contrast, a general increase in the inclusion rate—as typically advocated by most reform supporters—would ensnare nearly one out of every five tax filers over ten years based on longitudinal data for 2009-2018. Beyond targeting of the tax increase, several other measures would be helpful in garnering public support and political viability. The restoration of income averaging provisions would be beneficial and equitable for many self-employed workers and business proprietors as well as the infrequent recipients of sizeable lumpy gains. Providing single seniors with limited rollovers for the accrued gains, RRIF, LIF, and TFSA balances in their estates would cushion the impact from a higher gains inclusion rate and remedy existing inequities. Finally, if the reform were to extend to the principal residence exemption, various features could insulate most homeowners from near-term impacts yet establish proper incentives and equity for the long run. Box 1 summarizes these proposed provisions.

Given their extreme concentration at the highest income levels, capital gains and related forms of investment income are a key target for reducing top-end inequality in Canada. Taxation policies that currently favour those income sources relative to labour earnings are a natural focus for reform. Further increasing the already high top marginal tax rates would be limited in their ability to address top-tail inequalities, given the porous nature of the tax base for very

[117] It is no coincidence that the four US states with the fastest population growth over 2010–2020 have been Florida, Nevada, Texas, and Washington (all growing 15% or more and none having a state personal income tax), while the two large states with sub-average growth have been high-taxed California and New York. https://www.visualcapitalist.com/how-u-s-population-has-changed-decade-by-state/ This trend of movement toward low-taxed states continued in 2021 (Tax Foundation 2022).

high earners.[118] As cited earlier, the 2022 federal budget presaged revisions to the AMT toward the goal of "ensuring that all Canadians pay their fair share of tax." Yet the current AMT raises little revenue and catches fewer than 50,000 high-income taxpayers each year while ensnaring many filers in a long, complex tax form to determine whether they are even liable. The existing AMT would need to be radically strengthened and simplified to be rendered a significant contributor to reducing top-tail income inequalities. Before proceeding with AMT reform, it would be sensible to explore in depth the various types of threshold-based approaches to increased taxation of capital gains and related incomes. Analysis should focus on their comparative economic impacts, the numbers and types of filers affected, revenue impacts, compliance and administrative burdens, avoidance routes, and interactions with other tax provisions. It is not obvious that a reformed AMT would pose the best pathway to reform based on these criteria as well as the objective of reining in topmost incomes.

[118] Milligan (2022, 221) finds that expanding the personal tax base to include the full cash value of realized capital gains and corporate dividends would be far more effective in reducing top-tail inequalities than raising the top federal tax rate from 33% to 40%. The differential effectiveness between two policies is even greater on account of their opposite effects on avoidance incentives.

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Table 1: Patterns of Taxable Capital Gains Reporting, Canada, 2009–2018

No. of years with TCGs[a]	All filers excl. yrs with TCGs < $500	Avg annual total income	Avg annual total income excl. TCGs	Avg TCGs totals over 10 years	Share of all TCGs over 10 years
	No. (000s)	$/filer	$/filer	$/filer	%
0	28,764[a]	32,500	-	-	-
1	2,014	62,800	60,100	26,800	21.4
2	813	77,400	73,600	37,700	12.1
3	523	88,200	83,400	48,700	10.1
4	407	97,400	91,400	59,800	9.7
5	323	107,900	100,300	75,800	9.7
6	254	123,800	113,500	102,800	10.4
7	180	145,000	132,000	130,100	9.3
8	123	166,500	149,500	170,100	8.3
9	67	193,400	170,100	232,400	6.2
10	22	228,500	195,600	328,300	2.9
Total	33,490	40,000			100.0
4–10	1,376	123,400		103,200	56.4
1–10	4,726	85,900		53,300	

Notes: [a] Filers receiving taxable capital gains (TCGs) of $500 or less in any given year were reclassified in the source as not having any TCGs for that year (reducing the number of years logged for them); 46,000 such filers had some TCGs but never more than $500 in any year and are included in the 0 years category. $/filer figures have been rounded to the nearest $100.

Source: Corrections and extensions of the original Table A4 in Gagné-Dubé et al. (2021, 1192) generously extracted by those authors from the Longitudinal Administrative Databank; also calculations by this author.

Table 2: Net-of-Tax Cost for Top-Bracket Donations of Appreciated Securities, in %, 2022

	Ratio of Market value / Cost basis			
Inclusion rate (%)	2	5	10	∞
50	33.8	25.8	23.2	20.5
75	27.1	15.2	11.2	7.3
100	20.5	4.6	- 0.7[a]	- 6.0 [a]

Notes: Tabulated values are the net-of-tax cost (in percentages) of donating appreciated securities (and having the gains tax exempted plus receiving federal plus provincial
charitable donation tax credits) versus selling the securities and retaining the net-of-capital-gains tax proceeds. Ignores the lower credit rates for the first $200 of annual contributions. Calculations apply to a taxpayer in the top tax rate bracket (see the
text for other assumptions).

[a] Negative values indicate that the taxpayer benefits more by donating the asset to charity than by selling it, paying capital gains tax, and retaining the net-of-tax proceeds.

Source: Computed by the author using the following formula:

$100\{1 - Cf - Cp - (X - 1)/X * IR (Tf + Tp)\}$

where Cf and Cp = federal and provincial credit rates on donations, respectively

Tf and Tp = federal and provincial marginal tax rates, respectively

X = ratio of asset's current market value to its original cost basis

Table 2 assumes the values (Cf + Cp) = (Tf + Tp) = 0.53

Box 1: Summary of Policy Recommendations

Principal provisions
Increase the tax inclusion rate for capital gains above a specified threshold such as: Gains-linked threshold (annual or multi-year) Income-linked threshold (annual or multi-year) Lifetime indexed cumulative gains threshold
Alternatively, increase the effective tax rate on capital gains for higher incomes via Reform of the alternative minimum tax (AMT) Introduce a surtax for capital gains like the Net Investment Income Tax (NIIT)
Limit the tax credit for eligible dividends (or achieve via threshold scheme, AMT, or NIIT)
Limit and simplify investment expense deductibility
Phase out unlimited principal residence exemption (PRE)
Supplementary items
Reduce charitable tax credit rate for top-bracket filers
Tighten laws to limit tax avoidance of capital gains via CCPCs
Mitigating provisions
Restore income averaging (depends in part on gains carryover provisions)
Broaden scope for like-kind exchanges but limit rollover to half of the gain
Provide carve-outs for gains on venture capital, startups, and employee stock options
Introduce limited rollover for gains and RRIF/LIF/TFSA of single senior decedents' estates
Temper PRE phase-out via cost rebasing, limited exemption, and/or gains rollover