Technical Annex to the Economic Note

"The Capital Gains Tax: It Should Be Reduced, Not Increased"

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Mathieu Bédard

Capital Gains Taxation and Income Shifting

It is sometimes argued that all income should be taxed at the same rate on grounds of equity, but also for the sake of simplicity, neutrality, and not to create opportunities for arbitrage between different kinds of income.[1]

Yet the cost of taxation is not uniform; it is highest for those taxes that can easily be evaded, and the capital gains tax is the easiest tax to avoid. You simply have to choose not to realize your capital gains.

The argument in favour of taxing all sorts of income at the same rate is thus simplistic because it does not take into account the fact that different types of income are not all equally sensitive to tax rates, for one thing, and that tax bases with different sensitivity to taxes will not react the same way to a given rate, for another.

Capital gains, as argued in the Economic Note, are extremely sensitive to taxation. Different tax bases should be taxed according to their sensitivity to the rate, rather than simply at the same rate.[2] In fact, the current capital gains tax rate is creating distortions that would be exacerbated by an increase in the rate, which has been rumoured prior to the publication of the federal budget each of the last two years.

One of the reasons this debate lives on in Canada is that prior to 1972, the year when the Canadian taxation system was overhauled and the capital gains tax introduced, income shifting, from dividends to capital gains, was said to be rampant.[3] Some practitioners dispute this and suggest that income shifting "was a red herring to divert public attention from an innovation in taxation that was motivated by a desire to

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[1] James Mirrlees *et al.*, *Tax by Design: The Mirrlees Review of Tax System*, Oxford University Press, September 13 2011, p. 474. There also exists an interesting debate over whether capital gains can be defined as income, the scope of which goes far beyond the point of this short publication.

[2] Frank P. Ramsey, "A Contribution to the Theory of Taxation," *The Economic Journal*, Vol. 37, No. 145, March 1927, pp. 47-61.

[3] Stephen Richardson and Kathryn E. Moore, "Canadian Experience with the Taxation of Capital Gains," *Canadian Public Policy*, Vol. 21, Supplement, pp. S77-S99.

equalize the distribution of income and expand the size of government."[4] At any rate, it should be kept in mind that the taxation system of yore bears little resemblance to today's. Corporate income tax, for example, was much higher than it is now, as were the top marginal personal income tax rates, and this would definitely be expected to influence this kind of income substitution.[5]

But even leaving aside the above efficiency argument, and the profound differences between our current tax system and the one that existed prior to 1972, there are natural limits to the recourse to income shifting in order to benefit from a lower capital gains tax rate, stemming from the fact that it can only take place when shareholders have some influence (or complete control) over the financial management of the concerned businesses. This kind of tax planning can be very costly for small businesses, while larger businesses that would try to shift income type for the benefit of their shareholders are limited by the fact that they have to follow strict accounting rules that preclude abusing this form of tax avoidance. And if they did abuse it, the market would rightly sanction this kind of behaviour through a decrease in the value of shares, since "creative accounting" may deter prospective clients and investors. This does not mean that no income shifting takes place, but that there are countervailing phenomena at play.

Finally, as stated in the Economic Note, countries with no capital gains tax have found ways to deal with income shifting that are remarkably simple. New Zealand, for instance, tackles the opportunities for income shifting on an ongoing basis, as and when they pose a threat to government revenues.[6] Switzerland has been following a similar strategy.[7] Hong Kong has taken a more expeditious route, and chosen not to tax dividends either, thereby removing the impetus for this kind of arbitrage.[8]

The Effect of Inflation: An Illustration

Suppose someone invested $1,000,000 in a business in 1980. While this investment performed well for more than 25 years, the financial crisis of 2008-2009 hit the value of

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[4] Herbert Grubel, "Why There Should Be No Capital Gains Tax," *Tax Reform in Canada: Our Path to Greater Prosperity*, Jason Clemens (ed.), Fraser Institute, 2003, p. 151.

[5] Stephen Richardson and Kathryn E. Moore, *op. cit.*, footnote 3, pp. S82 and S95.

[6] Stephen Kirchner, "Taxing Consumption, Not Saving: New Zealand's Rejection of a Comprehensive Capital Gains Tax," in *Capital Gains Tax Reform in Canada: Lessons from Abroad*, Charles Lammam and Jason Clemens (eds.), Fraser Institute, 2014, p. 54.

[7] Christoph A. Schaltegger and Marc M. Winistoerfer, "Capital gains taxation in Switzerland," in *Capital Gains Tax Reform in Canada: Lessons from Abroad*, Charles Lammam and Jason Clemens (eds.), Fraser Institute, 2014, pp. 85-99.

[8] Bill Stacey, "Zero capital gains taxes in Hong Kong: Preserving simplicity and reducing cyclicality," in *Capital Gains Tax Reform in Canada: Lessons from Abroad*, Charles Lammam and Jason Clemens (eds.), Fraser Institute, 2014, p. 78.

this project and it never fully recovered. As a result, suppose this investment has a nominal value of $2,920,000 in 2016.

In real terms, however, since the cumulative inflation has been of 192% throughout this period, this investment has not increased in value. It is worth exactly as much as it was in 1980. Yet, if this investment were sold, assuming the investor is in the top marginal tax bracket in Quebec, he or she would have to pay approximately $508,800 in capital gains taxes. In real terms, not only did this entrepreneur make no capital gain, but in fact the tax made him realize a capital loss of 17%.

Now, let's suppose that the same investment had been less affected by the financial crisis, and made a 38% capital gain in real terms, and that its nominal value was now approximately of $4,000,000. The capital gains tax on this investment would amount to $795,000. The remaining gain, in real terms, would have been reduced to the equivalent of 10% since 1980, or less than 0.3% per year.

In other words, in this latter scenario an entrepreneur would have made mediocre gains, far inferior to what can be expected from an investment in a mutual fund, for instance. This would have been further diminished by the capital gains tax, down to an absolutely abysmal performance, despite the fact that being entrepreneur often involves taking big personal risks, with no job security and no guarantee of success.